

NETWORK APPLIANCE INC

Form 10-K/A

December 06, 2002

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SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K/A

(Mark One)

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

For the fiscal year ended April 26, 2002

OR

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

For the transition period from to .

Commission File Number 0-27130

NETWORK APPLIANCE, INC.

(Exact name of registrant as specified in its charter)

Delaware

77-0307520

(State or other jurisdiction of incorporation or organization)

(IRS Employer Identification No.)

495 East Java Drive,

Sunnyvale, California 94089

(Address of principal executive offices, including zip code)

Registrant's telephone number, including area code: (408) 822-6000

Securities registered pursuant to Section 12(b) of the Act:

None

Title of each class

Name of Exchange on which registered

none

none

Securities registered pursuant to Section 12(g) of the Act:

Common Stock, \$0.001 Par Value

(Title of Class)

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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 a check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

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

The aggregate market value of voting stock held by nonaffiliates of the Registrant, as of October 25, 2002, was \$2,322,696,600 (based on the closing price for shares of the Registrant's common stock as reported by the Nasdaq National Market for the last trading day prior to that date). Shares of common stock held by each executive officer, director, and holder of 5% or more of the outstanding common stock have been excluded in that such persons may be deemed to be affiliates. This determination of affiliate status is not necessarily a conclusive determination for other purposes.

On October 25, 2002, 336,998,969 shares of the Registrant's common stock, \$0.001 par value, were outstanding.

EXPLANATORY NOTE REGARDING THIS AMENDMENT ON FORM 10-K/A

Network Appliance Inc. (the Company) is filing this Annual Report on Form 10-K/A for the fiscal year ended April 30, 2002 solely for the purpose of revising certain non-cancelable operating lease commitments disclosed under the contractual obligations table on page 34 of the Form 10-K filed on June 28, 2002 and as disclosed in Note 4 Commitments and Contingencies to the consolidated financial statements. As a result of this revision, the total operating lease commitments reflect a lower future minimum payment obligation. This revision does not impact the Company's consolidated balance sheet, statement of income, stockholders' equity and comprehensive income or cash flows for any of the periods presented. The effect of the revision is presented in Note 14 to the consolidated financial statements.

The Company is amending only the following sections of the Annual Report on Form 10-K to reflect the effect of the revision:

Part II, Item 7.	Management's Discussion and Analysis of Financial Condition and Results of Operations
Part II, Item 8.	Financial Statements and Supplementary Data
Part IV, Item 14.	Exhibits 23.1

This amendment does not otherwise update the disclosures set forth in such items originally filed and does not otherwise reflect events occurring after the original filing of the Annual Report on Form 10-K on June 28, 2002.

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Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

As discussed in Note 14 to the consolidated financial statements in Item 8, certain non-cancelable operating lease commitment disclosures have been revised. The accompanying Management's Discussion and Analysis reflects this revision.

The following discussion of our financial condition and results of operations should be read together with the financial statements and the related notes set forth under Item 8. Financial Statements and Supplementary Data herein and the Risk Factors set forth in Item 1. Business of our Form 10-K filed on June 28, 2002.

Critical Accounting Policies

Our discussion and analysis of financial condition and results of operations is based upon our Consolidated Financial Statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America. 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 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 and impairment losses on investments;

valuation of intangible assets and goodwill; and

accounting for income taxes.

Revenue recognition and allowances

We apply the provisions of Statement of Position (SOP) 97-2, Software Revenue Recognition (as amended by SOP 98-4 and SOP 98-9), and related interpretations to all revenue transactions. We recognize revenue when:

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

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

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

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

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

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

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

We also maintain a separate allowance for doubtful accounts for estimated losses resulting from the inability of our customers to make required payments. 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 to ensure the accuracy of 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.

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 and impairment losses on investments

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

We performed a comprehensive analysis of our real estate facility requirements and identified excess facility space, which has subsequently been offered for sublease. Based upon the results of this analysis, during fiscal 2002, we recorded charges related to estimated facilities lease losses, net of expected sublease income. In determining the net facilities charge, various assumptions were made, including the time period over which the facilities will be vacant, expected sublease terms, and expected sublease rates. The charges recorded were estimates in accordance with Statement of Financial Accounting Standards (SFAS) No. 5, Accounting for Contingencies, and represented the low end of an estimated range that may be adjusted upon the occurrence of future triggering events. Triggering events may include, but are not limited to, changes in estimated time to sublease the facilities, sublease terms, sublease rates, and lease termination. Should operating lease rental rates decline or should it take longer than expected to find a suitable tenant to sublease the facility, adjustments to the facilities lease losses liabilities may be necessary in future periods based upon the then-current actual events and circumstances. During the fourth quarter of fiscal 2002, we purchased our

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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.

In fiscal 2002, we also recorded charges for a reduction in workforce in response to a decline in customer demand and macroeconomic conditions. See footnote 12 *Restructuring Charges* for further discussion. These estimates are reviewed and revised quarterly and may result in a substantial change to restructuring expense should different conditions prevail than were anticipated in original management estimates.

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. During fiscal 2002, we recorded a noncash, other-than-temporary write-down of \$13.0 million related to impairments of our investments in publicly traded and private companies. See footnote 2 *Short-Term Investments and Investments in Nonpublic Companies* for further discussion.

Valuation of intangible assets and goodwill

We periodically evaluate our intangible assets and goodwill for indications of impairment whenever events or changes in circumstances indicate that the carrying value may not be recoverable. Intangible assets include goodwill, purchased technology, and workforce. Factors we consider important that could trigger an impairment review include significant under-performance relative to expected historical or projected future operating results, significant changes in the manner of our use of the acquired assets or the strategy for our overall business, or significant negative industry or economic trends. If these criteria indicate that the value of the intangible asset may be impaired, an evaluation of the recoverability of the net carrying value of the asset over its remaining useful life is made. If this evaluation indicates that the intangible asset is not recoverable, based on the estimated undiscounted future cash flows of the entity or technology acquired over the remaining amortization period, the net carrying value of the related intangible asset will be reduced to fair value, and the remaining amortization period may be adjusted. Any such impairment charge could be significant and could have a material adverse effect on our reported financial statements if and when an impairment charge is recorded. If an impairment charge is recognized, the amortization related to goodwill and other intangible assets would decrease during the remainder of the fiscal year. No impairment losses were recorded during fiscal 2002 based on these measurements.

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. Sales to our international customers 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 sales. In addition, a decrease in the percentage of our total revenue from international customers or in the mix of international revenue among particular tax jurisdictions could increase our overall effective tax rate. Also, our current effective tax rate assumes that U.S. income taxes are not provided for undistributed earnings of certain non-U.S. subsidiaries. These earnings could become subject to incremental foreign withholding or federal and state income taxes should they be either deemed or actually remitted to the U.S.

The carrying value of our net deferred tax assets, which is made up primarily of income tax deductions, credits, and net operating loss carryforwards resulting from stock option exercises, assumes that we will be able to generate sufficient future income to fully utilize these tax deductions and credits. If we do not generate sufficient future income, the realization of these deferred tax assets may be impaired resulting in additional

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income tax expense. We have provided a valuation allowance on certain of our deferred tax assets because of uncertainty regarding their realizability due to expectation of future employee stock option exercises.

New Accounting Standards

On May 1, 2001, we adopted SFAS 133, Accounting for Derivative Instruments and Hedging Activities. The adoption of this accounting standard did not have a significant impact on our financial position, results of operations, or cash flow.

In June 2001, the Financial Accounting Standards Board (FASB) issued SFAS No. 141, Business Combinations, and SFAS No. 142, Goodwill and Other Intangible Assets. Under SFAS No. 141, all business combinations initiated after June 30, 2001 must be accounted for using the purchase method. Under SFAS No. 142, goodwill and intangible assets with indefinite lives are no longer amortized but are reviewed annually for impairment (or more frequently if indicators of impairment arise). Separable intangible assets that are not deemed to have indefinite lives will continue to be amortized over their useful lives (but with no maximum life). The amortization provisions of SFAS No. 142 apply to goodwill and intangible assets acquired after June 30, 2001. With respect to goodwill and intangible assets acquired prior to July 1, 2001, we are required to adopt SFAS No. 142 effective May 1, 2002. Upon adoption of SFAS No. 142, we will stop the amortization of goodwill (including acquired existing workforce) with a net carrying value of approximately \$49.8 million at April 30, 2002, and the annual amortization of \$15.2 million that resulted from business combinations initiated prior to the adoption. We will evaluate goodwill under the SFAS No. 142 transitional impairment test. Any transitional impairment loss will be recognized as a change in accounting principle on the date of adoption. We have not determined whether adoption of SFAS No. 142 will have an impact on our financial position, results of operations, and cash flow.

In October 2001, the FASB issued SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets, which addresses financial accounting and reporting for the impairment or disposal of long-lived assets. SFAS No. 144 supersedes SFAS No. 121, Accounting for the Impairment of Long-Lived Assets and for Assets to Be Disposed Of. Adoption of SFAS No. 144 is required for our fiscal year beginning May 1, 2002. We are currently evaluating the potential impact of adoption of SFAS No. 144 on our financial position and results of operations and have not yet determined the impact of adopting this statement.

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

	Years Ended April 30,		
	2002	2001	2000
Revenues:	100.0%	100.0%	100.0%
Product Revenue	91.4	95.2	96.2
Service Revenue	8.6	4.8	3.8
Cost of Revenues:			
Cost of Product Revenue	32.8	34.0	35.8
Cost of Service Revenue	7.0	5.9	4.9
Gross Profit	60.2	60.1	59.3
Operating Expenses:			
Sales and Marketing	35.6	28.7	26.6
Research and Development	14.6	12.0	10.6
General and Administrative	5.1	4.0	3.6
Amortization of Intangible Assets	2.6	1.2	
In-process Research and Development		2.7	
Stock Compensation	0.9	0.6	0.3
Restructuring Charges	1.5		
Total Operating Expenses	60.3	49.2	41.1
Income (Loss) from Operations	(0.1)	10.9	18.2
Other Income (Expense), Net	0.4	2.3	1.5
Income Before Income Taxes	0.3	13.2	19.7
Provision (Benefit) for Income Taxes	(0.1)	5.8	7.0
Net Income	0.4%	7.4%	12.7%

Fiscal 2002 Compared to Fiscal 2001

Product Revenues Product revenues decreased by 23.8% to \$729.9 million in fiscal 2002, from \$957.8 million in fiscal 2001. The decline in product revenues was due to a decrease in product sales to Internet-based companies and reduced capital spending among technology companies across all geographies, but primarily in North America. This decrease in product revenues for fiscal 2002 was specifically attributable to a lower volume of units and software licenses shipped, as compared to fiscal 2001.

Product revenues were negatively impacted by the following factors:

reduced demand for our products resulting from deteriorating macroeconomic conditions;

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

decreased sales through indirect channels, including sales through our OEM partners, representing 26.4% and 28.2% of total revenues for fiscal 2002 and 2001, respectively;

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

declining unit sales of our older products.

Product revenues were favorably impacted by the following factors:

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

a higher average selling price of our new products: our high-end F880 and low-end F87 filer products, as well as new NetCache appliances and software features;

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

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

higher sales of software subscription upgrades, representing 6.6% and 3.6% of total revenues for fiscal 2002 and 2001, respectively;

increased add-on software revenue from multiprotocol solutions; and

introduction of NearStore appliances for business continuance and online recovery.

Service Revenues Service revenues increased by 41.6% to \$68.5 million in fiscal 2002, from \$48.4 million in fiscal 2001. Service revenue is generally deferred and, in most cases, recognized ratably over the service period obligations, which are typically one to three years. The increase in service revenues (representing 8.6 % and 4.8% of total revenues for fiscal 2002 and 2001, respectively) was primarily related to a growing installed base resulting in new customer support contracts in addition to support contract renewals by existing customers.

International total revenues (including United States exports) decreased by 12.4% for fiscal 2002 as compared to fiscal 2001. International total revenues were \$335.2 million, or 42.0% of total revenues for fiscal 2002. The decline in international sales for fiscal 2002 was primarily a result of a slower demand in the Europe and Asia Pacific markets offset by our increased sales and marketing efforts internationally.

Product Gross Margin Product gross margin decreased to 64.1% of product revenues for fiscal 2002 as compared to 64.3% in fiscal 2001.

Product gross margin was negatively impacted by:

the decrease in product sales volume;

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

lower of cost or market adjustments to inventory;

decreased licensing of our software due to lower volume of units shipped;

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

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

Product gross margin was favorably impacted by:

lower costs of key components and subsystems;

favorable product and software mix;

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

higher average selling prices for our new products;

manufacturing overhead cost control and reduction efforts, including the restructuring impact;

December and July partial facility shutdowns; and

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

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Service Gross Margin Service gross margin increased to 18.2% for fiscal 2002 as compared to a negative gross margin of 23.8% in fiscal 2001. Investments in customer service decreased by 6.5% to \$56.0 million in fiscal 2002, from \$59.9 million in fiscal 2001. The improvement in service gross margin in fiscal 2002 was primarily due to operational and cost efficiencies in the global customer service organizations. The negative service gross margin in fiscal 2001 was due to the ramping up and continued investment in our service infrastructure in anticipation of service revenue growth.

Sales and Marketing Sales and marketing expenses consist primarily of salaries, commissions, advertising and promotional expenses, and certain customer service and support costs. Sales and marketing expenses decreased 1.6% to \$284.4 million for fiscal 2002, from \$289.0 million for fiscal 2001. These expenses were 35.6% and 28.7% of total revenues for fiscal 2002 and fiscal 2001, respectively. The decrease in absolute dollars was attributed to various cost control and reduction measures, restructuring impact, lower commission expenses and other profit-dependent payroll-related expenses, and disposal of certain capital assets in fiscal 2001, partially offset by the continued worldwide investment in our sales and customer service organizations. Sales and marketing headcount decreased to 1,224 in fiscal 2002, from 1,277 in fiscal 2001 due primarily to the restructuring impact. We expect to continue to selectively add sales capacity in an effort to expand domestic and international markets, introduce new products, establish and expand new distribution channels, and increase product and company awareness. We expect to increase our sales and marketing expenses commensurate with future revenue growth.

Research and Development Research and development expenses consist primarily of salaries and benefits, prototype expenses, non-recurring engineering charges, and fees paid to outside consultants. Research and development expenses decreased 3.5% to \$116.7 million in fiscal 2002, from \$120.9 million in fiscal 2001. These expenses represented 14.6% and 12.0% of total revenues for fiscal 2002 and 2001, respectively. Research and development expenses decreased in absolute dollars, primarily as a result of cost control, reduction in discretionary spending efforts, restructuring impact, the two holiday facility shutdowns, lower headcount, and lower profit-dependent payroll related expenses, partially offset by the operating impact of the Orca Systems, Inc. (Orca) and WebManage Technologies, Inc. (WebManage) acquisitions. Research and development headcount decreased to 514 in fiscal 2002, from 566 in fiscal 2001. We expect to continuously support current and future product development and enhancement efforts, and incur prototyping expenses and non-recurring engineering charges associated with the development of new products and technologies.

We believe that our future performance will depend in large part on our ability to maintain and enhance our current product line, develop new products that achieve market acceptance, maintain technological competitiveness, and meet an expanding range of customer requirements. We intend to continuously expand our existing product offerings and introduce new products, and expect that expenditures for these purposes will increase in absolute dollars. For both fiscal 2002 and 2001, no software development costs were capitalized.

General and Administrative General and administrative expenses decreased 0.1% to \$40.2 million in fiscal 2002, from \$40.2 million in fiscal 2001. These expenses represented 5.0% and 4.0% of total revenues for fiscal 2002 and 2001, respectively. Decreases in absolute dollars were primarily due to cost controls, reductions in discretionary spending, the impact of restructuring, the two holiday facility shutdowns, and lower profit-dependent payroll related expenses, partially offset by expenses associated with initiatives to enhance enterprise-wide management information systems, general legal costs, and an increase in the allowance for bad debts. General and administrative headcount decreased to 246 in fiscal 2002, from 253 in fiscal 2001. We believe that our general and administrative expenses will not increase significantly in absolute dollars in fiscal 2003.

Amortization of Intangible Assets Amortization of intangible assets represents the amortization on acquired intangible assets and amortization on the excess of the aggregate purchase price over the fair value of the tangible and identifiable intangible assets acquired by us. Intangible assets as of April 30, 2002, including goodwill, existing workforce, and technology, were being amortized over estimated useful lives of three to five years. We assess the recoverability of intangible assets by determining whether the amortized asset over its useful life may be recovered through estimated useful cash flows. Amortization of intangible assets charged to operations was \$20.9 million and \$11.7 million in fiscal 2002 and 2001, respectively.

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

The Orca acquisition has been successfully utilized for the design and development of the DAFS protocol. By eliminating much of the traditional operating system overhead, DAFS allows for improved I/O performance while using fewer CPU cycles. The protocol leverages next generation networking technologies that provide remote memory transfer capabilities, including Remote Direct Memory Access (RDMA) implemented in Virtual Interface (VI) and Infiniband. The DAFS protocol has good industry support and is now under consideration as an industry standard. We introduced DAFS capable products in April 2002.

Stock Compensation We account for stock-based employee compensation arrangements in accordance with the provisions of Accounting Principles Board (APB) No. 25, Accounting for Stock Issued to Employees, and comply with the provisions of SFAS No. 123, Accounting for Stock-Based Compensation, for non-employee compensation awards. Accordingly, we recognize the intrinsic value for employees and the fair value for non-employees as stock compensation expense over the vesting terms of the awards. Stock compensation expenses were \$7.2 million and \$6.2 million in fiscal 2002 and 2001, respectively. This increase was primarily attributable to the recognition of stock compensation on options assumed in the WebManage acquisition and the release of 165,310 contingently issuable milestone shares relating to Orca valued at \$3.0 million. We expect an additional stock compensation relating to 99,187 contingently issuable Orca common share, to be measured on the date the performance criteria are met.

Restructuring Charges In August 2001, we implemented a restructuring plan, which included a reduction in workforce by approximately 200 employees and a consolidation of facilities. The action was required to properly align and manage the business commensurate with our then-current revenue levels. All functional areas of the Company were affected by the reduction. We completed our actions during the second quarter of fiscal 2002. As a result of this restructuring, we incurred a charge of \$8.0 million. The restructuring charge included \$4.8 million of severance-related amounts, \$2.7 million of committed excess facilities and facility closure expenses, and \$0.5 million in fixed assets write-offs.

During the fourth quarter of 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.

As of April 30, 2002, we had paid substantially all of the severance liability. Of the balance at April 30, 2002, \$0.5 million was included in other accrued liabilities.

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

	<u>Severance- Related Amounts</u>	<u>Fixed Assets Write-Off</u>	<u>Facility</u>	<u>Total</u>
Restructuring charge	\$ 4,796	\$ 528	\$ 2,656	\$ 7,980
Cash payments	(4,508)		(803)	(5,311)
Non-cash portion		(528)	(37)	(565)
Adjustments	(95)		(1,509)	(1,604)
	<u> </u>	<u> </u>	<u> </u>	<u> </u>
Reserve balance at April 30, 2002	\$ 193	\$	\$ 307	\$ 500
	<u> </u>	<u> </u>	<u> </u>	<u> </u>

In April 2002, we announced and substantially completed a restructuring related to the closure of an engineering facility and consolidation of resources to the Sunnyvale headquarters, which included a headcount reduction of 34 employees. As a result of this restructuring, we incurred a charge of \$5.9 million. The restructuring charge included \$0.8 million of severance-related amounts, \$4.6 million of committed excess facilities and facility closure expenses, and \$0.5 million in fixed assets write-offs. Of the reserve balance at April 30, 2002, \$1.1 million was included in other accrued liabilities and the remaining \$3.6 million was classified as long-term obligations.

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

	<u>Severance- Related Amounts</u>	<u>Fixed Assets Write-Off</u>	<u>Facility</u>	<u>Total</u>
Restructuring charge	\$ 813	\$ 473	\$4,564	\$5,850
Cash payments	(629)		(32)	(661)
Non-cash portion		(473)		(473)
	<u> </u>	<u> </u>	<u> </u>	<u> </u>
Reserve balance at April 30, 2002	\$ 184	\$	\$4,532	\$4,716
	<u> </u>	<u> </u>	<u> </u>	<u> </u>

We expect annual cost savings of approximately \$29.8 million as a result of the restructuring and reduction in force actions taken in the second and fourth quarters of fiscal 2002.

Interest Income and Other, Net During fiscal 2002, interest income and other, net was \$16.6 million, as compared to \$23.4 million in fiscal 2001. The decrease in interest income was primarily due to lower average interest rates, partially offset by higher average investment balances from cash, short-term investments and restricted cash generated from operations. We expect interest income to decline further in fiscal 2003, as existing investments mature and proceeds are reinvested in a lower interest-rate environment. Interest income and other, net also included gains and losses from foreign currency transactions.

Impairment Loss 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 second quarter of fiscal 2002, we recorded a noncash, other-than-temporary write-down of \$13.0 million related to impairments of our investments in publicly traded and private companies. During fiscal 2002 and 2001, we sold shares of certain marketable equity securities and the realized gains for those periods were not material.

Provision (Benefit), for Income Taxes For fiscal 2002, we applied an annual benefit rate of 19.7% to pretax loss. For fiscal 2001, our effective tax rate was 34.5%, which excluded the effect of non-deductible amortization of goodwill and the write-off of acquired in-process research and development. Our estimate is based on existing tax laws and our current projections of income/(loss) and distributions of income/(loss)

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among different entities and tax jurisdictions, and is subject to change, based primarily on varying levels of profitability.

Fiscal 2001 Compared to Fiscal 2000

Business Combinations During the first quarter of fiscal 2001, we acquired Orca for a purchase price of \$50.0 million in common stock, assumed options and cash, with an obligation to provide 264,497 shares of common stock, which will result in additional stock compensation charges if certain performance criteria are achieved. We also paid certain transaction costs and assumed certain operating assets and liabilities. The acquisition was accounted for as a purchase. The purchase price of the transaction was allocated to the acquired assets and liabilities based on their estimated fair values as of the date of the acquisition. Amounts allocated to existing workforce and goodwill are being amortized on a straight-line basis over three-and five-year periods, respectively. Approximately \$26.7 million was allocated to in-process research and development and charged to operations because the acquired technology had not reached technological feasibility and had no alternative uses.

During the third quarter of fiscal 2001, we acquired WebManage for \$59.4 million in common stock, assumed options and cash, with an obligation to provide shares of common stock to be valued at \$3.0 million, if certain performance criteria are achieved. The performance criteria were met in March 2001 and the contingent consideration has been recorded as stock compensation in the fourth quarter of 2001. We also paid certain transaction costs and assumed certain operating assets and liabilities. The acquisition was accounted for as a purchase. The purchase price of the transaction was allocated to the acquired assets and liabilities based on their estimated fair values as of the date of the acquisition. Amounts allocated to existing technology and workforce are being amortized on a straight-line basis over three years and amounts allocated to goodwill are being amortized over five years.

Product Revenues Product revenues increased by 71.9% to \$957.8 million in fiscal 2001, from \$557.4 million in fiscal 2000. Product revenues growth was across all geographies, products and markets. This increase in product revenues for fiscal 2001 was primarily attributable to a higher volume of units shipped, as compared to fiscal 2000. This growth in volume declined in the second half of fiscal 2001. Factors impacting unit growth include:

demand for our F700 filers utilizing primarily fibre-channel disks;

introduction of our new higher capacity F840, mid-range F820 and F85 entry-level filer products;

increased worldwide demand for our NetCache appliances and content delivery network solutions;

increased worldwide shipment of NetApp Cluster Failover solutions, which require another filer to take over in the event of a hardware failure;

increased demand for the SnapMirror software option, which requires multiple filers to provide remote mirroring of data for quick disaster recovery and backup at remote sites;

expansion of our sales organization to 976 in fiscal 2001 from 582 in fiscal 2000; and

increased sales through indirect channels, including sales through our OEM partners, representing 28.2% and 26.8% of total total revenues for fiscal 2001 and 2000, respectively.

Product revenues growth was also positively impacted by:

a higher average selling price of our add-on software options;

SnapMirror, SnapRestore and SnapManager for Microsoft Exchange, and Cluster Failover, supporting mission-critical applications;

a higher average selling price of our new high-end F840 filers;

a higher average selling price due to the introduction of NetCache software features, including ContentReporter™ and ContentDirector;

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the increase in storage capacity;

increased add-on software revenue from multiprotocol solutions; and

higher software subscription (representing 3.6 % and 2.9% of total revenues for fiscal 2001 and 2000, respectively).

Overall product revenues growth was partially offset by:

declining demand for our products in the second half of fiscal 2001;

declining average selling price of the F700 filers and caching products due to competitive pricing; and

declining unit sales of our older products.

Service Revenues Service revenues increased by 120.3% to \$48.4 million in fiscal 2001, from \$21.9 million in fiscal 2000. The increase in service revenues (representing 4.8 % and 3.8% of total revenues for fiscal 2001 and 2000, respectively) was primarily related to a growing installed base needing maintenance and technical support.

International total revenues (including United States exports) grew by 115.0% for fiscal 2001 as compared to fiscal 2000. International total revenues were \$382.5 million, or 38.0% of total revenues for fiscal 2001. The increase in international revenues for fiscal 2001, was primarily a result of European and Asia Pacific total revenues growth, due to increased headcount in the direct sales force, increased indirect channel sales, increased shipments of filers, Cluster Failover solutions and NetCache appliances and increased sales of add-on software licenses, as compared to the corresponding periods of the prior fiscal year.

Product Gross Margin Product gross margin increased to 64.3% of product revenues for fiscal 2001, from 62.8% for fiscal 2000.

Product gross margin was favorably impacted by:

increased licensing of add-on software options such as Multi-Protocol, Cluster Failover, SnapMirror, SnapRestore, SnapManager and new software introductions including ContentReporter and ContentDirector;

growth in software subscriptions due primarily to a larger installed base;

lower costs of key components;

the increase in product volume;

increased manufacturing efficiencies; and

a mix shift to high-end F840 systems sold as diskless upgrades, carrying higher margin than configured systems.

Gross margin was negatively impacted by:

sales price reductions on storage products due to competitive pricing pressure;

higher disk content with an expanded storage capacity for the F840 filer;

lower sales volume in the second half of fiscal 2001; and

lower of cost or market adjustments to inventory.

Service Gross Margin Service gross margin was negative 23.8% for fiscal 2001 as compared to negative gross margin of 29.3% in fiscal 2000. Investments in customer service increased by 111.1% to \$59.9 million in fiscal 2001, from \$28.4 million in fiscal 2000. The negative service gross margin in both fiscal 2001 and 2000 was due to the ramping up and continued investment in our service infrastructure in anticipation of service revenues growth.

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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 87.8% to \$289.0 million for fiscal 2001 from \$153.9 million for fiscal 2000. These expenses were 28.7% and 26.6% of total revenues for fiscal 2001 and 2000, respectively. The increase in absolute dollars was primarily related to the continued worldwide expansion of our sales and customer service organizations, expansion of various marketing and industry initiatives, increased commission expenses in the first three quarters and disposal of certain capital assets in the fourth quarter. Sales and marketing headcount increased to 1,277 in fiscal 2001 from 775 in fiscal 2000.

Research and Development Research and development expenses consist primarily of salaries and benefits, prototype expenses, non-recurring engineering charges, and fees paid to outside consultants. Research and development expenses increased 96.4% to \$120.9 million in fiscal 2001 from \$61.6 million in fiscal 2000. These expenses represented 12.0% and 10.6% of total revenues, for fiscal year 2001 and 2000, respectively. Research and development expenses increased in absolute dollars, primarily as a result of increased headcount, operating impact of Orca and WebManage acquisitions, ongoing support of current and future product development and enhancement efforts, prototyping expenses and non-recurring engineering charges associated with the development of new products and technologies, including the NetApp F85, F800 series filers and the new generation of our NetCache appliances coupled with our content distribution and reporting software. Research and development headcount increased to 566 in fiscal 2001 from 327 in fiscal 2000. 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. For both fiscal 2001 and 2000, no software development costs were capitalized.

General and Administrative General and administrative expenses increased 90.7% to \$40.2 million in fiscal 2001, from \$21.1 million in fiscal 2000. These expenses represented 4.0% and 3.6% of total revenues, for fiscal 2001 and 2000, respectively. Increases in absolute dollars were primarily due to increased headcount, expenses associated with initiatives to enhance enterprise-wide management information systems and increased professional service fees. General and administrative headcount increased to 253 in fiscal 2001 from 162 in fiscal 2000.

Amortization of Intangible Assets Amortization of intangible assets represents the excess of the aggregate purchase price over the fair value of the tangible and identifiable intangible assets acquired by us. Intangible assets as of April 30, 2001, including goodwill, existing workforce and technology, are being amortized over the estimated useful life of three to five-year periods. We assess the recoverability of intangible assets by determining whether the amortized asset over its useful life may be recovered through estimated useful cash flows. Amortization of intangible assets charged to operations was \$11.7 million and \$0.2 million in fiscal 2001 and 2000, respectively.

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

We believe we can utilize the Orca acquisition to develop the first virtual interface-based (VI) next generation of network storage systems. We are leveraging VI architecture to develop the DAFS protocol.

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DAFS enables data transfers straight from the file server, allowing clusters of application servers in heterogeneous environments to share data from the memory of one system to the memory of another without involving general-purpose operating systems, thereby improving CPU utilization and speeding up data access. We expect to continue the development of products using this protocol and believe that there is a reasonable chance of successfully delivering initial products in calendar year 2001. However, there is risk associated with the completion of the in-process project and there can be no assurance that such project will meet with either technological or commercial success. Failure to successfully develop and commercialize this in-process project would result in the loss of the expected economic return inherent in the fair value allocation. Additionally, the value of other intangible assets acquired may become impaired. The risks associated with the research and development are still considered high and no assurance can be made that upcoming products will meet market expectations or gain market acceptance.

Stock Compensation We account for stock-based employee compensation arrangements in accordance with provisions of APB No. 25, Accounting for Stock Issued to Employees, for employee compensation awards and comply with the provisions of SFAS No. 123, Accounting for Stock-Based Compensation, for non-employee compensation awards. Accordingly, we recognize the intrinsic value for employees and the fair value for non-employees as stock compensation expense over the vesting terms of the awards. Stock compensation expenses were \$6.2 million and \$1.3 million in fiscal 2001 and 2000, respectively. This increase was primarily attributable to the recognition of stock compensation of unvested options assumed in the WebManage acquisition, issuance of contingently issuable milestone shares, increased participation in the salaried stock option grant program by certain highly compensated employees and non-employee stock options awards.

Total Other Income, net Total other income, net, was \$23.4 million and \$9.0 million in fiscal 2001 and 2000, respectively. The increase in interest income was primarily due to increased cash and short-term investments generated from operations and net proceeds from stock option exercises.

Provision for Income Taxes Our effective tax was 34.5%, excluding the effect of non-deductible amortization of goodwill and acquired in-process research and development of \$35.5 million for fiscal 2001. The effective tax rate for fiscal 2000 was 35.5%. The effective tax rates differed from the U.S. statutory rate primarily due to state taxes, credits, tax exempt interest, goodwill amortization and acquired in-process research and development.

Liquidity and Capital Resources

We derive our liquidity and capital resources primarily from our cash flow from operations and from working capital, which increased by \$46.8 million to \$463.6 million. As of April 30, 2002, as compared to the April 30, 2001 balances, our cash, cash equivalents, and short-term investments increased by \$90.1 million to \$454.1 million. We generated cash from operating activities totaling \$143.9 million and \$218.4 million in fiscal 2002 and 2001, respectively. Net cash provided by operating activities in fiscal 2002 was principally related to net income of \$3.0 million, decreases in accounts receivable, and increases in other accrued liabilities, deferred revenue, coupled with depreciation, impairment loss on investments, amortization of intangibles and stock compensation, partially offset by decreases in accounts payable, accrued compensation and related benefits and increases in inventories.

In addition to lower net income in fiscal 2002, the primary factors that impacted the period-to-period change in cash flows relating to operating activities included the following:

lower accounts receivable balances due to lower sales and more collections in fiscal 2002;

noncash acquisition-related charges, stock compensation, impairment loss on investments, provision for doubtful accounts, and depreciation included in net income;

increased accrued liabilities relating to the restructuring; and

increase in deferred revenue related to service and software subscription upgrades.

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The above factors were partially offset by the effects of:

decreased balances for accounts payable due to lower levels of business activity in fiscal 2002;

decreased accrued compensation and related benefits due to payouts of profit dependent personnel expenses accrued in fiscal 2001 and paid in fiscal 2002, vacation taken during the July and December 2001 holidays facility shutdowns, and lower commission accrual as a result of lower levels of sales;

increased inventory levels due to preparation for ramping our new NearStore product; and

decreased income taxes payable, primarily reflecting lower profitability in fiscal 2002.

We used \$284.2 million and \$83.7 million of cash in fiscal 2002 and 2001, respectively, for capital expenditures. The fiscal 2002 increase in property and equipment includes the purchase of the land and buildings at our Sunnyvale headquarters site for \$249.8 million. Since we have curtailed capital expenditures, purchases of fixed assets were only \$34.4 million in fiscal 2002, compared to \$83.7 million the same period a year ago. The decrease was primarily attributed to the slowdown in hiring and various cost control and cutting measures. We have used \$149.9 million and \$14.3 million in fiscal 2002 and 2001, respectively, for net purchases of short-term investments. In the first quarter of fiscal 2001, we acquired Orca for a purchase price of approximately \$50.0 million, including common stock, contingently issuable common stock, assumed options, cash payments of \$2.0 million and related transaction costs. In the third quarter of 2001, we acquired WebManage for a purchase price of approximately \$59.4 million, including common stock, assumed options, cash payments of \$5.0 million and related transaction costs. Investing activities in fiscal 2002 and 2001 also included new equity investments of \$1.1 million and \$7.0 million, respectively.

We received \$230.2 million in fiscal 2002 and used \$113.2 million in fiscal 2001 from financing activities. The increase in fiscal 2002 was primarily from the decrease in restricted cash (see Commitments and Contingencies Note 4 to Notes to Condensed Consolidated Financial Statements) partially offset by decreased proceeds from the sale of common stock. The decrease in cash provided by sales of common stock for fiscal 2002, compared to the corresponding period of the prior fiscal year, was primarily due to lower stock option exercise proceeds as a result of the decline in our stock price.

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

Contractual Obligations

The following summarizes our contractual obligations at April 30, 2002, and the effect such obligations are expected to have on our liquidity and cash flow in future periods, (in thousands):

	<u>2003</u>	<u>2004</u>	<u>2005</u>	<u>2006</u>	<u>2007</u>	<u>Thereafter</u>	<u>Total</u>
Operating lease payments	\$ 10,344	\$ 9,336	\$ 7,790	\$ 5,443	\$ 2,863	\$ 11,138	\$ 46,914
Venture capital funding commitments	1,144	1,144	1,144	1,143			4,575
Purchase commitments	3,966						3,966
	<u>\$ 15,454</u>	<u>\$ 10,480</u>	<u>\$ 8,934</u>	<u>\$ 6,586</u>	<u>\$ 2,863</u>	<u>\$ 11,138</u>	<u>\$ 55,455</u>

Table of Contents**Item 7a. *Quantitative and Qualitative Disclosures about Market Risk***

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

Market Interest and Interest Income Risk

Interest and Investment Income As of April 30, 2002, we had short-term investments of \$243.4 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 certain technology companies. These highly liquid investments, consisting primarily of government and corporate debt securities, are subject to interest rate and interest income risk and will decrease in value if market interest rates increase. A hypothetical 10 percent increase in market interest rates from levels at April 30, 2002, would cause the fair value of these short-term investments to decline by approximately \$0.5 million. Because we have the ability to hold these investments until maturity we would not expect any significant decline in value of our investments caused by market interest rate changes. Declines in interest rates over time will, however, reduce our interest income. We do not use derivative financial instruments in our investment portfolio.

Market Price Risk

Equity Securities We are also exposed to market price risk on our equity security included in our short-term investments. Such investment is in a publicly traded company in the volatile high-technology industry sector. We do not attempt to reduce or eliminate our market exposure on this security and, as a result, the amount of income and cash flow that we ultimately realize from this investment in future periods may vary materially from the current unrealized amount. A 50% adverse change in the equity price would result in an approximate \$0.3 million decrease in the fair value of our equity security as of April 30, 2002.

The hypothetical changes and assumptions discussed above will be different from what actually occurs in the future. Furthermore, such computations do not anticipate actions that may be taken by management, should the hypothetical market changes actually occur over time. As a result, the effect on actual earnings in the future will differ from those described above.

Foreign Currency Exchange Rate Risk

We hedge risks associated with foreign currency transactions in order to minimize the impact of changes in foreign currency exchange rates on earnings. We utilize forward contracts to hedge against the short-term impact of foreign currency fluctuations on certain assets and liabilities denominated in foreign currencies. All hedge instruments are marked to market through earnings every period. We believe that these forward contracts do not subject us to undue risk due to foreign exchange movements because gains and losses on these contracts are offset by losses and gains on the underlying assets and liabilities.

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

The following table provides information about our foreign exchange forward contracts outstanding on April 30, 2002, (in thousands):

Currency	Buy/Sell	Foreign Currency Amount	Contract Value USD	Fair Value in USD
AUD	Sell	8,296	\$ 4,472	\$ 4,484
CHF	Sell	3,155	\$ 1,945	\$ 1,945
GBP	Sell	13,270	\$ 19,309	\$ 19,347
EUR	Sell	72,311	\$ 64,733	\$ 64,827

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The following table provides information about our foreign exchange forward contracts outstanding on April 30, 2001, (in thousands):

Currency	Buy/Sell	Foreign Currency Amount	Contract Value USD	Fair Value in USD
AUD	Sell	17,312	\$ 8,693	\$ 8,733
CHF	Sell	5,300	\$ 3,082	\$ 3,048
GBP	Sell	18,085	\$25,845	\$25,878
EUR	Sell	50,728	\$44,324	\$44,726

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Item 8. *Financial Statements and Supplementary Data*

INDEPENDENT AUDITORS' REPORT

To the Stockholders of

Network Appliance, Inc.:

We have audited the accompanying consolidated balance sheets of Network Appliance, Inc. and its subsidiaries (the "Company") as of April 30, 2002 and 2001, and the related consolidated statements of income, stockholders' equity and comprehensive income and cash flows for each of the three years in the period ended April 30, 2002. Our audits also included the consolidated financial statement schedule listed in Item 14(a)(2). These financial statements and the financial statement schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on the financial statements and financial statement schedule based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of Network Appliance, Inc. and its subsidiaries as of April 30, 2002 and 2001, and the results of their operations and their cash flows for each of the three years in the period ended April 30, 2002 in conformity with accounting principles generally accepted in the United States of America. Also, in our opinion, the consolidated financial statement schedule listed in Item 14(a)(2), when considered in relation to the basic consolidated financial statements taken as a whole, presents fairly in all material respects the information set forth therein.

As discussed in Note 14, information in the notes to the consolidated financial statements concerning future minimum annual lease payments has been revised.

/s/ DELOITTE & TOUCHE LLP

San Jose, California

May 10, 2002 (December 4, 2002 as to Note 14)

Table of Contents**NETWORK APPLIANCE, INC.****CONSOLIDATED BALANCE SHEETS**

(In thousands, except per share amounts)

	April 30,	
	2002	2001
ASSETS		
Current Assets:		
Cash and cash equivalents	\$ 210,756	\$ 271,931
Short-term investments	243,371	92,094
Accounts receivable, net of allowances of \$8,416 in 2002 and \$4,030 in 2001	146,511	186,956
Inventories	23,849	22,504
Prepaid expenses and other	22,112	25,745
Deferred income taxes	32,529	36,287
	<hr/>	<hr/>
Total current assets	679,128	635,517
Restricted Cash		193,747
Property and Equipment, net	345,195	103,238
Intangible Assets	58,615	79,510
Other Assets	25,868	24,240
	<hr/>	<hr/>
	\$ 1,108,806	\$ 1,036,252
	<hr/>	<hr/>
LIABILITIES AND STOCKHOLDERS EQUITY		
Current Liabilities:		
Accounts payable	\$ 40,243	\$ 53,493
Income taxes payable	17,073	21,844
Accrued compensation and related benefits	36,912	50,523
Other accrued liabilities	45,193	34,597
Deferred revenue	76,139	58,316
	<hr/>	<hr/>
Total current liabilities	215,560	218,773
Long-Term Deferred Revenue	31,036	12,882
Long-Term Obligations	3,734	149
	<hr/>	<hr/>
	250,330	231,804
	<hr/>	<hr/>
Commitments and Contingencies (Note 4)		
Stockholders Equity:		
Preferred stock, \$0.001 par value, 5,000 shares authorized; shares outstanding: none in 2002 and 2001		
Common stock, \$0.001 par value; 880,000 shares authorized; shares outstanding: 335,135 in 2002 and 328,746 in 2001	335	329
Additional paid-in capital	656,619	616,266
Deferred stock compensation	(3,777)	(12,044)
Retained earnings	207,665	204,632
Cumulative other comprehensive loss	(2,366)	(4,735)
	<hr/>	<hr/>
Total stockholders equity	858,476	804,448
	<hr/>	<hr/>
	\$ 1,108,806	\$ 1,036,252

See notes to consolidated financial statements.

Table of Contents**NETWORK APPLIANCE, INC.****CONSOLIDATED STATEMENTS OF INCOME**

(In thousands, except per share amounts)

	Years Ended April 30,		
	2002	2001	2000
Revenues			
Product revenue	\$ 729,916	\$ 957,830	\$ 557,352
Service revenue	68,453	48,356	21,948
Total revenues	<u>798,369</u>	<u>1,006,186</u>	<u>579,300</u>
Cost of Revenues			
Cost of product revenue	261,857	341,821	207,477
Cost of service revenue	55,989	59,886	28,369
Total cost of revenues	<u>317,846</u>	<u>401,707</u>	<u>235,846</u>
Gross margin	<u>480,523</u>	<u>604,479</u>	<u>343,454</u>
Operating Expenses:			
Sales and marketing	284,355	289,003	153,877
Research and development	116,725	120,938	61,566
General and administrative	40,182	40,238	21,098
Amortization of intangible assets	20,895	11,732	200
In-process research and development		26,688	
Stock compensation(1)	7,202	6,223	1,345
Restructuring charges	12,226		
Total operating expenses	<u>481,585</u>	<u>494,822</u>	<u>238,086</u>
Income (Loss) from Operations	(1,062)	109,657	105,368
Other Income (Expense), net:			
Interest income and other, net	16,603	23,352	9,038
Impairment loss on investments	(13,008)		
Total other income, net	<u>3,595</u>	<u>23,352</u>	<u>9,038</u>
Income Before Income Taxes	2,533	133,009	114,406
Provision (Benefit) for Income Taxes	(500)	58,123	40,614
Net Income	<u>\$ 3,033</u>	<u>\$ 74,886</u>	<u>\$ 73,792</u>
Net Income per Share:			
Basic	<u>\$ 0.01</u>	<u>\$ 0.23</u>	<u>\$ 0.25</u>
Diluted	<u>\$ 0.01</u>	<u>\$ 0.21</u>	<u>\$ 0.21</u>
Shares Used in per Share Calculations:			
Basic	331,645	320,435	299,370

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Diluted	350,498	359,824	345,171
<hr/>			
(1) Stock compensation includes:			
Sales and marketing	\$ 1,023	\$ 1,054	\$ 619
Research and development	5,694	2,738	499
General and administrative	485	2,431	227
	<hr/>	<hr/>	<hr/>
	\$ 7,202	\$ 6,223	\$ 1,345
	<hr/>	<hr/>	<hr/>

See notes to consolidated financial statements.

Table of Contents**NETWORK APPLIANCE, INC.****CONSOLIDATED STATEMENTS OF STOCKHOLDERS EQUITY AND COMPREHENSIVE INCOME**

(In thousands)

	Common Stock		Deferred Stock Compensation	Retained Earnings	Cumulative Other Comprehensive Loss	Total
	Shares	Amount				
Balances, April 30, 1999	291,324	\$240,807	\$ (714)	\$ 55,954	\$ (323)	\$295,724
Components of comprehensive income:						
Net income				73,792		73,792
Currency translation adjustment					(2,204)	(2,204)
Unrealized gain on investments					8	8
Total comprehensive income						71,596
Issuance of common stock	20,479	53,833				53,833
Deferred stock compensation		1,845	(1,845)			
Amortization of deferred stock compensation			1,345			1,345
Reversal of deferred stock compensation due to employee terminations		(40)	40			
Income tax benefit from employee stock transactions		56,248				56,248
Balances, April 30, 2000	311,803	\$352,693	\$ (1,174)	\$129,746	\$ (2,519)	\$478,746
Components of comprehensive income:						
Net income				74,886		74,886
Currency translation adjustment					(790)	(790)
Unrealized loss on investments					(1,426)	(1,426)
Total comprehensive income						72,670
Issuance of common stock	15,924	80,510				80,510
Common shares issued and options assumed pursuant to business acquisitions	918	101,237				101,237
Issuance of milestone shares	101	3,000				3,000
Deferred stock compensation		14,127	(14,127)			
Amortization of deferred stock compensation			3,223			3,223
Reversal of deferred stock compensation due to employee terminations		(34)	34			
Income tax benefit from employee stock transactions		65,062				65,062
Balances, April 30, 2001	328,746	\$616,595	\$ (12,044)	\$204,632	\$ (4,735)	\$804,448

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Components of comprehensive income:

Net income			3,033			3,033
Currency translation adjustment				1,115		1,115
Unrealized gain on investments				1,254		1,254
						<u> </u>
Total comprehensive income						5,402
Issuance of common stock	6,389	36,472				36,472
Issuance of milestone shares		3,015				3,015
Deferred stock compensation		1,301	(1,301)			
Amortization of deferred stock compensation				4,187		4,187
Reversal of deferred stock compensation due to employee terminations		(5,381)	5,381			
Income tax benefit from employee stock transactions		4,952				4,952
	<u> </u>	<u> </u>	<u> </u>	<u> </u>	<u> </u>	<u> </u>
Balances, April 30, 2002	335,135	\$ 656,954	\$ (3,777)	\$ 207,665	\$ (2,366)	\$ 858,476
	<u> </u>	<u> </u>	<u> </u>	<u> </u>	<u> </u>	<u> </u>

See notes to consolidated financial statements.

Table of Contents**NETWORK APPLIANCE, INC.****CONSOLIDATED STATEMENTS OF CASH FLOWS**

(In thousands)

	Years Ended April 30,		
	2002	2001	2000
Cash Flows from Operating Activities:			
Net income	\$ 3,033	\$ 74,886	\$ 73,792
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	44,395	30,528	14,163
In-process research and development		26,688	
Amortization of intangibles	20,895	11,732	200
Stock compensation expense	7,202	6,223	1,345
Impairment loss on investments	13,008		
Loss on disposal of equipment	3,029	9,356	1,904
Provision for doubtful accounts	7,549	2,443	1,275
Deferred income taxes	(4,592)	(35,467)	(11,614)
Deferred rent	(71)	95	(39)
Changes in assets and liabilities:			
Accounts receivable	33,045	(80,483)	(53,352)
Inventories	(6,156)	(13,683)	(12,425)
Prepaid expenses and other assets	(993)	47	(16,320)
Accounts payable	(13,250)	30,771	18,935
Income taxes payable	181	93,166	55,647
Accrued compensation and related benefits	(13,611)	15,472	19,713
Other accrued liabilities	14,252	(1,279)	13,148
Deferred revenue	35,977	47,858	11,708
Net cash provided by operating activities	<u>143,893</u>	<u>218,353</u>	<u>118,080</u>
Cash Flows from Investing Activities:			
Purchases of short-term investments	(361,791)	(165,897)	(99,514)
Redemptions of short-term investments	211,862	151,595	30,650
Purchases of property and equipment	(284,238)	(83,685)	(40,819)
Purchases of equity securities	(1,120)	(7,041)	(7,000)
Purchases of businesses, net of cash acquired		(7,171)	
Payment of deposits, net			2,500
Net cash used in investing activities	<u>(435,287)</u>	<u>(112,199)</u>	<u>(114,183)</u>
Cash Flows from Financing Activities:			
Proceeds from sale of common stock, net	36,472	80,510	53,833
Decrease/(Increase) in restricted cash	193,747	(193,747)	
Net cash provided by (used in) financing activities	<u>230,219</u>	<u>(113,237)</u>	<u>53,833</u>
Net Increase (Decrease) in Cash and Cash Equivalents	(61,175)	(7,083)	57,730
Cash and Cash Equivalents:			
Beginning of year	<u>271,931</u>	<u>279,014</u>	<u>221,284</u>
End of year	<u>\$ 210,756</u>	<u>\$ 271,931</u>	<u>\$ 279,014</u>

See notes to consolidated financial statements.

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NETWORK APPLIANCE, INC.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Dollar and share amounts in thousands, except per-share data)**

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, Inc. is a worldwide leader in enterprise network storage and data management solutions. 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.

2. Significant Accounting Policies

Fiscal Year 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 consolidated financial statements that our fiscal year end is April 30. Fiscal 2002, 2001 and 2000 were 52-week fiscal years.

Basis of Presentation The consolidated financial statements include the company and its wholly-owned subsidiaries. Intercompany accounts and transactions are eliminated in consolidation. Certain amounts from prior years have been reclassified to conform to current-year presentation. These reclassifications did not change previously reported total assets, liabilities, stockholders' equity or net income.

Cash and Cash Equivalents We consider all highly liquid debt investments with original maturities of three months or less to be cash equivalents.

Short-Term Investments Our short-term investments consist primarily of securities with original maturities ranging between three and twelve months. All of our investments are classified as available-for-sale, which are carried at fair market value, and unrealized gains or losses recorded in cumulative other comprehensive loss, which is 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 determines the appropriate classification of debt and equity securities at the time of purchase and reevaluates the classification at each reporting date. Available-for-sale investments are reviewed for evidence of reductions in market value that are other than temporary. 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. During fiscal 2002, we recorded a noncash, other-than-temporary write-down of \$3,641 related to an impairment of our investment in a publicly traded company. No write-downs were recorded during fiscal 2001 and 2000.

Approximately \$193,747 of our investment portfolio at April 30, 2001 was invested in a certificate of deposit and was restricted to collateralize our operating leases and classified as noncurrent restricted cash. During fiscal 2002, we discontinued our operating leases by purchasing the land and buildings at our Sunnyvale headquarters site, converting restricted investments to property and equipment on the balance sheet.

Investments in Nonpublic Companies We have certain investments in nonpublicly traded companies in which we have less than 20% of the voting rights and in which we do not exercise significant influence. As of April 30, 2002 and 2001, \$1,724 and \$10,084 of these investments are included in other long-term assets on the balance sheet and are carried at cost. We perform periodic reviews of our investments for impairment. 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

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NETWORK APPLIANCE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

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. During fiscal 2002, we recorded a noncash, other-than-temporary write-down of \$9,367 related to impairments of our investments in private companies. No write-downs were recorded during fiscal 2001 and 2000.

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

Property and Equipment Property and equipment are recorded at cost. Depreciation is computed using the straight-line method over the estimated useful lives of the assets, which generally range from three to five years. Leasehold improvements are amortized over the shorter of the estimated useful lives of the assets or the remaining term of the lease. Building improvements are amortized over the estimated lives of the assets, which generally range from ten to forty years. Construction in progress will be amortized over the estimated useful lives of the respective assets when they are ready for their intended use.

We review the carrying values of long-lived assets whenever events and circumstances indicate that the net book value of an asset may not be recovered through expected future cash flows from its use and eventual disposition. The amount of impairment loss, if any, is measured as the difference between the net book value and the estimated fair value of the asset.

Goodwill and Purchased Intangible Assets Goodwill and purchased intangible assets include goodwill and other intangible assets such as existing workforce and existing technology, which are carried at cost less accumulated amortization. For business combinations consummated before July 1, 2001, goodwill and existing workforce were amortized through April 30, 2002, using the straight-line method over an estimated useful life of three to five years. Amortization of other purchased intangibles is computed using the straight-line method over the expected useful life of three to five years. We evaluate the impairment of goodwill and purchased intangible assets whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. See Note 2 *Recently Issued Accounting Standards* of Notes to Consolidated Financial Statements.

Revenue Recognition and Allowance We apply the provisions of SOP 97-2, *Software Revenue Recognition* (as amended by SOP 98-4 and SOP 98-9) and related interpretations to all revenue transactions. We recognize revenue when:

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

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

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

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

For arrangements with multiple elements, we allocate revenue to each element using the residual method based on vendor specific objective evidence of the undelivered items. We defer the portion of the arrangement

Table of Contents**NETWORK APPLIANCE, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Dollar and share amounts in thousands, except per-share data)**

fee equal to the fair value of the undelivered elements until they are delivered. Vendor specific objective evidence is based on the price charged when the element is sold separately.

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

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

	Years Ended April 30,		
	2002	2001	2000
Revenues:			
Products	84.8%	91.6%	93.3%
Software subscriptions	6.6%	3.6%	2.9%
	-----	-----	-----
System products and software subscriptions	91.4%	95.2%	96.2%
Services	8.6%	4.8%	3.8%
	-----	-----	-----
Total revenues	100.0%	100.0%	100.0%
	=====	=====	=====

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

We also maintain a separate allowance for doubtful accounts for estimated losses resulting from the inability of our customers to make required payments. 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.

Advertising Costs Advertising costs are charged to operations when incurred. Advertising expenses for fiscal 2002, 2001 and 2000 were approximately \$2,543, \$5,258 and \$2,594, respectively.

Software Development Costs The costs for the development of new software products and substantial enhancements to existing software products are expensed as incurred until technological feasibility has been established, at which time any additional costs would be capitalized in accordance with SFAS No. 86, *Accounting for the Costs of Software to be Sold, Leased, or otherwise Marketed*. Because we believe our current process for developing software is essentially completed concurrently with the establishment of technological feasibility, which occurs upon the completion of a working model, no costs have been capitalized for any of the periods presented. In accordance with SOP 98-1, *Accounting for the Costs of Computer Software Developed or Obtained for Internal Use*, the cost of internally-developed software is capitalized and included in property and equipment at the point at which the conceptual formulation, design and testing of possible software project alternatives have been completed and management authorizes and commits to funding the project. Pilot projects and projects where expected future economic benefits are less than probable are not capitalized. Internally-developed software costs include the cost of software tools and licenses used in the development of our systems, as well as consulting costs. Completed projects are transferred to property and equipment at

cost and are amortized on a straight-line basis over their estimated useful lives, generally three years.

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NETWORK APPLIANCE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

Foreign Currency Translation and Foreign Exchange Contracts For subsidiaries whose functional currency is the local currency, gains and losses resulting from translation of these foreign currency financial statements into U.S. dollars are recorded within stockholders' equity as part of cumulative other comprehensive loss. For subsidiaries where the functional currency is the U.S. dollar, gains and losses resulting from the process of remeasuring foreign currency financial statements into U.S. dollars are included in other income.

In fiscal 2002, we determined that the functional currency of one of our subsidiaries had changed from the Euro to the U.S. Dollar. Accordingly, all monetary assets and liabilities were translated at the current exchange rate in effect as of the balance sheet date, nonmonetary assets and liabilities were translated at historical rates, and total revenues and expenses were translated at average exchange rates in effect during the period. Transaction gains and losses are included in other income (expense) in the accompanying consolidated statements of operations.

We utilize forward exchange contracts to hedge against the short-term impact of foreign currency fluctuations on certain assets or liabilities denominated in foreign currencies. The gains or losses on these contracts are included in income as the exchange rates change. Management believes that these forward contracts do not subject us to undue risk due to foreign exchange movements because gains and losses on these contracts are offset by losses and gains on the underlying assets and transactions being hedged.

Derivative Instruments On May 1, 2001, we adopted SFAS 133, Accounting for Derivative Instruments and Hedging Activities. The adoption of this accounting standard did not have a significant impact on our financial position, results of operations, or cash flow.

As a result of our significant international operations, we are subject to risks associated with fluctuating exchange rates. We use foreign currency forward contracts to attempt to minimize the impact of exchange rate movements on our balance sheet relating to certain foreign currency assets and liabilities. Gains and losses on these undesignated derivatives offset gains and losses on the assets and liabilities being hedged, and the net amount is included in earnings. In fiscal 2002, net gains generated by hedged assets and liabilities totaled \$1,684, which were offset by losses on the related derivative instruments of \$3,485. In fiscal 2001, net losses generated by hedged assets and liabilities totaled \$2,250, which were offset by gains on the related derivative instruments of \$3,898. In fiscal 2000, net losses generated by hedged assets and liabilities totaled \$2,745, which were offset by gains on the related derivative instruments of \$1,102. We do not enter into derivative financial instruments for speculative or trading purposes. Currently, we do not enter into any foreign exchange forward contracts to hedge exposures related to forecasted transactions, firm commitments or equity investments.

Use of Estimates The preparation of the consolidated financial statements and related disclosures in conformity with accounting principles generally accepted in the United States of America requires management to establish accounting policies which contain estimates and assumptions that affect the amounts reported in the consolidated financial statements and accompanying notes. Actual results could differ from those estimates.

Concentration of Credit Risk Financial instruments which potentially subject us to concentrations of credit risk consist primarily of cash equivalents, short-term investments, and accounts receivable. Cash, cash equivalents, and short-term investments consist primarily of U.S. government agencies, corporate bonds, U.S. commercial paper, municipal securities, cash accounts held at various banks, and money market funds held at several financial institutions. We sell our products primarily to large organizations in different industries and geographies. Credit risk is mitigated by our credit evaluation process and limited payment terms. We do not require collateral or other security to support accounts receivable. In addition, we maintain an allowance for potential credit losses. In entering into forward foreign exchange contracts, we have assumed the risk that might arise from the possible inability of counterparties to meet the terms of their contracts. The

Table of Contents**NETWORK APPLIANCE, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Dollar and share amounts in thousands, except per-share data)**

counterparties to these contracts are major multinational commercial banks, and we do not expect any losses as a result of counterparty defaults.

Comprehensive Income Comprehensive income for the years ending April 30, 2002, 2001, and 2000 has been disclosed within the consolidated statement of stockholders' equity and comprehensive income.

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

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

	Years Ended April 30		
	2002	2001	2000
Net Income (Numerator):			
Net Income	\$ 3,033	\$ 74,886	\$ 73,792
Shares (Denominator):			
Weighted average common shares outstanding	331,798	320,692	299,554
Weighted average common shares outstanding subject to repurchase	(153)	(257)	(184)
Shares used in basic computation	331,645	320,435	299,370
Weighted average common shares outstanding subject to repurchase	153	257	184
Common shares issuable upon exercise of stock options	18,700	39,132	45,617
Shares used in diluted computation	350,498	359,824	345,171
Net Income per Share:			
Basic	\$ 0.01	\$ 0.23	\$ 0.25
Diluted	\$ 0.01	\$ 0.21	\$ 0.21

At April 30, 2002, 2001, and 2000, 30,991, 18,005, and 537 shares of common stock options with a weighted average exercise price of \$40.17, \$59.45, and \$95.00 respectively, were excluded from the diluted net income per share computation, as their exercise prices were greater than the average market price of the common shares for the periods.

Statements of Cash Flows Supplemental cash flow and noncash investing and financing activities are as follows:

Years Ended April 30

	2002	2001	2000
Supplemental Cash Flow Information:			
Income taxes paid	\$ 8,460	\$ 6,688	\$ 4,517
Noncash Investing and Financing Activities:			
Deferred stock compensation, net of reversals	(4,080)	14,093	1,805
Income tax benefit from employee stock transactions	4,952	65,062	56,248
Conversion of evaluation inventory to fixed assets	5,777	10,892	3,723
Common stock issued and options assumed for acquired businesses		101,237	
Conversion of equity securities to short-term investments		6,000	
Milestone shares issued	3,015	3,000	

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NETWORK APPLIANCE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

Stock-Based Compensation We record stock compensation in accordance with provisions of APB No. 25, Accounting for Stock Issued to Employees, and all of its interpretations for employee awards, and in accordance with the provisions of SFAS No. 123, Accounting for Stock-Based Compensation, for non-employee awards. Accordingly, we recognize the intrinsic value for employees and the fair value for non-employees as stock compensation expense over the vesting terms of the awards.

Recently Issued Accounting Standards In June 2001, the FASB issued SFAS No. 141, Business Combinations, and SFAS No. 142, Goodwill and Other Intangible Assets. Under SFAS No. 141, all business combinations initiated after June 30, 2001 must be accounted for using the purchase method. Under SFAS No. 142, goodwill and intangible assets with indefinite lives are no longer amortized but are reviewed annually for impairment (or more frequently if indicators of impairment arise). Separable intangible assets that are not deemed to have indefinite lives will continue to be amortized over their useful lives (but with no maximum life). The amortization provisions of SFAS No. 142 apply to goodwill and intangible assets acquired after June 30, 2001. With respect to goodwill and intangible assets acquired prior to July 1, 2001, we are required to adopt SFAS No. 142 effective May 1, 2002. Upon adoption of SFAS No. 142, we will stop the amortization of goodwill (including acquired existing workforce) with a net carrying value of approximately \$49,779 at April 30, 2002 and the annual amortization of \$15,177 that resulted from business combinations initiated prior to the adoption. We will evaluate goodwill under the SFAS No. 142 transitional impairment test. Any transitional impairment loss will be recognized as a change in accounting principle on the date of adoption. We have not determined whether adoption of SFAS No. 142 will have an impact on our financial position, results of operations, and cash flow.

In October 2001, the FASB issued SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets, which addresses financial accounting and reporting for the impairment or disposal of long-lived assets. SFAS No. 144 supersedes SFAS No. 121, Accounting for the Impairment of Long-Lived Assets and for Assets to Be Disposed Of. Adoption of SFAS No. 144 is required for our fiscal year beginning May 1, 2002. We are currently evaluating the potential impact of adoption of SFAS No. 144 on our financial position and results of operations and have not yet determined the impact of adopting this statement.

Table of Contents**NETWORK APPLIANCE, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

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

3. Balance Sheet Components**Short-term investments**

The following is a summary of investments at April 30, 2002:

	Amortized Cost	Unrealized		Estimated Fair Value
		Gains	Losses	
Municipal bonds	\$ 7,999	\$	\$	\$ 7,999
Corporate securities	1,000		417	583
Corporate bonds	73,971	179	57	74,093
U.S. government agencies	160,681	279	264	160,696
Money market funds	168,003			168,003
Total debt and equity securities	411,654	458	738	411,374
Less cash equivalents	168,003			168,003
Short-term investments	\$ 243,651	\$ 458	\$ 738	\$ 243,371

The following is a summary of investments at April 30, 2001:

	Amortized Cost	Unrealized		Estimated Fair Value
		Gains	Losses	
Municipal bonds	\$ 27,581	\$ 41	\$	\$ 27,622
Municipal securities	186,650			186,650
Corporate securities	5,827	267	2,722	3,372
Corporate bonds	2,598	3		2,601
U.S. Commercial Paper	112,998			112,998
Total debt and equity securities	335,654	311	2,722	333,243
Less cash equivalents	241,149			241,149
Short-term investments	\$ 94,505	\$ 311	\$ 2,722	\$ 92,094

Inventories, net

April 30,

2002

2001

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Purchased components	\$ 11,870	\$ 11,106
Work in process	1,431	560
Finished goods	10,548	10,838
	<u>\$ 23,849</u>	<u>\$ 22,504</u>

Table of Contents**NETWORK APPLIANCE, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Dollar and share amounts in thousands, except per-share data)****Property and Equipment**

	April 30,	
	2002	2001
Land and buildings	\$ 262,876	\$
Leasehold improvements	12,304	18,943
Computers, related equipment, and purchased software	123,164	101,329
Furnitures	18,327	15,841
Construction in progress	4,978	7,909
	<hr/>	<hr/>
	421,649	144,022
Accumulated depreciation and amortization	(76,454)	(40,784)
	<hr/>	<hr/>
	\$ 345,195	\$ 103,238
	<hr/>	<hr/>

4. Commitments and Contingencies

In fiscal 2002 we terminated our operating lease obligations for our Sunnyvale headquarters site by purchasing the land and buildings for \$249.8 million. As a result of headcount reductions in fiscal 2002, we are not currently utilizing certain existing spaces at our California headquarters site. Additionally, we have also exited office spaces under non-cancellable leases in other locations both in the United States and Europe. If we are unable to successfully sublease our vacated and unoccupied office spaces under operating leases, our operating results may be adversely affected. See Note 12 Restructuring Charges.

We lease other sales offices and research and development facilities throughout the United States and internationally. These sales offices are also leased under operating leases which expire through fiscal 2019. We are responsible for certain maintenance costs, taxes, and insurance under these leases. The aggregate annual minimum rent commitment under our operating leases is included in the minimum annual lease payments schedule below.

Future minimum annual lease payments as of April 30, 2002, are as follows:

Years Ending April 30	
2003	\$ 10,344
2004	9,336
2005	7,790
2006	5,443
2007	2,863
Thereafter	11,138
	<hr/>
Total lease payments	\$ 46,914
	<hr/>

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Rent expense was \$18,150, \$18,090, and \$7,779 for the years ended April 30, 2002, 2001, and 2000, respectively. Rent expense under certain of our facility leases is recognized on a straight-line basis over the term of the lease. The difference between the amounts paid and the amounts expensed is classified as long-term obligations in the accompanying consolidated balance sheets.

We have entered into agreements and established Network Appliance accounts with Deutsche Banc Alex.Brown whereby we have the option to guarantee any defaults of certain margin loans made to two corporate officers by the financial institution on their Network Appliance stock. We have also entered into an agreement and established a Network Appliance account with Goldman, Sachs and Co. whereby we have the option to guarantee any default of certain margin loan made to a third corporate officer by the financial institution on his Network Appliance stock. The amount of the guarantee is limited to the excess, if any, of the

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NETWORK APPLIANCE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

amount of such loans over the fair market value of the Network Appliance stock securing the loans. As of April 30, 2002, there was no such amount.

In May 2000, we entered into a split dollar insurance arrangement with our CEO. Under the arrangement, we will pay the annual premiums on several insurance policies on the life of the survivor of our CEO and his wife, and our CEO will reimburse us each year for a portion of those premiums equal to the economic value of the term insurance coverage provided him under the policies. For each of the 2001 and 2002 fiscal years, we paid an aggregate net annual premium on these split dollar policies in the amount of \$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. Upon the death of both our CEO and his wife or any earlier cash-out of the policies, we will be entitled to a refund of all cumulative premiums paid on these policies by us, and the balance will be paid to our CEO or his designated beneficiaries. The arrangement is terminable by us upon thirty (30)-days prior notice, and such termination will trigger a refund of the net cumulative premiums paid by us on the policies.

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

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

5. Line of Credit

In July 1998, we negotiated a \$5,000 unsecured revolving credit facility with a domestic commercial bank. Under terms of the credit facility, which expires in October 2002, we must maintain various financial covenants. Any borrowings under this agreement bear interest at either LIBOR plus 1% or at the lender's prime lending rate, such rate determined at our discretion. There were no amounts outstanding under this line of credit at April 30, 2002 or 2001.

We also have foreign exchange facilities used for hedging arrangements with several banks that allow us to enter into foreign exchange contracts of up to \$135,000, of which \$44,397 was available at April 30, 2002.

6. Stockholders Equity

Stock Splits On December 20, 1999 and March 22, 2000, we effected two-for-one stock splits of the outstanding shares of common stock. All share and per share amounts in these consolidated financial statements have been adjusted to give effect to the stock splits.

Preferred Stock Our Board of Directors has the authority to issue up to 5,000 shares of preferred stock and to determine the price, rights, preferences, privileges, and restrictions, including voting rights, of those shares without any further vote or action by the stockholders.

Stock Option Plans We adopted the 1993 Stock Option/ Stock Issuance Plan (the 1993 Plan) in April 1993. In September 1995, we adopted the 1995 Stock Incentive Plan (the 1995 Plan). The 1995 Plan replaced the 1993 Plan, and provides for the grant of options and the issuance of common stock under terms substantially the same as those provided under the 1993 Plan, except that the 1995 Plan does not allow for the exercise of options prior to vesting. Accordingly, all options and shares issued under the 1993 Plan were incorporated into the 1995 Plan upon the effectiveness of our initial public offering.

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NETWORK APPLIANCE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

Under the 1995 Plan, the board of directors may grant to employees, directors and consultants options to purchase shares of our common stock. The exercise price for an incentive stock option and a nonqualified stock option cannot be less than 100% and 85%, respectively, of the fair market value of our common stock as determined by the board of directors on the date of grant. Options granted under the 1995 Plan generally vest at a rate of 25% on the first anniversary of the vesting commencement date and then ratably over the following 36 months. Options expire as determined by the board of directors, but not more than ten years after the date of grant.

In April 1997, the board of directors adopted the Special Nonofficer Stock Option Plan (the Nonofficer Plan) which provides for the grant of options and the issuance of common stock under terms substantially the same as those provided under the 1995 Plan, except that the Nonofficer Plan allows only for the issuance of nonqualified options to nonofficer employees.

In August 1999, the board of directors adopted the 1999 Stock Option Plan (the 1999 Plan), which is comprised of two separate equity incentive programs: (i) the Discretionary Option Grant Program under which options may be granted to eligible individuals during the service period at a fixed price per share and (ii) the Automatic Option Grant Program under which nonemployee board members will automatically receive special option grants at designated intervals over their period of board service.

The 1999 Plan will supplement the existing 1995 Plan and Nonofficer Plan and those plans will continue to remain in full force and effect until all available shares have been issued under each such plan. However, the Automatic Option Grant Program previously in effect under the 1995 Plan terminated as of October 26, 1999, and all automatic option grants made to nonemployee board members on or after that date will be made under the 1999 Plan.

Under the 1999 Plan, the board of directors may grant to employees, directors and consultants and other independent advisors options to purchase shares of our common stock during their period of service with us. The exercise price for an incentive stock option and a nonstatutory option cannot be less than 100% of the fair market value of the common stock on the grant date. Options granted under the 1999 Plan generally vest at a rate of 25% on the first anniversary of the vesting commencement date and then ratably over the following 36 months. Options will have a term of ten years after the date of grant, subject to earlier termination upon the occurrence of certain events. In fiscal 2002, the 1999 plan was amended to increase the share reserve by an additional 13,400 shares of common stock and effect certain changes to the Automatic Option Grant Program in effect for the nonemployee members of the board of directors.

Options granted under the 1999 Plan are subject to the cancellation/regrant program with the following limitations: (i) only options held by employees who are neither executive officers nor members of the board can be repriced; and (ii) the total number of repriced options will not exceed ten percent of the total number of shares of common stock authorized for issuance under the 1999 Plan.

In fiscal 2001, we assumed various stock option plans in connection with our Orca and WebManage acquisitions. Pursuant to the provisions of the merger agreements, outstanding shares were exchanged under certain exchange ratios in effect at the time of merger. Options granted under these plans generally vest at a rate of 25% on the first anniversary of the vesting commencement date and then ratably over the following 36 months. Options expire as determined by the board of directors, but not more than ten years after the date of grant.

Table of Contents**NETWORK APPLIANCE, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Dollar and share amounts in thousands, except per-share data)**

A summary of the combined activity under our stock option plans and agreements is as follows:

	Shares Available for Grant	Outstanding Options	
		Number of Shares	Weighted Average Exercise Price
Balances, April 30, 1999 (26,348 options exercisable at a weighted average exercise price of \$1.73)	22,320	69,972	\$ 3.53
Shares reserved for plan	13,200		
Options granted (weighted average fair value of \$13.98)	(25,773)	25,773	28.60
Options exercised		(18,976)	2.55
Options canceled	3,127	(3,127)	7.19
Balances, April 30, 2000 (24,845 options exercisable at a weighted average exercise price of \$2.87)	12,874	73,642	12.45
Shares reserved for plan	15,614		
Options granted (weighted average fair value of \$26.84)	(17,868)	17,868	45.03
Options exercised		(15,484)	4.41
Options canceled	3,462	(3,462)	25.92
Balances, April 30, 2001 (30,285 options exercisable at a weighted average exercise price of \$9.01)	14,082	72,564	21.50
Shares reserved for plan	13,400		
Options granted (weighted average fair value of \$10.03)	(16,444)	16,444	16.15
Options exercised		(5,291)	3.88
Options canceled	4,198	(4,198)	37.04
Balances, April 30, 2002	15,236	79,519	\$20.74

Additional information regarding options outstanding as of April 30, 2002 is as follows:

Options Outstanding					
Range of Exercise Prices	Number Outstanding at April 30, 2002	Weighted Average Remaining Contractual Life (in years)	Weighted Average Exercise Price	Options Exercisable	
				Number Exercisable	Weighted Average Exercise Price
\$ 0.01 - \$ 2	45 9,590	4.47	\$ 1.67	9,442	\$ 1.69
2.74 - 4.	51 11,338	5.89	3.97	10,200	3.91
4.80 - 11.2	5 10,700	7.08	9.11	6,989	8.81
11.55 - 15.	32 13,454	8.88	14.10	3,099	13.22

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15.72 - 20.	16 13,250	8.39	18.93	5,124	18.60
20.52 - 31.	25 8,066	8.88	24.87	2,071	28.52
33.63 - 53.	94 8,336	8.06	51.00	3,555	50.33
56.94 - 124.9	9 4,785	8.16	88.78	2,184	88.71
	<u> </u>			<u> </u>	
\$ 0.01 - \$124.	99 79,519	7.47	\$20.74	42,664	\$16.06
	<u> </u>			<u> </u>	

Employee Stock Purchase Plan Under the Employee Stock Purchase Plan (ESPP), employees are entitled to purchase shares of our common stock at 85% of the fair market value at certain specified dates. In fiscal 2002, the plan was amended to increase the share reserve by an additional 3,000 shares of common stock and extend the term of the ESPP to the last business day of May, 2011. Of the 11,200 shares authorized to be

Table of Contents**NETWORK APPLIANCE, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Dollar and share amounts in thousands, except per-share data)**

issued under this plan, 4,171 shares were available for issuance at April 30, 2002, and 1,094, 448, and 1,473 shares were issued in fiscal 2002, 2001, and 2000, respectively, at a weighted average price of \$14.60, \$27.96, and \$3.87, respectively.

Pro Forma Information As discussed in Note 2, we continue to account for our stock-based awards using the intrinsic value method in accordance with APB No. 25, *Accounting for Stock Issued to Employees* and its related interpretations. Accordingly, no compensation expense has been recognized in the financial statements for employee stock arrangements with the exception of \$7,202, \$6,223, and \$1,345 in fiscal 2002, 2001, and 2000, respectively, which consists of the amortization of deferred stock compensation related to the granting of nonqualified stock options at exercise prices below market, the recognition of stock compensation of unvested options assumed in the WebManage acquisition, and the issue of contingently issuable milestone shares.

Our calculations are based on a multiple option valuation approach, and forfeitures are recognized as they occur. Pro forma information under SFAS 123 is as follows:

	Years Ended April 30,		
	2002	2001	2000
Net income (loss)	\$(263,544)	\$(151,713)	\$18,622
Net income (loss) per share, basic	(0.79)	(0.47)	0.06
Net income (loss) per share, diluted	(0.79)	(0.47)	0.05

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 following weighted-average assumptions are used:

	Employee Stock Option Plans Years Ended April 30,			Employee Stock Purchase Plan Years Ended April 30,		
	2002	2001	2000	2002	2001	2000
Expected Life (in years)	3.33	3.21	3.20	0.50	0.50	0.50
Risk-free interest rate	5%	6%	6%	3%	6%	5%
Volatility	92%	80%	65%	92%	80%	65%
Expected dividend						

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 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.

Deferred Stock Compensation We recorded \$1,301, \$14,127, and \$1,845 of deferred compensation in fiscal 2002, 2001 and 2000, respectively, primarily related to the recognition of stock compensation of unvested options assumed in the WebManage acquisition, and the grant of stock options to certain highly compensated employees. We reversed \$5,381, \$34, and \$40 of deferred compensation in fiscal 2002, 2001, and 2000, respectively due to employee terminations. The reversal in fiscal 2002 primarily related to the forfeiture of unvested options assumed in the WebManage acquisition as a result of employee terminations.

Table of Contents**NETWORK APPLIANCE, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Dollar and share amounts in thousands, except per-share data)**

Under terms of the 1995 Stock Option Plan, highly compensated employees as defined by our management are eligible to contribute between \$15 and \$75 in annual salary for the rights to be granted nonqualified stock options. The discount from fair market value, which is equal to the amount of salary contributed, has been recorded as deferred compensation expense. The deferred compensation expense is amortized ratably over a one-year period.

In fiscal 2001, under terms of the acquisition agreement with WebManage, we issued an additional 101 shares of common stock to former WebManage stockholders upon meeting certain performance criteria. The fair market value of the shares of \$3,000 was measured on the date the performance criteria were met and was recognized as stock compensation.

In fiscal 2002, under terms of the acquisition agreement with Orca, we released an additional 165 shares of common stock to former Orca stockholders upon meeting certain performance criteria. The fair market value of the shares of \$3,015 was measured on the date the performance criteria were met and was recognized as stock compensation.

In fiscal 2002, we issued an option grant of 100,000 shares of common stock under the 1999 Plan to a nonemployee board member with an exercise price of \$15.72 per share, the fair market value per share on the grant date, in recognition for services performed outside of the normal capacity of a board member. 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.

7. Income Taxes

Income before income taxes is as follows:

	Years Ended April 30,		
	2002	2001	2000
Domestic	\$(30,482)	\$ 105,262	\$ 105,806
Foreign	33,015	27,747	8,600
Total	\$ 2,533	\$ 133,009	\$ 114,406

The provision for income taxes consists of the following:

	Years Ended April 30,		
	2002	2001	2000
Current:			
Federal	\$(3,141)	\$ 50,383	\$ 41,475
State	(134)	20,075	7,973
Foreign	5,356	9,670	2,780
Total current	2,081	80,128	52,228

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Deferred:

Federal	1,552	(7,556)	(8,631)
State	(4,133)	(14,449)	(2,983)
	<u> </u>	<u> </u>	<u> </u>
Total deferred	(2,581)	(22,005)	(11,614)
	<u> </u>	<u> </u>	<u> </u>
Provision/(benefit) for income taxes	\$ (500)	\$ 58,123	\$ 40,614
	<u> </u>	<u> </u>	<u> </u>

Table of Contents**NETWORK APPLIANCE, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Dollar and share amounts in thousands, except per-share data)**

The provision for income taxes differs from the amount computed by applying the statutory federal income tax rate as follows:

	Years Ended April 30,		
	2002	2001	2000
Tax computed at federal statutory rate	\$ 886	\$46,553	\$40,042
State income taxes, net of federal benefit	(2,774)	3,657	5,720
Federal and state credits	(3,543)	(1,976)	(2,623)
Tax exempt interest	(582)	(4,467)	(3,301)
In process research and development		9,341	
Goodwill amortization	5,098	3,070	
Deferred acquisition costs	1,056		
Foreign earnings in lower tax jurisdiction	(1,469)		
Other	828	1,945	776
	<u> </u>	<u> </u>	<u> </u>
Provision/(benefit) for income taxes	\$ (500)	\$58,123	\$40,614
	<u> </u>	<u> </u>	<u> </u>

The income tax benefits associated with disposition from employee stock transactions of \$4,952, \$65,062, and \$56,248, respectively, for fiscal 2002, 2001, and 2000, were recognized as additional paid in capital.

The components of our deferred tax assets and liabilities are as follows:

	Years Ended April 30,	
	2002	2001
Inventory reserves and capitalization	\$ 12,020	\$ 19,235
Reserves and accruals not currently deductible	12,024	8,099
Net operating loss and credit carryforwards	371,898	335,145
Deferred stock compensation	3,767	2,788
Deferred revenue	10,768	10,934
Capitalized research and development expenditures	16,622	12,522
Write-down of investments	5,203	
Unrealized loss on investments	109	985
Other	323	895
	<u> </u>	<u> </u>
Gross deferred tax assets	432,734	390,603
Valuation allowance	(367,613)	(330,860)
	<u> </u>	<u> </u>
Deferred tax assets	65,121	59,743
Depreciation	(4,126)	(1,134)
State deferred taxes	(8,213)	(6,767)
Acquisition intangibles	(3,870)	(5,512)
	<u> </u>	<u> </u>
Deferred tax liabilities	(16,209)	(13,413)

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Net deferred tax assets	\$ 48,912	\$ 46,330
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Current net deferred tax assets are \$32,529 and \$36,287, as of fiscal 2002 and 2001, respectively. Non-current net deferred tax assets for fiscal 2002 and 2001 are \$16,383 and \$10,043, respectively, and are included in other assets within the accompanying consolidated balance sheets.

As of fiscal 2002, the federal and state net operating loss carryforwards for income tax purposes were approximately \$832,681 and \$160,687, respectively. The federal net operating loss carryforwards will begin to expire in fiscal 2011, and the state net operating loss carryforwards will begin to expire in fiscal 2006. As of

Table of Contents**NETWORK APPLIANCE, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Dollar and share amounts in thousands, except per-share data)**

fiscal 2002, we had federal and state credit carryforwards of approximately \$34,406 and \$31,602, respectively, available to offset future taxable income. These federal credit carryforwards will begin to expire in fiscal 2013 and the state credits will begin to expire in fiscal 2008.

We have provided a valuation allowance on certain of our deferred tax assets because of uncertainty regarding their realizability due to expectation of future employee stock option exercises. Deferred tax assets of approximately \$367,613 and \$330,860 at the end of fiscal 2002 and 2001, respectively, pertain to certain tax credits and net operating loss carryforwards resulting from the exercise of employee stock options. If recognized, the tax benefit of these credits and losses will be accounted for as a credit to stockholders' equity rather than as a reduction of the income tax provision.

8. Segment, Geographic and Customer Information

Under SFAS 131, Disclosures about Segments of an Enterprise and Related Information, we operate in one reportable industry segment: the design, manufacturing, marketing and technical support of high-performance networked storage solutions. We market our products in the United States and in foreign countries through our sales personnel and our subsidiaries. The Chief Executive Officer is our Chief Operating Decision Maker (CODM), as defined by SFAS 131. The CODM evaluates resource allocation decisions and operational performance based upon revenue by geographic regions of the segment. Under paragraph 17 of SFAS No. 131, we have one reportable segment as all the geographic operating segments identified can be aggregated into one reportable segment. For the years ended April 30, 2002, 2001 and 2000, we recorded revenue from customers throughout the United States and Canada; Europe; Latin America, Australia and Asia Pacific.

The following presents total revenues for the years ended April 30, 2002, 2001, and 2000 by geographic area and long-lived assets as of April 30, 2002 and 2001 by geographic area.

	Years Ended April 30,		
	2002	2001	2000
Total Revenues:			
United States	\$463,162	\$ 623,704	\$401,377
International	335,207	382,482	177,923
	<hr/>	<hr/>	<hr/>
Total revenues	\$798,369	\$ 1,006,186	\$579,300
	<hr/>	<hr/>	<hr/>
Long-lived Assets:			
United States	\$415,372	\$ 198,468	
International	14,306	8,520	
	<hr/>	<hr/>	
Total Long-lived Assets	\$429,678	\$ 206,988	
	<hr/>	<hr/>	

Total revenues above are attributed to regions based on the customers' shipment locations.

International sales include export sales primarily to the United Kingdom, Germany, Japan, France, Israel, the Netherlands, Switzerland, Sweden, Canada and Australia. No single foreign country accounted for 10% or more of total revenues in fiscal 2002, 2001, and 2000.

No customer accounted for 10% or more of total revenues in fiscal 2002, 2001, or 2000.

9. Fair Value of Financial Instruments

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The following summary disclosures are made in accordance with the provisions of SFAS No. 107, Disclosures About Fair Value of Financial Instruments, which requires the disclosure of fair value information about both on-and off-balance sheet financial instruments where it is practicable to estimate the

Table of Contents**NETWORK APPLIANCE, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Dollar and share amounts in thousands, except per-share data)**

value. Fair value is defined in SFAS 107 as the amount at which an instrument could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale. Because SFAS 107 excludes certain financial instruments and all non-financial instruments from its disclosure requirements, any aggregation of the fair value amounts presented would not represent the underlying value of the Company. Amounts at April 30 consist of:

	Years Ended April 30,			
	2002		2001	
	Carrying Amount	Estimated Fair Value	Carrying Amount	Estimated Fair Value
Assets:				
Cash and cash equivalents	\$ 210,756	\$ 210,756	\$ 271,931	\$ 271,931
Short-term investments	243,371	243,371	92,094	92,094
Other investments in equity securities	1,724	1,724	10,084	10,084
Restricted cash			193,747	193,747

We do not use derivative financial instruments for speculative or trading purposes. We enter into forward foreign exchange contracts to hedge trade and intercompany receivables and payables against future movement in foreign exchange rates. All hedge contracts are marked to market through earnings every period.

The forward foreign exchange contracts require us to exchange foreign currencies for U.S. dollars or vice versa and generally mature in one month or less. As of April 30, 2002, we had \$90,459 of outstanding foreign exchange contracts in Australian Dollars, British Pounds, Swiss Francs and European Currency Units, that had remaining maturities of one month or less. As of April 30, 2001, we had \$81,944 of outstanding foreign exchange contracts in British Pounds, Swiss Francs and European Currency Units, that had remaining maturities of one month or less. These foreign exchange contracts are adjusted to the fair value at the end of every month and are included in other income (expense), net. Gains and losses on these foreign exchange contracts are offset by losses and gains on the underlying assets and liabilities. At April 30, 2002 and 2001, the estimated fair values of forward foreign exchange contracts were \$90,603 and \$82,385, respectively. Unrealized gains or losses on foreign exchange contracts were not significant at April 30, 2002. The fair value of foreign exchange contracts is based on prevailing financial market information. Other than foreign exchange contracts, we have not entered into any other material financial derivative instruments.

Approximately \$193,747 of our investment portfolio at April 30, 2001 was invested in a certificate of deposit and was restricted to collateralize our operating leases and classified as non-current restricted cash. In fiscal 2002, the restricted investments were converted to property and equipment on the balance sheet as we discontinued our operating leases by purchasing the land and buildings at our Sunnyvale, California headquarters site.

The fair values of cash and cash equivalents, short-term investments and restricted cash reported in the consolidated balance sheets approximate their carrying value. The fair value of short-term investments and foreign exchange contracts is based on quoted market prices. Other investments in equity securities comprise investments in companies in the volatile high-technology market.

10. Employee Benefit Plan

We have established a 401(k) tax-deferred savings plan (Savings Plan). Employees meeting the eligibility requirements, as defined, may contribute specified percentages of their salaries. We contributed \$1,235, \$1,109, and \$611 for fiscal 2002, 2001, and 2000, respectively.

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NETWORK APPLIANCE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

11. Acquisitions

In June 2000, we completed the acquisition of Orca, a Waltham, Massachusetts-based developer of high performance Virtual Interface (VI) Architecture software for enterprise-class UNIX and Windows systems. The acquisition fits with our strategy of developing highly available and reliable intelligent storage solutions that improve the performance of today's Internet and enterprise applications and strengthen our ability to develop next generation storage networking architectures and protocols. The acquisition was accounted for as a purchase. Under terms of the agreement, we acquired Orca for \$50,037 in common stock, assumed options and cash, with an obligation to provide 264 shares of common stock, which will result in additional stock compensation charges if certain performance criteria are achieved. Certain performance criteria were met and as such, 165 shares of common stock were issued and recorded during fiscal 2002. The fair market value of such shares of \$3,015 was measured on the date the performance criteria were met and was recognized as stock compensation. The remaining 99 shares of contingently issuable common stock will be issued if certain performance criteria are achieved. We also paid certain transaction costs and assumed certain operating assets and liabilities.

The purchase price of the transaction was allocated to the acquired assets and liabilities based on their estimated fair values as of the date of the acquisition. Approximately \$26,688 was allocated to in-process research and development and charged to operations because the acquired technology had not reached technological feasibility and had no alternative uses. The value was determined by estimating the costs to develop the acquired in-process technology into commercially viable products, estimating the resulting net cash flows from such projects, and discounting the net cash flows back to their present value. The discount rate included a factor that took into account the uncertainty surrounding the successful development of the acquired in-process technology. These estimates are subject to change, given the uncertainties of the development process, and no assurance can be given that deviations from these estimates will not occur. Excluding the charge that may result from 264 contingently issuable common shares, research and development costs to bring the products from Orca to technological feasibility are not expected to have a material impact on our future results of operations or financial condition. Costs incurred prior to establishment of technological feasibility are charged to research and development expense and have not been material through April 30, 2002. The Orca acquisition has been successfully utilized for the design and development of the DAFS protocol. By eliminating much of the traditional operating system overhead, DAFS allows for improved I/O performance while using fewer CPU cycles. The protocol leverages next generation networking technologies that provide remote memory transfer capabilities, including RDMA implemented in VI and Infiniband. The DAFS protocol has good industry support and is now under consideration as an industry standard. We introduced DAFS capable product in April 2002.

In November 2000, we completed the acquisition of WebManage, a Chelmsford, Massachusetts-based software developer of content management, distribution, and analysis solutions. WebManage develops software that intelligently distributes content between various points on the Internet and enables organizations to plan, manage and deliver Internet/intranet services. The acquisition was accounted for as a purchase. Under terms of the agreement, we acquired WebManage for \$59,371 in common stock, assumed options, and cash. We also had an obligation to provide shares of common stock to be valued at \$3,000 if certain performance criteria were achieved. The performance criteria were met in March 2001 and as such, the contingent consideration has been recorded as stock compensation in the fourth quarter of 2001. We also paid certain transaction costs and assumed certain operating assets and liabilities.

Table of Contents**NETWORK APPLIANCE, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Dollar and share amounts in thousands, except per-share data)**

The total purchase prices and final allocation among the fair value of tangible and intangible assets and liabilities acquired (including purchased in-process technology) are summarized as follows (*in thousands*):

Total Purchase Price:

	<u>Orca</u>	<u>WebManage</u>
Total cash consideration	\$ 2,000	\$ 4,970
Value of shares issued	23,526	41,909
Value of options assumed	24,053	24,053
Deferred stock compensation		(12,304)
Transaction costs	458	743
	<u>\$50,037</u>	<u>\$ 59,371</u>

Purchase Price Allocation:

	<u>\$</u>	<u>\$</u>	<u>Amortization Period</u>
			<u>(Years)</u>
Tangible assets	\$ 353	\$ 868	
Intangible assets:			
Existing Technology		17,179	3
Existing Workforce	423	1,380	3
Goodwill	24,101	48,085	5
In-process R&D	26,688		Expensed
Tangible liabilities	(1,359)	(1,276)	
Deferred income taxes	(169)	(6,865)	
	<u>\$50,037</u>	<u>\$59,371</u>	

In accordance with FASB interpretation No. 44, Accounting for Certain Transactions Involving Stock Compensation, we recorded the intrinsic value, measured as the difference between the grant price and fair market value on the acquisition consummation date, of unvested options assumed in the WebManage acquisition as deferred stock compensation. Such deferred stock compensation, which aggregated \$12,304, is recorded as a separate component of stockholders' equity in the accompanying condensed consolidated balance sheet and will be amortized over the vesting term of the related options.

The operating results of Orca and WebManage have been included in the condensed consolidated statements of operations since their acquisition dates. The following unaudited pro forma consolidated amounts give effect to these acquisitions as if they had occurred on April 30, 1999 by consolidating the results of operations of the acquired entities with our results for the years ended April 30, 2001 and April 30, 2000.

<u>Years Ended April 30,</u>	
<u>2001</u>	<u>2000</u>
(In thousands)	

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Revenues	\$ 1,006,738	\$ 581,206
Net Income	\$ 88,197	\$ 51,092
Net Income per share:		
Basic	\$ 0.28	\$ 0.17
	<u> </u>	<u> </u>
Diluted	\$ 0.24	\$ 0.15
	<u> </u>	<u> </u>
Shares used in per share calculation:		
Basic	320,712	300,288
	<u> </u>	<u> </u>
Diluted	360,160	346,433
	<u> </u>	<u> </u>

Table of Contents**NETWORK APPLIANCE, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Dollar and share amounts in thousands, except per-share data)**

The pro-forma results of operations give effect to certain adjustments, including amortization of purchased intangibles, goodwill, contingently issuable shares, common stock, and assumed options in connection with the acquisitions. The \$26,688 charge for purchased in-process research and development has been excluded from the pro-forma results, as it is a material nonrecurring charge.

12. Restructuring Charges*Fiscal 2002 Second Quarter Restructuring Plan:*

In August 2001, we implemented a restructuring plan, which included a reduction in workforce by approximately 200 employees and a consolidation of facilities. The action was required to properly align and manage the business commensurate with our then current revenue levels. All functional areas of the Company were affected by the reduction. We completed our actions during the second quarter of fiscal 2002. As a result of this restructuring, we incurred a charge of \$7,980. The restructuring charge included \$4,796 of severance-related amounts, \$2,656 of committed excess facilities and facility closure expenses, and \$528 in fixed assets write-offs.

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

The following analysis sets forth the significant components of the restructuring reserve at April 30, 2002:

	<u>Severance- Related Amounts</u>	<u>Fixed Assets Write-Off</u>	<u>Facility</u>	<u>Total</u>
Restructuring charge	\$ 4,796	\$ 528	\$ 2,656	\$ 7,980
Cash payments	(4,508)		(803)	(5,311)
Non-cash portion		(528)	(37)	(565)
Adjustments	(95)		(1,509)	(1,604)
	<u> </u>	<u> </u>	<u> </u>	<u> </u>
Reserve balance at April 30, 2002	\$ 193	\$	\$ 307	\$ 500
	<u> </u>	<u> </u>	<u> </u>	<u> </u>

Fiscal 2002 Fourth Quarter Restructuring Plan:

In April 2002, we announced and substantially completed a restructuring related to the closure of an engineering facility and consolidation of resources to the Sunnyvale headquarters, which included a headcount reduction of 34 employees. 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-off.

The following analysis sets forth the significant components of the restructuring reserve at April 30, 2002:

	<u>Severance- Related Amounts</u>	<u>Fixed Assets Write-Off</u>	<u>Facility</u>	<u>Total</u>
Restructuring charge	\$ 813	\$ 473	\$4,564	\$5,850
Cash payments	(629)		(32)	(661)
Non-cash portion		(473)		(473)
	<u> </u>	<u> </u>	<u> </u>	<u> </u>

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Reserve balance at April 30, 2002	\$ 184	\$	\$4,532	\$4,716
	<u> </u>	<u> </u>	<u> </u>	<u> </u>

Of the reserve balance at April 30, 2002, \$1,061 was included in other accrued liabilities and the remaining \$3,655 was classified as long-term obligations.

Table of Contents**NETWORK APPLIANCE, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

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

13. Selected Quarterly Financial Data (Unaudited)

	Year Ended April 30, 2002			
	Q1	Q2	Q3	Q4
Total revenues	\$ 200,426	\$ 194,715	\$ 198,349	\$ 204,879
Gross margin	112,349	113,731	123,337	131,106
Net income (loss)	(513)	(11,211)	6,984	7,773
Net income (loss) per share, basic	(0.00)	(0.03)	0.02	0.02
Net income (loss) per share, diluted	(0.00)	(0.03)	0.02	0.02

	Year Ended April 30, 2001			
	Q1	Q2	Q3	Q4
Total revenues	\$ 231,159	\$ 260,777	\$ 288,409	\$ 225,841
Gross margin	141,702	161,463	174,646	126,668
Net income	4,976	35,360	34,071	479
Net income per share, basic	0.02	0.11	0.11	0.00
Net income per share, diluted	0.01	0.10	0.09	0.00

14. Revision of Future Minimum Lease Payments

Subsequent to the issuance of the Company's fiscal 2002 consolidated financial statements, the Company's management determined that the future minimum annual lease payments as of April 30, 2002 had been improperly calculated. As a result, the future minimum annual lease payments have been revised in Note 4 from the amounts previously reported.

A summary of the effects of this revision on future minimum annual lease payments are as follows:

Years Ending April 30	As Previously Reported	As Revised
2003	\$ 9,194	\$ 10,344
2004	7,786	9,336
2005	7,624	7,790
2006	4,559	5,443
2007	2,817	2,863
Thereafter	122,444	11,138
Total lease payments	\$ 154,424	\$ 46,914

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PART IV

Item 14. Exhibits, Financial Statement Schedules and Reports on Form 8-K

(a)(1) The following consolidated financial statements of Network Appliance, Inc. and Report of Deloitte & Touche LLP, have been filed as part of this Form 10-K/A under Item 8, above:

Index to Consolidated Financial Statements

Independent Auditors Report

Consolidated Balance Sheets April 30, 2002 and 2001

Consolidated Statements of Income for the years ended April 30, 2002, 2001, and 2000

Consolidated Statements of Stockholders Equity and Comprehensive Income for the years ended April 30, 2002, 2001, and 2000

Consolidated Statements of Cash Flows for the years ended April 30, 2002, 2001, and 2000

Notes to Consolidated Financial Statements

(a)(2) *Financial Statement Schedule.*

The following financial statement schedule of the Company is filed in Part IV, Item 14(d) of this Annual Report:

Schedule II Valuation and Qualifying Accounts

All other schedules have been omitted since the required information is not present in amounts sufficient to require submission of the schedule or because the information required is included in the consolidated financial statements or notes thereto.

(a)(3) *Exhibits.*

Exhibit No.	Description
2.1(7)	Agreement and Plan of Merger of Network Appliance, Inc. (a Delaware corporation) and Network Appliance, Inc. (a California corporation).
3.1(7)	Certificate of Incorporation of the Company.
3.2(7)	Bylaws of the Company.
4.1(7)	Reference is made to Exhibits 3.1 and 3.2.
10.1(1)	The Company's Employee Stock Purchase Plan.
10.2(2)	The Company's Amended and Restated 1995 Stock Incentive Plan.
10.3(2)	The Company's Special Non-Officer Stock Option Plan.
10.4(8)	The Company's 1999 Stock Incentive Plan.
10.5 (3)	OEM Distribution and License Agreement, dated October 27, 1998, by and between Dell Products L.P. and the Company.
10.6(4)	OEM Distribution and License Agreement, dated November 6, 1998, by and between Fujitsu Limited and the Company.
10.7(5)	Closing Certificate (Phase IV) and Agreement, dated October 2, 2000, by and between BNP Leasing Corporation and the Company.
10.8(5)	Construction Management Agreement (Phase IV), dated October 2, 2000, by and between BNP Leasing Corporation and the Company.
10.9(5)	Purchase Agreement (Phase IV Land), dated October 2, 2000, by and between BNP Leasing Corporation and the Company.

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- 10.10(5) Pledge Agreement (Phase IV Land), dated October 2, 2000, by and between BNP Leasing Corporation and the Company.
- 10.11(5) Lease Agreement (Phase IV Land), dated October 2, 2000, by and between BNP Leasing Corporation and the Company.

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Exhibit No.	Description
10.12(5)	Purchase Agreement (Phase IV Improvements), dated October 2, 2000, by and between BNP Leasing Corporation and the Company.
10.13(5)	Pledge Agreement (Phase IV Improvements), dated October 2, 2000, by and between BNP Leasing Corporation and the Company.
10.14(5)	Lease Agreement (Phase IV Improvements), dated October 2, 2000, by and between BNP Leasing Corporation and the Company.
10.15 (6)	Patent Cross License Agreement dated December 11, 2000 by and between Intel Corporation and the Company.
10.16(1)	Form of Indemnification Agreement entered into between the Company and its directors and officers.
10.17(9)	Short Form Termination of Operative Documents, dated April 24, 2002, by and between BNP Leasing Corporation and the Company.
21.1(9)	Subsidiaries of the Company.
23.1	Independent Auditors Consent.
24.1(9)	Power of Attorney (see signature page).
99.1	Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

- (1) Previously filed as an exhibit to the Company's Registration Statement on Form S-1 (No. 33-97864).
- (2) Previously filed as an exhibit with the Company's Annual Report on Form 10-K dated July 23, 1997.
- (3) Previously filed as an exhibit with the Company's Quarterly Report on Form 10-Q dated December 11, 1998.
- (4) Previously filed as an exhibit with the Company's Quarterly Report on Form 10-Q dated March 11, 1999.
- (5) Previously filed as an exhibit with the Company's Quarterly Report on Form 10-Q dated December 11, 2000.
- (6) Previously filed as an exhibit with the Company's Quarterly Report on Form 10-Q dated March 12, 2001.
- (7) Previously filed as an exhibit with the Company's Current Report on Form 8-K dated December 4, 2001.
- (8) Previously filed as an exhibit with the Company's Registration Statement on Form S-8 dated November 26, 2001.
- (9) Previously filed as an exhibit with the Company's Annual Report on Form 10-K dated June 28, 2002.

Specified portions of this agreement have been omitted and have been filed separately with the Commission pursuant to a request for confidential treatment.

(b) *Reports on Form 8-K.*

We filed a current report on Form 8-K, dated November 1, 2001, describing, pursuant to Item 5, the completion of our reincorporation into the State of Delaware.

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SIGNATURE

Pursuant to the requirements of Section 13 or 15(d) 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: December 6, 2002

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**CERTIFICATIONS PURSUANT TO RULE 13a-14 UNDER THE
SECURITIES EXCHANGE ACT OF 1934, AS AMENDED**

I, Daniel J. Warmenhoven, Chief Executive Officer, certify that:

1. I have reviewed this annual report on Form 10-K/A of Network Appliance Inc. (the registrant);
2. Based on my knowledge, this annual 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 annual report;
3. Based on my knowledge, the financial statements, and other financial information included in this annual 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 annual report.

Date: December 6, 2002

/s/ DANIEL J. WARMENHOVEN

Daniel J. Warmenhoven
Chief Executive Officer

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**CERTIFICATIONS PURSUANT TO RULE 13a-14 UNDER THE
SECURITIES EXCHANGE ACT OF 1934, AS AMENDED**

I, Steven J. Gomo, Senior Vice President and Chief Financial Officer, certify that:

1. I have reviewed this annual report on Form 10-K/A of Network Appliance Inc. (the registrant);
2. Based on my knowledge, this annual 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 annual report;
3. Based on my knowledge, the financial statements, and other financial information included in this annual 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 annual report.

Date: December 6, 2002

/S/ STEVEN J. GOMO

Steven J. Gomo
Senior Vice President and Chief Financial Officer

Table of Contents**SCHEDULE II****NETWORK APPLIANCE, INC.**

VALUATION AND QUALIFYING ACCOUNTS
YEARS ENDED APRIL 30, 2002, 2001 AND 2000
(In thousands)

Description	Balance at Beginning of Period	Charged to Costs and Expenses	Deductions	Balance at End of Period
Allowance for doubtful accounts:				
2002	\$4,030	\$7,549	\$3,163	\$8,416
2001	3,039	2,443	1,452	4,030
2000	1,886	1,275	122	3,039

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