NETWORK APPLIANCE INC
Form 10-Q
March 07, 2007

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UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

Form 10-Q

(Mark One)

þ **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d)**
OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended January 26, 2007

or

o **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d)**
OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from to

Commission file number 0-27130

Network Appliance, Inc.
(Exact name of registrant as specified in its charter)

Delaware	**77-0307520**
(State or other jurisdiction of incorporation or organization)	*(IRS Employer Identification No.)*

495 East Java Drive,
Sunnyvale, California 94089
(Address of principal executive offices, including zip code)

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes þ No o

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act.

Large accelerated filer þ Accelerated filer o Non-accelerated filer o

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act). Yes o No þ

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

Class	Outstanding at February 23, 2007
Common Stock	371,059,425

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TRADEMARKS

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PART I. FINANCIAL INFORMATION

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

NETWORK APPLIANCE, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS

	January 26, 2007	April 30, 2006
	(In thousands	unaudited)
ASSETS		
Current Assets:		
Cash and cash equivalents	$ 490,216	$ 461,256
Short-term investments	805,094	861,636
Accounts receivable, net of allowances of $2,775 at January 26, 2007 and $2,380 at April 30, 2006	438,818	415,295
Inventories	61,474	64,452
Prepaid expenses and other assets	48,266	43,536
Short-term restricted cash and investments	126,014	138,539
Deferred income taxes	63,542	48,496
Total current assets	2,033,424	2,033,210
Property and Equipment, net	586,578	513,193
Goodwill	601,318	487,535
Intangible Assets, net	89,994	75,051
Long-Term Restricted Cash and Investments	59,702	108,371
Other Assets	122,273	43,605
	$ 3,493,289	$ 3,260,965
LIABILITIES AND STOCKHOLDERS EQUITY		
Current Liabilities:		
Current portion of long-term debt	$ 123,951	$ 166,211
Accounts payable	124,262	101,278
Income taxes payable	39,305	51,577
Accrued compensation and related benefits	147,832	129,636
Other accrued liabilities	91,119	69,073
Deferred revenue	546,562	399,388
Total current liabilities	1,073,031	917,163
Long-Term Debt	27,180	133,789
Long-Term Deferred Revenue	398,326	282,149
Long-Term Obligations	19,883	4,411

Total liabilities	1,518,420	1,337,512
Stockholders Equity:		
Common stock (419,094 shares at January 26, 2007 and 407,994 shares at April 30, 2006)	419	408
Additional paid-in capital	2,262,428	1,872,962
Deferred stock compensation		(49,266)
Treasury stock (48,980 shares at January 26, 2007 and 31,996 shares at April 30, 2006)	(1,423,690)	(817,983)
Retained earnings	1,136,544	928,430
Accumulated other comprehensive loss	(832)	(11,098)
Total stockholders equity	1,974,869	1,923,453
	$ 3,493,289	$ 3,260,965

See accompanying notes to unaudited condensed consolidated financial statements.

NETWORK APPLIANCE, INC.

CONDENSED CONSOLIDATED STATEMENTS OF INCOME

	Three Months Ended		Nine Months Ended	
	January 26, 2007	January 27, 2006	January 26, 2007	January 27, 2006
	(In thousands, except per share amounts unaudited)			
Revenues:				
Product	$ 550,882	$ 413,489	$ 1,497,777	$ 1,122,135
Software subscriptions	84,969	60,747	242,052	171,507
Service	93,427	62,795	263,260	174,853
Total	729,278	537,031	2,003,089	1,468,495
Cost of Revenues:				
Cost of product	211,211	161,349	585,437	432,131
Cost of software subscriptions	2,710	2,156	7,458	6,232
Cost of service	71,248	46,502	191,708	130,530
Total cost of revenues	285,169	210,007	784,603	568,893
Gross margin	444,109	327,024	1,218,486	899,602
Operating Expenses:				
Sales and marketing	236,433	153,333	636,214	430,377
Research and development	97,516	65,087	276,555	175,391
General and administrative	37,724	25,022	105,337	68,011
In process research and development				5,000
Restructuring charges (recoveries)		117	(74)	(495)
Gain on sale of assets			(25,339)	
Total operating expenses	371,673	243,559	992,693	678,284
Income from Operations	72,436	83,465	225,793	221,318
Other Income (Expense), net:				
Interest income	17,086	9,891	51,220	28,590
Interest expense	(2,335)	17	(11,377)	(34)
Other income	533	984	3,191	487
Net gain (loss) on investments	884		(1,116)	101
Total other income (expense), net	16,168	10,892	41,918	29,144
Income before Income Taxes	88,604	94,357	267,711	250,462
Provision for Income Taxes	22,090	17,964	59,597	43,231
Net Income	$ 66,514	$ 76,393	$ 208,114	$ 207,231

Net Income per Share:				
Basic	$ 0.18	$ 0.21	$ 0.56	$ 0.56
Diluted	$ 0.17	$ 0.20	$ 0.53	$ 0.54
Shares Used in per Share Calculations:				
Basic	371,287	371,768	371,938	370,069
Diluted	389,120	389,149	389,555	386,991

See accompanying notes to unaudited condensed consolidated financial statements.

NETWORK APPLIANCE, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

	Nine Months Ended	
	January 26, 2007	January 27, 2006
	(In thousands unaudited)	
Cash Flows from Operating Activities:		
Net income	$ 208,114	$ 207,231
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	62,316	46,175
In process research and development		5,000
Amortization of intangible assets	14,970	11,329
Amortization of patents	1,486	1,487
Stock compensation	124,679	9,442
Net loss (gain) on investments	1,116	(101)
Gain on sale of assets	(25,339)	
Net loss on disposal of equipment	686	1,318
Allowance for doubtful accounts	186	921
Deferred rent	979	301
Excess tax benefit from stock-based compensation	(43,463)	
Changes in assets and liabilities:		
Accounts receivable	(22,996)	(70,153)
Inventories	3,495	(38,397)
Prepaid expenses and other assets	(981)	(6,590)
Accounts payable	4,446	16,072
Income taxes payable	31,569	39,620
Accrued compensation and related benefits	16,870	12,992
Other accrued liabilities	12,127	970
Deferred revenue	263,449	144,737
Net cash provided by operating activities	653,709	382,354
Cash Flows from Investing Activities:		
Purchases of investments	(1,938,191)	(450,555)
Redemptions of investments	2,007,726	471,755
Redemptions of restricted investments	63,236	
Increase (decrease) in restricted cash	333	(1,997)
Proceeds from sale of assets	23,914	
Purchases of property and equipment	(112,411)	(96,476)
Proceeds from sales of investments	1,774	130
Purchases of equity securities	(1,333)	(7,100)
Purchase of businesses, net of cash acquired	(131,241)	(53,747)
Net cash used in investing activities	(86,193)	(137,990)

Cash Flows from Financing Activities:				
Proceeds from sale of common stock related to employee stock transactions		177,425		141,725
Excess tax benefit from stock-based compensation		43,463		
Repayment of debt		(148,869)		
Tax withholding payments reimbursed by restricted stock		(4,692)		(794)
Repurchases of common stock		(605,708)		(390,147)
Net cash used in financing activities		(538,381)		(249,216)
Effect of Exchange Rate Changes on Cash and Cash Equivalents		(175)		(565)
Net Increase in Cash and Cash Equivalents		28,960		(5,417)
Cash and Cash Equivalents:				
Beginning of period		461,256		193,542
End of period	$	490,216	$	188,125
Noncash Investing and Financing Activities:				
Acquisition of property and equipment on account	$	17,157	$	11,158
Options assumed for acquired business	$	8,369	$	38,456
Common stocks received from sale of assets	$	9,069	$	
Supplemental cash flow information:				
Income taxes paid	$	30,260	$	5,625
Interest paid on debt	$	8,776	$	

See accompanying notes to unaudited condensed consolidated financial statements.

NETWORK APPLIANCE, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(In thousands, except per-share data)
(Unaudited)

1. The Company

Based in Sunnyvale, California, Network Appliance was incorporated in California in April 1992 and reincorporated in Delaware in November 2001. Network Appliance, Inc. is a leading supplier of enterprise storage and data management software and hardware products and services. Our solutions help global enterprises meet major information technology challenges such as managing storage growth, assuring secure and timely information access, protecting data, and controlling costs by providing innovative solutions that simplify the complexity associated with managing corporate data. Network Appliance^{tm} solutions are the data management and storage foundation for many of the world s leading corporations and government agencies. In the following notes to our interim condensed consolidated financial statements, Network Appliance is also referred to as we, our, and us.

2. Condensed Consolidated Financial Statements

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

We operate on a 52-week or 53-week year ending on the last Friday in April. For presentation purposes we have indicated in the accompanying interim unaudited condensed consolidated financial statements that our fiscal year end is April 30. The third quarter of fiscal 2007 and 2006 were both 13-week fiscal periods. The first nine months of fiscal 2007 and 2006 were both 39-week fiscal periods.

These financial statements should be read in conjunction with the audited consolidated financial statements and accompanying notes included in our Annual Report on Form 10-K for the year ended April 30, 2006. The results of operations for the quarter ended January 26, 2007 are not necessarily indicative of the operating results to be expected for the full fiscal year or future operating periods.

In fiscal 2006, we began to separately disclose software subscriptions revenue and cost of software subscriptions revenue in our income statements. All prior periods have been revised to reflect this presentation. Such balances were previously included as a part of product revenue and cost of product revenue and disclosed separately in our footnotes.

3. Significant Accounting Policies and Use of Estimates

Revenue Recognition: We apply the provisions of Statement of Position (SOP) No. 97-2, *Software Revenue Recognition* (SOP No. 97-2), and related interpretations to our product sales, both hardware and software, because our software is essential to the performance of our hardware. We recognize revenue when:

Persuasive evidence of an arrangement exists: It is our customary practice to have a purchase order and/or contract prior to recognizing revenue on an arrangement from our end users, customers, value-added resellers, or distributors.

Delivery has occurred: Our product is physically delivered to our customers, generally with standard transfer terms such as FOB origin. We typically do not allow for restocking rights with any of our value-

NETWORK APPLIANCE, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

added resellers or distributors. Products shipped with acceptance criteria or return rights are not recognized as revenue until all criteria are achieved. If undelivered products or services exist that are essential to the functionality of the delivered product in an arrangement, delivery is not considered to have occurred.

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

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

Our multiple element arrangements include our systems and generally may also include one or more of the following undelivered elements: software subscriptions, premium hardware maintenance, storage review services, and installation services. Our software subscriptions entitle our customers to receive unspecified product upgrades and enhancements on a when-and-if-available basis, bug fixes, and patch releases. Premium hardware maintenance services include contracts for technical support and minimum response times. Revenue from software subscriptions and premium hardware maintenance services is recognized ratably over the contractual term, generally from one to three years. We also offer extended service contracts (which extend our standard parts warranty and may include premium hardware maintenance) at the end of the warranty term; revenues from these contracts are recognized ratably over the contract term. When storage optimization reviews are sold as a bundled element with our software subscriptions and premium hardware maintenance services, the revenue is recognized ratably over the contract term. We typically sell technical consulting services separately from any of our other revenue elements, either on a time and materials basis or for fixed price standard projects; we recognize revenue for these services as they are performed. Revenue from hardware installation services is recognized at the time of delivery and any remaining costs are accrued, as the remaining undelivered services are considered to be inconsequential and perfunctory. For arrangements with multiple elements, we recognize as revenue the difference between the total arrangement price and the greater of fair value or stated price for any undelivered elements (the residual method).

If the arrangement contains both software-related and non-software-related elements, we allocate revenue to the non-software elements based on objective and reliable evidence of fair value in accordance with Emerging Issues Task Force (EITF) 00-21, *Revenue Arrangements with Multiple Deliverables.* Non-software elements are items for which the functionality of the software is not essential to its performance; the non-software-related elements in our arrangements may consist of storage optimization reviews (which are sold only within a bundled service offering that also contains software-related services), and/or technical consulting. For undelivered software-related elements, we apply the provisions of SOP No. 97-2 and determine fair value of these undelivered software-related elements based on vendor-specific objective evidence which for us consists of the prices charged when these services are sold separately. To determine the fair value of our undelivered elements, we analyze both the selling prices when the elements are sold separately as well as the concentrations of those prices. We believe these concentrations have been sufficient to enable us to establish VSOE or objective and reliable evidence of fair value for the undelivered elements. If VSOE or objective and reliable evidence cannot be obtained to establish fair value of the undelivered elements, revenue from the entire arrangement would be deferred and recognized once these elements are delivered or fair value is established.

We record reductions to revenue for estimated sales returns at the time of shipment. Sales returns are estimated based on historical sales returns, current trends, and our expectations regarding future experience. Reductions to revenue associated with sales returns include consideration of historical sales levels, the timing and magnitude of historical sales returns, and a projection of this experience into the future. We monitor and analyze the accuracy of sales returns estimates by reviewing actual returns and adjust them for future expectations to determine the

NETWORK APPLIANCE, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

adequacy of our current and future reserve needs. If actual future returns and allowances differ from past experience, additional allowances may be required.

Stock-Based Compensation: Beginning in fiscal 2007, we estimate the fair value of stock options using the Black-Scholes valuation model, consistent with the provisions of the Financial Accounting Standards Board s (FASB) SFAS No. 123 (revised 2004), *Share-Based Payment* (SFAS No. 123R) as interpreted by Staff Accounting Bulletin (SAB) No. 107. Option-pricing models require the input of highly subjective assumptions, including the expected term of options, the determination of risk-free interest rates, and the expected price volatility of the stock underlying such options. In addition, we estimate the number of share-based awards that will be forfeited due to employee turnover based on historical trends. Finally, we capitalize into inventory a portion of the periodic stock-based compensation expense that relates to employees working in manufacturing activities.

In November 2005, FASB issued Financial Statement Position, or FSP, on SFAS No. 123R, *Transition Election Related to Accounting for Tax Effects of Share-Based Payment Awards* (FSP No. 123R-3). Effective upon issuance, FSP No. 123R-3 provides for an alternative transition method for calculating the tax effects of stock-based compensation expense pursuant to SFAS No. 123R. The alternative transition method provides simplified approaches to establish the beginning balance of a tax benefit pool comprised of the additional paid-in capital, or APIC, related to the tax effects of employee stock-based compensation expense, and to determine the subsequent impact on the APIC tax benefit pool and the statement of cash flows of stock-based awards that were outstanding upon the adoption of SFAS No. 123R. Because we have not made the election to use the simplified approach to establish the beginning balance of the tax benefit pool, the tax effects of stock-based compensation expense were calculated as if Statement of Financial Accounting Standards (SFAS) No. 123, *Accounting for Stock-Based Compensation* had always been applied for recognition purposes. For awards that are both fully vested and partially vested as of the date of adoption, the financing cash inflow is the excess tax benefit computed as if SFAS No. 123 had always been applied for recognition purposes.

Use of Estimates: The preparation of the condensed consolidated financial statements is in conformity with generally accepted accounting principles and requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the condensed consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Such estimates include, but are not limited to, revenue recognition and allowances; valuation of goodwill and intangibles; accounting for income taxes; inventory reserves and write-down; restructuring accruals; impairment losses on investments; accounting for stock-based compensation; and loss contingencies. Actual results could differ from those estimates.

4. Stock-based Compensation

Effective May 1, 2006, we adopted SFAS No. 123R, *Share-Based Payments* (SFAS No. 123R), which provides guidance on accounting for stock-based awards for employee services. We elected to adopt the modified prospective method, and accordingly we were not required to restate our prior period financial statements.

Prior to the adoption of SFAS No. 123R

Prior to the adoption of SFAS No. 123R, stock-based compensation expense had not been recognized in our consolidated statement of operations, other than those related to acquisitions and restricted stock awards. As a result of adopting SFAS No. 123R, pre-tax stock-based compensation expense recorded for the three- and nine-month periods ended January 26, 2007 of $39,234 and $124,679, respectively, was related to employee stock options, restricted stock units (RSUs), restricted stock awards (RSAs), and employee stock purchases under our Employee Stock Purchase Plan. Pre-tax stock-based compensation expense of $4,070 and $9,442 for the three- and nine-month periods ended January 27, 2006, respectively, which we recorded under APB No. 25, was related to RSUs, RSAs, and options assumed from acquisitions.

NETWORK APPLIANCE, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

As a result of adoption of SFAS No. 123R, our income from operations and net income for the three-month period ended January 26, 2007 were $34,163 and $32,444 lower, respectively, and $109,431 and $94,571 lower, respectively, for the nine-month period ended January 26, 2007, than they would have been if we had continued to account for share-based compensation under APB No. 25. Basic and diluted earnings per share for the three-month period ended January 26, 2007, were $0.09 and $0.08 lower, respectively, and basic and diluted earnings per share for the nine months ended January 26, 2007 were each $0.25 lower than they would have been if we had continued to account for share-based compensation under APB No. 25. We currently estimate that the impact of adopting SFAS No. 123R on our fiscal year ending April 30, 2007 will be between $0.33 and $0.40 per share.

As required by SFAS No. 123R, we eliminated the unamortized deferred stock compensation of $49,266 on May 1, 2006. Our common stock and additional paid-in capital were also reduced by the same amount and had been included in the Stockholders Equity of our Consolidated Balance Sheets as of April 30, 2006.

Had compensation expense been determined based on the fair value at the grant date for awards, consistent with the provisions of SFAS No. 123, our pro forma net income and pro forma net income per share for the three- and nine-month periods ended January 27, 2006, would be as follows:

		Three Months Ended January 27, 2006		**Nine Months Ended January 27, 2006**
Net income as reported	$	76,393	$	207,231
Add: stock-based employee compensation expense included in reported net income under APB No. 25, net of related tax effects		2,442		5,665
Deduct: total stock-based compensation determined under fair value based method for all awards, net of related tax effects		(24,860)		(74,224)
Pro forma net income	$	53,975	$	138,672
Basic net income per share, as reported	$	0.21	$	0.56
Diluted net income per share, as reported	$	0.20	$	0.54
Basic net income per share, pro forma	$	0.15	$	0.37
Diluted net income per share, pro forma	$	0.14	$	0.36

SFAS No. 123R requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. In our pro forma information required under SFAS No. 123

for the periods prior to fiscal 2007, we reflect cancellations and forfeitures due to employee terminations as they occurred.

NETWORK APPLIANCE, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

SFAS No. 123R stock-based compensation expense

The stock-based compensation expenses included in the Condensed Consolidated Statement of Income for the three- and nine-month periods ended January 26, 2007 are as follows:

	Three Months Ended January 26, 2007	Nine Months Ended January 26, 2007
Cost of product revenue	$ 922	$ 2,660
Cost of service revenue	2,533	7,657
Sales and marketing	17,315	54,747
Research and development	12,276	39,166
General and administrative	6,188	20,449
Total stock-based compensation expense before income taxes	39,234	124,679
Income taxes	(5,371)	(20,652)
Total stock-based compensation expense after income taxes	33,863	104,027

The following table summarizes stock-based compensation associated with each type of award:

	Three Months Ended January 26, 2007	Nine Months Ended January 26, 2007
Employee stock options and awards	$ 36,276	$ 115,574
Employee stock purchase plan (ESPP)	2,954	9,609
Amounts (capitalized in) reduced from inventory	4	(504)
Total stock-based compensation expense before income taxes	39,234	124,679
Income taxes	(5,371)	(20,652)
Total stock-based compensation expense after income taxes	33,863	104,027

In conjunction with the adoption of SFAS No. 123R, we changed our accounting policy of attributing the fair value of stock-based compensation to expense from the accelerated multiple-option approach provided by APB No. 25, as allowed under SFAS No. 123, to the straight-line single-option approach. Compensation expense for all stock-based payment awards expected to vest that were granted on or prior to April 30, 2006 will continue to be recognized using the accelerated multiple-option method. Compensation expense for all stock-based payment awards expected to vest that were granted subsequent to April 30, 2006 is recognized on a straight-line basis under the single-option approach.

Income Tax Benefits Recorded in Stockholders Equity

For the three- and nine-month periods ended January 26, 2007, the total income tax benefit associated with employee stock transactions was $13,555 and $92,575, respectively. For the three- and nine-month periods ended January 27, 2006, the total income tax benefit associated with employee stock transactions was $6,045 and $22,334, respectively.

NETWORK APPLIANCE, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Income Tax Effects on Statements of Cash Flows

In accordance with SFAS No. 123R, we have presented tax benefits resulting from tax deductions in excess of the compensation cost recognized for those options as financing cash flows for the nine-month period ended January 26, 2007. Prior to the adoption of SFAS No. 123R, tax benefits of stock option exercises were presented as operating cash flows. Tax benefits, related to tax deductions in excess of the compensation cost recognized, of $43,463 presented as financing cash flows for the nine-month period ended January 26, 2007, would have been classified as operating cash flows if we had not adopted SFAS No. 123R.

Valuation Assumptions

In compliance with SFAS No. 123R, we estimated the fair value of stock options using the Black-Scholes model on the date of the grant. Assumptions used in the Black-Scholes valuation model were as follows:

	Stock Options Three Months Ended January 26, 2007	ESPP Three Months Ended January 26, 2007	Stock Options Nine Months Ended January 26, 2007	ESPP Nine Months Ended January 26, 2007
Expected life in years(1)	4.0	0.5	4.0	0.5
Risk-free interest rate(2)	4.64%	5.06%	4.77%	5.06%
Volatility(3)	35%	35%	35%	35%
Expected dividend(4)	0%	0%	0%	0%

(1) The expected life of 4.0 years represented the period that our stock-based award was expected to be outstanding and was determined based on historical experience on similar awards. The expected life of 0.5 years for the purchase was based on the term of the purchase period of the purchase plan.

(2) The risk-free interest rate for the options was based upon U.S. Treasury bills with equivalent expected terms of our employee stock-based award. The risk-free interest rate for purchases was based upon U.S. Treasury bills (2) yield curve in effect at the time of grant for the expected term of the purchase period.

(3) We used the implied volatility of traded options to estimate our stock price volatility. Prior to adoption of SFAS No. 123R, we estimated volatility based upon historical volatility rates as required by SFAS No. 123.

(4) The expected dividend was determined based on our history and expected dividend payouts.

As required by SFAS No. 123R, we estimate our forfeiture rates based on historical voluntary termination behavior.

NETWORK APPLIANCE, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Stock Options

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

		Outstanding Options		Weighted	
	Options Available for Grant	Number of Shares	Weighted Average Exercise Price	Average Remaining Contractual Term	Aggregate Intrinsic Value
Outstanding at April 30, 2006	22,546	65,709	$ 26.08		
Shares Reserved for Plan	10,900				
Options Granted	(11,640)	11,640	35.10		
Assumed Topio Options (See Note 16)	858				
RSUs Granted	(15)	15			
Options Exercised		(9,510)	14.74		
RSUs Exercised		(93)			
Options Forfeitures and Cancellations	2,206	(2,206)	39.38		
RSUs Forfeitures and Cancellations	20	(20)			
Options Expired	(39)				
Outstanding at January 26, 2007	24,836	65,535	$ 28.92	5.90	$ 758,531
Options vested and expected to vest at January 26, 2007		62,566	29.11	0.51	720,601
Exercisable at January 26, 2007		39,069	27.95	4.79	570,664
RSUs vested and expected to vest at January 26, 2007		678		1.48	$ 24,920
Exercisable at January 26, 2007					

The intrinsic value represents the difference between the exercise price of stock options and the market price of our stock on that day for all in-the-money options. The weighted-average fair value as of the grant date was $14.10. The total intrinsic value of options exercised was $96,699 and $214,030 for the three- and nine-month periods ended January 26, 2007, respectively, and $83,322 and $176,681 for the three- and nine-month periods ended January 27, 2006, respectively. We received $65,270 and $140,217 from the exercise of stock options for the three- and nine-month periods ended January 26, 2007, respectively, and received $54,764 and $112,963 from the exercise of stock options for the three- and nine-month periods ended January 27, 2006, respectively.

The following table summarizes our non-vested shares (restricted stock awards) as of January 26, 2007:

	Number of Shares	Weighted-Average Grant-Date Fair Value
Non-vested at April 30, 2006	228	$ 27.58
Awards granted	125	39.83
Awards vested	(67)	21.92
Awards canceled/expired/forfeited		
Non-vested at January 26, 2007	286	$ 34.25

Although non-vested shares are legally issued, they are considered contingently returnable shares subject to repurchase by the Company when employees terminate their employment. The total fair value of shares vested during the three- and nine-month periods ended January 26, 2007 was $367 and $2,449, respectively. There was

NETWORK APPLIANCE, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

$26,258 of total unrecognized compensation as of January 26, 2007 related to restricted stock awards. The unrecognized compensation will be amortized over a weighted-average period of 1.9 years.

The following table summarizes information about stock options outstanding under all option plans as of January 26, 2007:

			Options Outstanding		Options Exercisable	
Range of Exercise Prices		Number Outstanding at January 26, 2007	Weighted Average Remaining Contractual Life (In Years)	Weighted Average Exercise Price	Number Exercisable	Weighted Average Exercise Price
$	$	749	1.93			
0.02	5.00	2,604	2.69	3.09	2,121	3.69
5.11	10.00	3,592	5.07	9.18	3,514	9.23
10.24	15.00	3,778	3.23	11.80	3,757	11.80
15.21	20.00	8,522	5.42	17.18	7,355	16.95
20.16	25.00	12,360	6.27	22.05	8,873	21.74
25.64	30.00	5,959	8.31	28.53	1,826	28.67
30.88	35.00	12,236	7.28	32.37	3,572	31.94
36.71	45.00	8,539	7.25	39.34	856	41.08
46.56	55.00	4,282	3.31	53.53	4,281	53.53
56.94	122.19	2,914	3.39	88.93	2,914	88.93
$	$ 122.19	65,535	5.90	$ 28.92	39,069	$ 27.95

Employee Stock Purchase Plan

	Number of Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term	Aggregate Intrinsic Value
Outstanding at January 26, 2007	721	$ 32.74	0.34	$ 2,877
Vested and expected to vest at January 26, 2007	706	$ 32.74	0.34	$ 2,814

The total intrinsic value of employee stock purchases was $9,520 and $20,462 for the three- and nine-month periods ended January 26, 2007. The intrinsic value of employee stock purchases was $7,882 and $16,778 for the three- and nine-month periods ended January 27, 2006, respectively. The compensation cost for options purchased under the ESPP plan was $2,954 and $9,609 for the three- and nine-month periods ended January 26, 2007, respectively. This compensation cost will be amortized on a straight-line basis over a weighted-average period of approximately 0.34 years.

The following table shows the shares issued and their purchase price per share for the employee stock purchase plan for the six-month period ended November 30, 2006:

Purchase date		November 30, 2006
Shares issued		744
Average purchase price per share	$	26.48

NETWORK APPLIANCE, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

5. Debt

On March 31, 2006, Network Appliance Global LTD. (Global), a subsidiary of the Company, entered into a loan agreement (the Loan Agreement), with the lenders and JPMorgan Chase Bank, National Association, as administrative agent. The Loan Agreement provides for a term loan available in two tranches, a tranche of $220,000 (Tranche A) and a tranche of $80,000 (Tranche B), for an aggregate borrowing of $300,000. The proceeds of the term loan have been used to finance a dividend from Global to the Company under the American Jobs Creation Act. The Tranche A term loan together with accrued and unpaid interest, are due in full on the maturity date of March 31, 2008. The Tranche B term loan was fully repaid as of January 26, 2007. Loan repayments of $63,864 and $87,267 are due in the remainder of fiscal 2007 and in fiscal 2008, respectively.

Interest for both the Tranche A and Tranche B term loan accrues at a floating rate based on the base rate in effect from time to time, plus a margin, which totaled 5.48% at January 26, 2007.

During the three- and nine-month periods ended January 26, 2007, we made repayments of $42,297 and $148,869, respectively, on the term loan. The Tranche A term loan was secured by certain investments totaling $180,155 as of January 26, 2007 held by Global and the Tranche B term loan was secured by a pledge of accounts receivable by Global s subsidiary, Network Appliance B.V.

As of January 26, 2007, Global was in compliance with all debt covenants as required by the Loan Agreement.

6. Short-Term Investments

The following is a summary of investments at January 26, 2007:

	Amortized	Gross Unrealized		Estimated
	Cost	Gains	Losses	Fair Value
Auction rate securities	$ 144,977	$	$	$ 144,977
Municipal bonds	5,112		33	5,079
Corporate securities	128,869	14	123	128,760
Corporate bonds	492,702	79	2,248	490,533
U.S. government agencies	269,926	3	1,338	268,591
U.S. Treasuries	15,176		162	15,014
Marketable equity securities	4,637	4,432		9,069
Money market funds	134,432			134,432
Total debt and equity securities	1,195,831	4,528	3,904	1,196,455
Less cash equivalents	211,289	12	95	211,206
Less short-term restricted investments	124,662		711	123,951(1)
Less long-term restricted investments	56,933		729	56,204(1)

Short-term investments	$ 802,947	$ 4,516	$ 2,369	$ 805,094

NETWORK APPLIANCE, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The following is a summary of investments at April 30, 2006:

	Amortized	Gross Unrealized		Estimated
	Cost	Gains	Losses	Fair Value
Auction rate securities	$ 325,608	$ 1	$	$ 325,609
Municipal bonds	5,024		65	4,959
Corporate securities	4,945		3	4,942
Corporate bonds	469,135	9	5,339	463,805
U.S. government agencies	286,983		3,812	283,171
U.S. Treasuries	20,189		386	19,803
Money market funds	472,722	17	114	472,625
Total debt and equity securities	1,584,606	27	9,719	1,574,914
Less cash equivalents	472,224	17	114	472,127
Less short-term restricted investments	138,215		1,507	136,708(2)
Less long-term restricted investments	106,616		2,173	104,443(2)
Short-term investments	$ 867,551	$ 10	$ 5,925	$ 861,636

(1) As of January 26, 2007, we have pledged $123,951 and $56,204 of short-term and long-term restricted investments, respectively, for the Tranche A term loan as defined in the Loan Agreement (see Note 5). In addition, we have short-term and long-term restricted cash of $2,063 and $3,498, respectively, relating to our foreign rent, custom, and service performance guarantees. These combined amounts are presented as short-term and long-term restricted cash and investments in the accompanying Consolidated Balance Sheets as of January 26, 2007.

(2) As of April 30, 2006, we have pledged $136,708 and $104,443 of short-term and long-term restricted investments, respectively, for the Tranche A term loan as defined in Loan Agreement (see Note 5). In addition, we have short-term and long-term restricted cash of $1,831 and $3,928, respectively, relating to our foreign rent, custom, and service performance guarantees. These combined amounts are presented as short-term and long-term restricted cash and investments in the accompanying Consolidated Balance Sheets as of April 30, 2006.

We record net unrealized gains or losses on available-for-sale securities in stockholders equity. Realized gains or losses are reflected in income which have not been material for all years presented. The following table shows the gross unrealized losses and fair values of our investments, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, at January 26, 2007:

	Less Than 12 Months		12 Months or Greater		Total	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
Municipal bonds	$ 3,519	$ (24)	$ 1,560	$ (9)	$ 5,079	$ (33)
Corporate securities	73,049	(123)			73,049	(123)
Corporate bonds	134,618	(626)	288,974	(1,622)	423,592	(2,248)
U.S. Treasury	4,949	(79)	4,988	(83)	9,937	(162)
U.S. government agencies	101,061	(460)	156,385	(878)	257,446	(1,338)
Total	$ 317,196	$ (1,312)	$ 451,907	$ (2,592)	$ 769,103	$ (3,904)

NETWORK APPLIANCE, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Management evaluates investments on a regular basis to determine if an other-than-temporary impairment has occurred, and there were no such impairment as of January 26, 2007. The unrealized losses on these investments at January 26, 2007 were primarily due to interest rate fluctuations. We have the ability and intent to hold these investments until recovery of their carrying values. We also believe that we will be able to collect all principal and interest amounts due to us at maturity given the high credit quality of these investments. Accordingly, we do not consider these investments to be other-than-temporarily impaired at January 26, 2007.

7. Inventories

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

	January 26, 2007	April 30, 2006
Purchased components	$ 22,812	$ 17,231
Work in process	972	744
Finished goods	37,690	46,477
	$ 61,474	$ 64,452

8. Goodwill and Intangible Assets

Goodwill is reviewed annually for impairment (or more frequently if indicators of impairment arise). We completed our annual impairment assessment in fiscal 2006 and concluded that goodwill was not impaired. In the three- and nine-month periods ended January 26, 2007, there were no indicators that would suggest that goodwill and intangible assets should be assessed for impairment. During the second quarter of fiscal year 2007, we recorded a reduction of goodwill for $1,180 in connection with the divestiture of certain NetCache assets.

During December 2006, we acquired Topio, Inc. (Topio) and recorded goodwill of $114,960 and intangible assets of $31,400 resulting from the allocation of the purchase price. See Note 16, Business Combinations.

Intangible assets are summarized as follows:

	Amortization	January 26, 2007			April 30, 2006		
	Period (Years)	Gross Assets	Accumulated Amortization	Net Assets	Gross Assets	Accumulated Amortization	Net Assets
Intangible Assets:							
Patents	5	$ 10,040	$ (6,934)	$ 3,106	$ 10,040	$ (5,448)	$ 4,592
Existing technology	4 - 5	113,625	(44,600)	69,025	91,025	(32,297)	58,728

Trademarks/tradenames	3 - 6	5,280	(1,422)	3,858	5,080	(739)	4,341
Customer Contracts/relationships	1.5 - 5	17,220	(3,653)	13,567	8,620	(2,380)	6,240
Covenants Not to Compete	1.5 - 2	9,510	(9,072)	438	9,510	(8,360)	1,150
Total Intangible Assets, Net		$ 155,675	$ (65,681)	$ 89,994	$ 124,275	$ (49,224)	$ 75,051

NETWORK APPLIANCE, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Amortization expense for identified intangible assets is summarized below:

	Three Months Ended		Nine Months Ended	
	January 26, 2007	January 27, 2006	January 26, 2007	January 27, 2006
Patents	$ 495	$ 495	$ 1,486	$ 1,487
Existing technology	4,572	3,866	12,303	7,920
Other identified intangibles	1,026	940	2,668	3,409
	$ 6,093	$ 5,301	$ 16,457	$ 12,816

Based on the identified intangible assets recorded at January 26, 2007, the future amortization expense of identified intangibles for the remainder of fiscal 2007 and the next four fiscal years and thereafter is as follows:

Year Ending April,	Amount
Remainder of Fiscal 2007	$ 6,985
2008	27,176
2009	24,664
2010	19,694
2011	8,987
Thereafter	2,488
Total	$ 89,994

9. Derivative Instruments

As a result of our significant international operations, we are subject to risks associated with fluctuating exchange rates. We use derivative financial instruments, principally currency forward contracts and currency options, to attempt to minimize the impact of exchange rate movements on our balance sheet and operating results. Factors that could have an impact on the effectiveness of our hedging program include the accuracy of forecasts and the volatility of foreign currency markets. These programs reduce, but do not always entirely eliminate, the impact of currency exchange movements. The maturities of these instruments are generally less than one year.

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

Balance Sheet Exposures: We utilize foreign currency forward and options contracts to hedge exchange rate fluctuations related to certain foreign assets and liabilities. Gains and losses on these derivatives offset gains and losses on the assets and liabilities being hedged and the net amount is included in earnings. For the three-month period ended January 26, 2007, net losses generated by hedged assets and liabilities totaled $22 and were offset by gains on the related derivative instruments of $495. For the nine-month period ended January 26, 2007, net gains generated by hedged assets and liabilities and related derivative instruments totaled $522 and $770, respectively. For the three-month period ended January 27, 2006, net gains generated by hedged assets and liabilities totaled $1,169 and were offset by losses on the related derivative instruments of $113. For the nine-month period ended January 27, 2006, net losses generated by hedged assets and liabilities totaled $2,407 and were offset by gains on the related derivative instruments of $3,035.

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

NETWORK APPLIANCE, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

If the underlying forecasted transactions do not occur, or if it becomes probable that they will not occur, the gain or loss on the related cash flow hedge is recognized immediately in earnings. For the three- and nine-month periods ended January 26, 2007 and January 27, 2006, we did not record any gains or losses related to forecasted transactions that did not occur or that became improbable.

We measure the effectiveness of hedges of forecasted transactions on at least a quarterly basis by comparing the fair values of the designated currency forward contracts with the fair values of the forecasted transactions.

As of January 26, 2007, the notional fair value of our foreign exchange forward and foreign currency option contracts totaled $387,262.

10. Earnings Per Share

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

During all periods presented, we had certain options outstanding, which could potentially dilute basic earnings per share in the future, but were excluded in the computation of diluted earnings per share in such periods, as their effect would have been antidilutive. These certain options were antidilutive in the three- and nine-month periods ended January 26, 2007 and January 27, 2006 as these options exercise prices were above the average market prices in such periods. For the three-month periods ended January 26, 2007 and January 27, 2006, 18,571 and 18,450 shares of common stock options with a weighted average exercise price of $47.89 and $47.83, respectively, were excluded from the diluted net income per share computation. For the nine-month periods ended January 26, 2007 and January 27, 2006, 22,271 and 18,881 shares of common stock options with a weighted average exercise price of $44.75 and $48.04, respectively, were excluded from the diluted net income per share computation.

NETWORK APPLIANCE, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

	Three Months Ended		Nine Months Ended	
	January 26, 2007	January 27, 2006	January 26, 2007	January 27, 2006
Net Income (Numerator):				
Net income, basic and diluted	$ 66,514	$ 76,393	$ 208,114	$ 207,231
Shares (Denominator):				
Weighted average common shares outstanding	371,735	372,289	372,372	370,543
Weighted average common shares outstanding subject to repurchase	(448)	(521)	(434)	(474)
Shares used in basic computation	371,287	371,768	371,938	370,069
Weighted average common shares outstanding subject to repurchase	448	521	434	474
Common shares issuable upon exercise of stock options	17,385	16,860	17,183	16,448
Shares used in diluted computation	389,120	389,149	389,555	386,991
Net Income Per Share:				
Basic	$ 0.18	$ 0.21	$ 0.56	$ 0.56
Diluted	$ 0.17	$ 0.20	$ 0.53	$ 0.54

11. Stockholders Equity

Stock Repurchase Program

On November 15, 2006, our Board approved a new stock repurchase program in which up to $800,000 of additional shares may be purchased.

Share repurchase activities for the three- and nine-month periods ended January 26, 2007 and January 27, 2006, were as follows:

	Three Months Ended	Nine Months Ended

	January 26, 2007	January 27, 2006	January 26, 2007	January 27, 2006
Shares repurchased	6,165	5,025	16,984	14,612
Cost of shares repurchased	$ 241,800	$ 145,583	$ 605,708	$ 390,147
Average price per share	$ 39.22	$ 28.97	$ 35.66	$ 26.70

Since the inception of the stock repurchase program through January 26, 2007, we have purchased a total of 48,980 shares of our common stock at an average price of $29.07 per share for an aggregate purchase price of $1,423,690. At January 26, 2007, $599,948 remained available for repurchases under the plan. The stock repurchase program may be suspended or discontinued at any time.

NETWORK APPLIANCE, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Comprehensive Income

The components of comprehensive income were as follows:

	Three Months Ended		Nine Months Ended	
	January 26, 2007	January 27, 2006	January 26, 2007	January 27, 2006
Net income	$ 66,514	$ 76,393	$ 208,114	$ 207,231
Currency translation adjustment	437	(12)	1,323	(1,996)
Unrealized gain (loss) on investments	1,990	1,327	8,566	(4,492)
Unrealized gain (loss) on derivatives	(458)	352	377	559
Comprehensive income	$ 68,483	$ 78,060	$ 218,380	$ 201,302

The components of accumulated other comprehensive loss were as follows:

	January 26, 2007	April 30, 2006
Accumulated translation adjustments	$ 1,690	$ 367
Accumulated unrealized loss on investments	(1,148)	(9,714)
Accumulated unrealized loss on derivatives	(1,374)	(1,751)
Total accumulated other comprehensive loss	$ (832)	$ (11,098)

12. Divestiture

On September 11, 2006, we completed the sale of certain assets of our NetCache product line to Blue Coat Systems Inc. (Blue Coat), as previously discussed in our annual report on Form 10-K. We received $23,914 in cash and 360 shares of Blue Coat s common stock with a fair value of $9,069 as of January 26, 2007. In addition, we accrued $2,032 for costs expected to be incurred to fulfill our engineering and service contractual obligations. Because of these continuing obligations, the NetCache sale does not qualify for presentation as a discontinued operation. As a result of this divestiture, we recorded a pre-tax gain of $25,339 in our income from operations and a reduction of goodwill of $1,180. We recorded revenues of $13,160 and $20,560 from NetCache products for three months ended January 26, 2007 and January 27, 2006, and $51,012 and $52,199 from NetCache products for the nine months ended January 26, 2007 and January 27, 2006, respectively. The contribution to operating income from these products was not significant.

13. Restructuring Charges

In fiscal 2002, as a result of continuing unfavorable economic conditions and a reduction in information technology (IT) spending rates, we implemented two restructuring plans, which included reductions in our workforce and consolidations of our facilities. As of January 26, 2007, we have no outstanding balance in our restructuring liability for the first restructuring. The second restructuring related to the closure of an engineering facility and consolidation of resources to the Sunnyvale headquarters. In fiscal 2006, we implemented a third restructuring plan related to the move of our global services center operations from Sunnyvale to our new flagship support center at our Research Triangle Park facility in North Carolina. Of the reserve balance at January 26, 2007, $542 was included in other accrued liabilities and the remaining $1,689 was classified as long-term obligations.

NETWORK APPLIANCE, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Our restructuring estimates are reviewed and revised periodically and may result in a substantial charge or reduction to restructuring expense should different conditions prevail than were anticipated in previous management estimates. Such estimates included various assumptions such as the time period over which the facilities will be vacant, expected sublease terms, and expected sublease rates. During the quarter ended January 26, 2007, we did not record any reduction or charges in the restructuring reserve.

	Facility Accrual	Severance-Related	Total
Reserve balance at April 30, 2005	$ 4,503	$	$ 4,503
Restructuring charges	281	859	1,140
Adjustments	(1,256)		(1,256)
Cash payments	(862)	(521)	(1,383)
Reserve balance at April 30, 2006	$ 2,666	$ 338	$ 3,004
Restructuring recoveries		(74)	(74)
Cash payments	(149)	(82)	(231)
Reserve balance at July 28, 2006	$ 2,517	$ 182	$ 2,699
Cash payments	(143)	(182)	(325)
Reserve balance at October 27, 2006	$ 2,374	$	$ 2,374
Cash payments	(143)		(143)
Reserve balance at January 26, 2007	$ 2,231	$	$ 2,231

14. New Accounting Pronouncements

In February 2007, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities Including an Amendment of FASB Statement No. 115.* SFAS No. 159 allows measurement at fair value of eligible financial assets and liabilities that are not otherwise measured at fair value. If the fair value option for an eligible item is elected, unrealized gains and losses for that item shall be reported in current earnings at each subsequent reporting date. SFAS No. 159 also establishes presentation and disclosure requirements designed to draw comparison between the different measurement attributes the company elects for similar types of assets and liabilities. This statement is effective for our fiscal year beginning May 1, 2008. We are currently evaluating the effect, if any, that the adoption of SFAS No. 159 will have on our consolidated financial statements

In September, 2006, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 157, *Fair Value Measurements.* SFAS No. 157 provides a framework for measuring fair value, clarifies the definition of fair value, and expands disclosures regarding fair value measurements. SFAS No. 157 does not require any new fair value measurements and eliminates inconsistencies in guidance found in various prior accounting pronouncements. We are required to adopt SFAS No. 157 for our fiscal year beginning May 1, 2008. We are currently evaluating the effect that the adoption of SFAS No. 157 will have on our consolidated results of operations and financial condition, but do not expect it to have a material impact.

In September 2006, the SEC issued Staff Accounting Bulletin (SAB) No. 108, *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements.* SAB No. 108 provides guidance on how prior year misstatements should be taken into consideration when quantifying misstatements in current year financial statements for purposes of determining whether the current year s financial statements are materially misstated. SAB No. 108 is effective for fiscal years ending on or after November 15, 2006. We are required to adopt SAB No. 108 for our fiscal year beginning on May 1, 2007. We are currently evaluating the effect that the adoption of SAB No. 108 will have on our consolidated results of operations and financial condition.

NETWORK APPLIANCE, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

In July 2006, the Financial Accounting Standards Board (FASB) issued FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes an Interpretation of FASB Statement No. 109* (FIN No. 48). FIN No. 48 prescribes a comprehensive model for how a company should recognize, measure, present, and disclose in its financial statements uncertain tax positions that the Company has taken or expects to take on a tax return (including a decision whether to file or not to file a return in a particular jurisdiction). FIN No. 48 is applicable to all uncertain tax positions for taxes accounted for under FASB Statement No. 109, *Accounting for Income Taxes* (SFAS No. 109), and substantially changes the applicable accounting model. FIN No. 48 is likely to cause greater volatility in income statements as more items are recognized discretely within income tax expense. We are required to adopt FIN No. 48 for our fiscal year beginning May 1, 2007. We are currently evaluating the effect that the adoption of FIN No. 48 will have on our consolidated results of operations and financial condition but do not expect it to have a material impact.

15. Commitments and Contingencies

The following summarizes our commitments and contingencies at January 26, 2007, and the effect such obligations may have on our future periods:

	Remainder of 2007	2008	2009	2010	2011	Thereafter	Total
Contractual Obligations:							
Office operating lease payments(1)	$ 4,538	$ 19,650	$ 19,138	$ 16,250	$ 13,606	$ 36,387	$ 109,569
Real estate lease payments(2)		1,482	4,726	5,978	5,978	99,700	117,864
Equipment operating lease payments(3)	2,767	8,916	6,216	1,046	7	3	18,955
Venture capital funding commitments(4)	431	338	325	313	300	25	1,732
Capital expenditures(5)	3,990	256					4,246
Communications and maintenance(6)	6,012	15,635	10,697	4,128	223	3	36,698
Total Contractual Cash Obligations	$ 17,738	$ 46,277	$ 41,102	$ 27,715	$ 20,114	$ 136,118	$ 289,064
Other Commercial Commitments:							
Lines of Credit(7)	$ 450	$ 1,583	$	$	$	$ 362	$ 2,395

(1) We lease sales offices and research and development facilities throughout the U.S. and internationally. These sales offices are leased under operating leases which expire through fiscal 2016. We are responsible for certain maintenance costs, taxes, and insurance under these leases. Substantially all lease agreements have fixed payment terms based on the passage of time. Some lease agreements provide us with the option to renew or terminate the lease. Our future operating lease obligations would change if we were to exercise these options and if we were to enter into additional operating lease agreements. Rent operating lease payments in the table exclude lease payments which are accrued as part of our fiscal 2002 restructurings and include only rent lease commitments that are over one year.

(2) Included in the above contractual cash obligations pursuant to two financing arrangements with BNP Paribas LLC (BNP) are (a) lease commitments of $1,482 in fiscal 2008; $4,726 in fiscal 2009, $5,978 in each of the fiscal years 2010, 2011, and 2012, $4,495 in fiscal 2013; and $1,252 in fiscal 2014, which are based on the LIBOR rate at January 26, 2007 for a term of five years, and (b) at the expiration or termination of the lease, a

NETWORK APPLIANCE, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

supplemental payment obligation equal to our minimum guarantee of $87,975 in the event that we elect not to purchase or arrange for sale of the buildings.

(3) Equipment operating leases include servers and IT equipment used in our engineering labs and data centers.

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

(5) Capital expenditures include worldwide contractual commitments to purchase equipment and to construct building and leasehold improvements, which will be recorded as Property and Equipment.

(6) We are required to pay based on a minimum volume under certain communication contracts with major telecommunication companies as well as maintenance contracts with multiple vendors. Such obligations expire in April 2010.

(7) The amounts outstanding under these letters of credit relate to workers compensation, a customs guarantee, a corporate credit card program, and a foreign rent guarantee.

On December 16, 2005, we entered into financing, construction, and leasing arrangements with BNP for office space to be located on land currently owned by us in Sunnyvale, California. These arrangements require us to lease our land to BNP for a period of 50 years to construct approximately 190,000 square feet of office space costing up to $38,500. After completion of construction, we will pay minimum lease payments, which vary based on London Interbank Offered Rate (LIBOR) plus a spread (5.78% at January 26, 2007) on the cost of the facilities. We expect to begin making lease payments on the completed buildings in September 2007 for a term of five years. We have the option to renew the lease for two consecutive five-year periods upon approval by BNP. Upon expiration (or upon any earlier termination) of the lease term, we must elect one of the following options: We may (i) purchase the building from BNP for $38,500, (ii) if certain conditions are met, arrange for the sale of the building by BNP to a third party for an amount equal to at least $32,725, and be liable for any deficiency between the net proceeds received from the third party and $32,725, or (iii) pay BNP a supplemental payment of $32,725, in which event we may recoup some or all of such payment by arranging for a sale of the building by BNP during the ensuing two-year period.

On December 14, 2006, we entered into additional financing, construction, and leasing arrangements with BNP for office space to be located on land currently owned by us in Sunnyvale, California. These arrangements require us to lease our land to BNP for a period of 50 years to construct approximately 190,000 square feet of office space and parking structure costing up to $65,000. After completion of construction, we will pay minimum lease payments, which vary based on LIBOR plus a spread (5.78% at January 26, 2007) on the cost of the facilities. We expect to begin making lease payments on the completed buildings in September 2008 for a term of five years. We have the option to renew the lease for two consecutive five-year periods upon approval by BNP. Upon expiration (or upon any earlier termination) of the lease term, we must elect one of the following options: We may (i) purchase the building from BNP for $65,000, (ii) if certain conditions are met, arrange for the sale of the building by BNP to a third party for an amount equal to at least $55,250, and be liable for any deficiency between the net proceeds received from the third party and $55,250, or (iii) pay BNP a supplemental payment of $55,250, in which event we may recoup some or all of such payment by arranging for a sale of the building by BNP during the ensuing two-year period.

Both leases also require us to maintain specified financial covenants with which we were in compliance as of January 26, 2007. Such specified financial covenants include a maximum ratio of Total Debt to Earnings Before Interest, Taxes, Depreciation and Amortization (EBITDA) and a Minimum Unencumbered Cash and Short Term Investments.

As of January 26, 2007, the notional fair value of our foreign exchange forward and foreign currency option contracts totaled $387,262. We do not believe that these derivatives present significant credit risks, because the counterparties to the derivatives consist of major financial institutions, and we manage the notional amount of

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NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

contracts entered into with any one counterparty. We do not enter into derivative financial instruments for speculative or trading purposes. Other than the risk associated with the financial condition of the counterparties, our maximum exposure related to foreign currency forward and option contracts is limited to the premiums paid on purchased options only.

We have both recourse and nonrecourse lease financing arrangements with third-party leasing companies through preexisting relationships with the customers. We sell our products directly to the leasing company, and the lease arrangement is made between our customer and the leasing company. Under the terms of recourse leases, which are generally three years or less, we remain liable for the aggregate unpaid remaining lease payments to the third-party leasing company in the event that any customers default. For these recourse arrangements, revenues on the sale of our product to the leasing company are deferred and recognized into income as payments to the leasing company come due. As of January 26, 2007 and April 30, 2006, the maximum recourse exposure under such leases totaled approximately $9,215 and $8,443, respectively. Under the terms of the nonrecourse leases, we do not have any continuing obligations or liabilities. To date, we have not experienced significant losses under this lease financing program.

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

During the quarter, two shareholder derivative lawsuits were filed against various of our officers and directors and naming us as a nominal defendant. The suits allege improper practices relating to the timing of stock option grants. Management believes that the claims are without merit and intends to defend the actions vigorously.

In addition, we are subject to various legal proceedings and claims which may arise in the normal course of business. While the outcome of these legal matters is currently not determinable, we do not believe that any current litigation or claims will have a material adverse effect on our business, cash flow, operating results, or financial condition.

We are currently undergoing federal income tax audits in the U.S. and several foreign tax jurisdictions. The rights to some of our intellectual property (IP) are owned by certain of our foreign subsidiaries, and payments are made between foreign and U.S. tax jurisdictions relating to the use of this IP. Recently, some other companies have had their foreign IP arrangements challenged as part of an examination. Our management does not believe, based upon information currently known to us, that the final resolution of any of our audits will have a material adverse effect upon our consolidated financial position and the results of operations and cash flows. However, if upon the conclusion of these audits the ultimate determination of our taxes owed in any of these tax jurisdictions is for an amount in excess of the tax provision we have recorded or reserved for, our overall effective tax rate may be adversely impacted in the period of adjustment.

The General Services Administration (GSA) is currently auditing our records under the schedule contracts it had with us to verify our compliance with various contract provisions. If the audit determines that we did not comply with such provisions, we may be required to pay the GSA a potential settlement. The exact date for completion of the audit and the subsequent negotiation process is unknown and may not be concluded for some time. Our management does not believe, based upon information currently known to us, that the final resolution of our audit will have a material adverse effect upon our consolidated financial position and the results of operations and cash flows.

NETWORK APPLIANCE, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

16. Business Combination

Acquisition of Topio

On December 7, 2006, we acquired Topio, Inc. (Topio), a privately held company based in Santa Clara, California, that develops and sells enterprise-class software for data replication and rapid recovery across the spectrum of locations, platforms and storage that support an enterprise. The acquisition will continue to expand our data protection portfolio and simplify the replication of data from other storage arrays to our storage systems. Under terms of the agreement, we paid Topio $137,201 in cash, assumed approximately 853 stock options with a fair value of approximately $8,369. We also incurred $793 acquisition-related transaction costs and assumed certain operating assets and liabilities. The net deferred income tax liability of $5,150 is comprised of deferred tax assets of $7,644 primarily related to net operating losses incurred from inception through the acquisition date and a deferred tax liability of $12,794 related to acquired intangible assets. The historical operations of Topio were not significant.

The acquisition was accounted for under the purchase method of accounting. The total purchase price for Topio is summarized below:

	Topio
Cash consideration	$ 137,201
Stock options assumed	8,369
Acquisition-related transaction costs	793
	$ 146,363

In accordance with SFAS 141, we have preliminarily allocated the purchase price to the estimated tangible and intangible assets acquired and liabilities assumed, based on their estimated fair values. Goodwill of $114,960 was generated in connection with our acquisition of Topio. The current and future potential of the Topio technology will enable us to expand our data protection portfolio and simplify the replication of data from other storage arrays to our storage systems. In addition, Topio has an experienced and knowledgeable workforce and an existing infrastructure. These opportunities, along with the ability to leverage the Topio workforce, were significant contributing factors to the establishment of the purchase price, resulting in the recognition of a significant amount of goodwill. The fair values assigned to tangible and intangible assets acquired and liabilities assumed are based on management estimates and assumptions, and other information compiled by management, including third-party valuations that utilized established valuation techniques appropriate for the high-technology industry. Goodwill recorded as a result of this acquisition is not expected to be deductible for tax purposes. In accordance with SFAS 142, *Goodwill and Other Intangible Assets* (SFAS 142), goodwill is not amortized but will be reviewed at least annually for

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NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

impairment. Purchased intangibles with finite lives will be amortized over their respective estimated useful lives on a straight line basis. The purchase price has been preliminarily allocated as follows:

Purchase Price Allocation:	Topio	Amortization Period (Years)
Fair value of tangible assets acquired	$ 7,905	
Intangible assets:		
Existing Technology	18,800	4
Patents and Core Technology	3,800	4
Maintenance Agreements and Customer Relationships	100	4
BCP Contracts and Related Relationships	8,200	6
Non compete agreements	300	2
Trademarks and tradenames	200	2
Goodwill	114,960	
Fair value of liabilities assumed	(2,752)	
Net deferred income taxes	(5,150)	
	$ 146,363	

Because Topio had recently introduced its products, no amount was allocated to in-process research and development.

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

This Quarterly Report on Form 10-Q contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended (the Exchange Act), and is subject to the safe harbor provisions set forth in the Exchange Act. Forward-looking statements usually contain the words estimate, intend, plan, predict, seek, may, will, should, would, anticipate similar expressions and variations or negatives of these words. In addition, any statements that refer to expectations, projections, or other characterizations of future events or circumstances, including any underlying assumptions, are forward-looking statements. All forward-looking statements, including, but not limited to, (1) our anticipation that the SAN competitiveness of our new products will continue to contribute to the block-based protocols component of our business; (2) our expectation that future gross margins may be negatively affected by various factors such as global service investment cost and competition; (3) our belief that our strategic investments are targeted at some of the strongest growth areas of the storage market; (4) our belief that our new emerging products will further expand our market opportunity; (5) our expectation that price per petabyte will continue to decline for our hardware products; (6) our plan to invest in the people, processes and systems necessary to best optimize our revenue growth; (7) our expectation that higher disk content associated with high-end and mid-range storage systems will negatively affect our gross margin in the future; (8) our expectation that our service margin may experience some variability; (9) our estimate of the impact that adopting SFAS No. 123R will have on our earnings per share; (10) our estimates of future amortization of patents, trademarks, tradenames, customer contracts, and relationships; (11) our expectation to continue to selectively add sales capacity in an effort to expand domestic and international markets; (12) our expectation that we will increase our sales and marketing expenses commensurate with future revenue growth; (13) our belief 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; (14) our expectation that we will continuously support current and future product development and enhancement efforts and incur corresponding charges; (15) our intention to continuously broaden our existing product offerings and introduce new products; (16) our belief regarding our research and development and general and administrative expenses will increase in absolute dollars for the remainder of fiscal 2007; (17) our estimates regarding future amortization of covenants not to compete; (18) our expectation that interest income will increase year over year; (19) our belief that period-to-period changes in foreign exchange gains or losses will continue to be impacted by hedging costs associated with our forward and option activities and forecast variance; (20) our expectation that cash provided by operating activities may fluctuate in future periods; (21) our expectations regarding our contractual cash obligations and other commercial commitments at January 26, 2007, for future periods; (22) our expectation regarding the complete construction of our building under the BNP lease and the estimates regarding future minimum lease payments under the lease term; (23) our expectation that our existing facilities and those currently being developed will be sufficient for our needs for at least the next two years and that our contractual commitments, and any required capital expenditures over the next few years, will be funded through cash from operations and existing cash and investments; (24) our belief that claims on the derivative lawsuits are without merit; (25) our expectation that capital expenditures will increase consistent with our business growth; (26) our expectation that we will incur higher capital expenditures in the near future; (27) our belief that our cash and cash equivalents, short-term investments, and cash generated from operations will satisfy our working capital needs, capital expenditures, stock repurchases, contractual obligations, and other liquidity requirements associated with our operations through at least the next 12 months and (28) our belief that, based upon information available to us, that any current litigation and claims including our audits will not have a material adverse impact on our operating results, are inherently uncertain as they are based on management s current expectations and assumptions concerning future events, and they are subject to numerous known and unknown risks and uncertainties. Readers are cautioned not to place undue reliance on these forward-looking statements, which speak only as of the date hereof and are based upon information available to us at this time. These statements are not guarantees of future performance. We disclaim any obligation to update information in any forward-looking statement.

Third Quarter Fiscal 2007 Overview

During the third quarter and first nine months of fiscal 2007, our revenue grew year over year and the increase was across all major products categories and geographies. The net increase in revenues was attributable to increased software licenses and software subscriptions, increased service revenue, an expanded portfolio with new products and solutions for the enterprise customers, and was partially offset by lower cost-per-megabyte disks, and a decline in shipments and lower average selling prices of our older generation products.

From a product perspective, we continued to enhance our data management and data protection portfolios with a key acquisition and several product introductions. We extended our data center portfolio with several additions including new midrange platforms, broader Fibre Channel (FC) storage area network (SAN) capabilities, significant enhancements in the NetApp® Manageability Software Family, and new professional services, all aimed at making enterprise data center management easier for customers who demand high-performance SAN solutions and increased application uptime to meet their business needs. We anticipate the SAN competitiveness of our new FAS3070, along with the strength of our high-end FAS6070 SAN-configured systems, to continue to contribute to an increase in the block-based protocols component of our business.

From a market perspective, we also continued to gain market acceptance in the storage area network (SAN) market while maintaining leadership in both the network-attached storage (NAS) and iSCSI markets. According to International Data Corporation s (IDC s) Worldwide Quarterly Disk Storage Systems Tracker Q3 2006, NetApp gained share in both capacity shipped and revenue for the FC SAN market. NetApp also continued to grow faster than the market in FC SAN in both revenue and capacity, year over year. For capacity shipped, NetApp grew at 210.2%, while the market grew at 46.3%. In terms of revenue, NetApp grew faster than the market for the 11th consecutive quarter at 62.1%, while the market grew at 14.1%. Sequentially, NetApp grew at 16.0%, while the market grew at 6.4%.

NetApp also demonstrated continued leadership in the NAS and iSCSI storage markets in the third quarter, according to IDC. NetApp maintained the number-one market share position in capacity shipped for NAS (42.0%) and in iSCSI for both capacity shipped (32.6%) and revenue (21.5%).

In IDC s calculations of the network storage market (which includes SAN, NAS, and iSCSI), NetApp grew faster than the market, year over year, in both capacity shipped and revenue. For capacity shipped, NetApp grew at 106.8%, while the market grew at 62.6%. In terms of revenue, NetApp grew 18.9%, while the market grew at 17.2%.

Despite continuous downward pricing pressures and competitive environments, our revenue continued to grow faster than our competitors. We expect to continue to experience price declines per petabyte for our hardware products, which may have an adverse impact on our future gross margins if not offset by a product mix with higher software content and higher average selling prices associated with new products. According to IDC s Worldwide Disk Storage Systems 2006-2010 Forecast and Analysis, November 2006, IDC predicts that the industry average dollar per petabyte (PB) will drop from $8.61/PB in 2006 to $1.88/PB in 2010. At the same time, we also expect our future gross margins may be negatively affected by factors such as global service investment cost, competition, indirect sales including OEM, and high disk content, partially offset by new product introductions and add-on software mix.

We believe that our strategic investments are targeted at some of the strongest growth areas of the storage market, such as modular storage, archive and compliance, data protection, data classification, data discovery, data migration, data permanence, data security and privacy, iSCSI, and grid computing. However, if any storage market trends and emerging standards on which we are basing our assumptions do not materialize as anticipated, our business could be materially adversely affected.

Continued revenue growth depends on the introduction and market acceptance of our new products and solutions. We believe that our new emerging products will further expand our market opportunity. Our acquisition of Topio in December 2006 will also help us expand our heterogeneous data protection portfolio as part of our plan to broaden our total addressable market. If we fail to introduce new products in a timely manner or to successfully integrate acquired technology into our existing architecture, or if there is no or reduced demand for these or our current products, we may experience adverse impact on our expected growth rates. We plan to invest in the people, processes, and systems necessary to best optimize our revenue growth and long-term profitability. However, we cannot assure you that such investments will achieve our financial objectives.

Third Quarter Fiscal 2007 Financial Performance

Our revenues for the third quarter of fiscal 2007 were $729.3 million, a 35.8% increase over the same period a year ago. Our revenues for the first nine months of fiscal 2007 were $2,003.1 million, a 36.4% increase over the same period a year ago. Our revenue growth was driven by the adoption of our enterprise storage products, the FAS3000 and FAS6000 series, and emerging products such as VTL.

Our overall gross margins for both the third quarter of fiscal 2007 and 2006 were 60.9%. The overall gross margin decreased to 60.8% in the first nine months of fiscal 2007, from 61.3% in the same period a year ago. The decline in our gross margin was primarily attributable to the impact of the adoption of Statement of Financial Accounting Standards (SFAS) No. 123 (revised 2004), *Share-Based Payment* (SFAS No. 123R) and the related stock-based compensation expense, partially offset by a higher add-on software mix and favorable production costs.

Cash, cash equivalents, and short-term investments decreased to $1,295.3 million as of January 26, 2007, compared to $1,322.9 million as of April 30, 2006, due primarily to cash used to repurchase our common stock of $605.7 million and net cash paid of $131.2 million in connection with the Topio acquisition, partially offset by cash generated from operations and $23.9 million received from the sale of certain NetCache® assets. Days sales outstanding decreased to 55 days as of January 26, 2007, compared to 63 days as of April 30, 2006, reflecting more linear shipments. Inventory turns were 18.2 times and 14.7 times as of January 26, 2007 and April 30, 2006, respectively, reflecting higher inventory at fiscal 2006 year end associated with the new FAS6000 launch and improved inventory management. Deferred revenue increased to $944.9 million as of January 26, 2007, from $681.5 million reported as of April 30, 2006, due to higher software subscription and service billings attributable to an increase in larger enterprise customers. Capital purchases of plant, property, and equipment for the first nine months of fiscal 2007 and 2006 were $112.4 million and $96.5 million, respectively, reflecting continued capital investment to meet our business growth.

Critical Accounting Estimates and Policies

Our discussion and analysis of financial condition and results of operations are 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 such statements requires us to make estimates and assumptions that affect the reported amounts of revenues and expenses during the reporting period and the reported amounts of assets and liabilities as of the date of the financial statements. Our estimates are based on historical experience and other assumptions that we consider to be appropriate in the circumstances. However, actual future results may vary from our estimates.

We believe that the following accounting policies are critical as defined by the Securities and Exchange Commission, in that they are both highly important to the portrayal of our financial condition and results, and require difficult management judgments and assumptions about matters that are inherently uncertain. We also have other important policies, including those related to derivative instruments and concentration of credit risk. However, these policies do not meet the definition of critical accounting policies because they do not generally require us to make estimates or judgments that are difficult or subjective. These policies are discussed in Note 3 to the Consolidated Financial Statements accompanying this Quarterly Report on Form 10-Q.

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

Revenue recognition and allowances

Valuation of goodwill and intangibles

Accounting for income taxes

Inventory write-downs

Restructuring accruals

Impairment losses on investments

Accounting for stock-based compensation

Loss contingencies

Revenue Recognition and Allowances

We apply the provisions of Statement of Position (SOP) No. 97-2, *Software Revenue Recognition* (SOP No. 97-2), and related interpretations to our product sales, both hardware and software, because our software is essential to the performance of our hardware. We recognize revenue when:

> *Persuasive evidence of an arrangement exists:* It is our customary practice to have a purchase order and/or contract prior to recognizing revenue on an arrangement from our end users, customers, value-added resellers, or distributors.
>
> *Delivery has occurred:* Our product is physically delivered to our customers, generally with standard transfer terms such as FOB origin. We typically do not allow for restocking rights with any of our value-added resellers or distributors. Products shipped with acceptance criteria or return rights are not recognized as revenue until all criteria are achieved. If undelivered products or services exist that are essential to the functionality of the delivered product in an arrangement, delivery is not considered to have occurred.
>
> *The fee is fixed or determinable:* Arrangements with payment terms extending beyond our standard terms, conditions and practices are not considered to be fixed or determinable. Revenue from such arrangements is recognized as the fees become due and payable. We typically do not allow for price-protection rights with any of our value-added resellers or distributors.
>
> *Collection is probable:* Probability of collection is assessed on a customer-by-customer basis. Customers are subjected to a credit review process that evaluates the customers financial position and ultimately their ability to pay. If it is determined at the outset of an arrangement that collection is not probable based upon our review process, revenue is recognized upon cash receipt.

Our multiple element arrangements include our systems and generally may also include one or more of the following undelivered elements: software subscriptions, premium hardware maintenance, storage review services, and installation services. Our software subscriptions entitle our customers to receive unspecified product upgrades and enhancements on a when-and-if-available basis, bug fixes, and patch releases. Premium hardware maintenance services include contracts for technical support and minimum response times. Revenue from software subscriptions and premium hardware maintenance services is recognized ratably over the contractual term, generally from one to three years. We also offer extended service contracts (which extend our standard parts warranty and may include premium hardware maintenance) at the end of the warranty term; revenues from these contracts are recognized ratably over the contract term. When storage optimization reviews are sold as a bundled element with our software subscriptions and premium hardware maintenance services, the revenue is recognized ratably over the contract term. We typically sell technical consulting services separately from any of our other revenue elements, either on a time and materials basis or for fixed price standard projects; we recognize revenue for these services as they are performed. Revenue from hardware installation services is recognized at the time of delivery and any remaining costs are accrued, as the remaining undelivered services are considered to be inconsequential and perfunctory. For arrangements with multiple elements, we recognize as revenue the difference between the total arrangement price and the greater of fair value or stated price for any undelivered elements (the residual method).

If the arrangement contains both software-related and non-software-related elements, we allocate revenue to the non-software elements based on objective and reliable evidence of fair value in accordance with Emerging Issues Task Force (EITF) 00-21, *Revenue Arrangements with Multiple Deliverables.* Non-software elements are items for which the functionality of the software is not essential to its performance; the non-software-related elements in our arrangements may consist of storage optimization reviews (which are sold only within a bundled service offering that also contains software-related services), and/or technical consulting. For undelivered software-related elements, we apply the provisions of SOP No. 97-2 and determine fair value of these undelivered software-related elements based on vendor-specific objective evidence which for us consists of the prices charged when these services are sold separately. To determine the fair value of our undelivered elements, we analyze both the selling prices when the elements are sold separately as well as the concentrations of those prices. We believe those concentrations have been sufficient to enable us to establish VSOE or objective and reliable evidence of fair value for the undelivered elements. If VSOE or objective and reliable evidence cannot be obtained to establish fair value of the undelivered elements, revenue from the entire arrangement would be deferred and recognized once these elements are delivered or fair value is established.

We record reductions to revenue for estimated sales returns at the time of shipment. Sales returns are estimated based on historical sales returns, current trends, and our expectations regarding future experience. Reductions to revenue associated with sales returns include consideration of historical sales levels, the timing and magnitude of historical sales returns, and a projection of this experience into the future. We monitor and analyze the accuracy of sales returns estimates by reviewing actual returns and adjust them for future expectations to determine the adequacy of our current and future reserve needs. Our reserve levels have been sufficient to cover actual returns and have not required material changes in subsequent periods. While we currently have no expectations for significant changes to these reserves, 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 based on our assessment of the collectibility of specific customer accounts and the aging of the accounts receivable. We analyze accounts receivable and historical bad debts, customer concentrations, customer solvency, current economic and geographic trends, and changes in customer payment terms and practices when evaluating the adequacy of current and future allowance. In circumstances where we are aware of a specific customer s inability to meet its financial obligations to us, a specific allowance for bad debt is estimated and recorded, which reduces the recognized receivable to the estimated amount we believe will ultimately be collected. We monitor and analyze the accuracy of allowance for doubtful accounts estimate by reviewing past collectibility and adjust it for future expectations to determine the adequacy of our current and future allowance. Our reserve levels have generally been sufficient to cover credit losses. Our allowance for doubtful accounts as of January 26, 2007 was $2.8 million, compared to $2.4 million as of April 30, 2006. During the year ended April 30, 2006, we reduced our reserve by $1.5 million due to overall improvement in our collections history. However, if the financial condition of our customers were to deteriorate, resulting in an impairment of their ability to make payments, additional allowances may be required.

Valuation of Goodwill and Intangibles

Identifiable intangible assets are amortized over time, while in-process research and development is recorded as a charge on the date of acquisition and goodwill is capitalized, subject to periodic review for impairment. Accordingly, the allocation of the acquisition cost to identifiable intangible assets has a significant impact on our future operating results. The allocation process requires extensive use of estimates and assumptions, including estimates of future cash flows expected to be generated by the acquired assets. Should conditions be different than management s current assessment, material write-downs of the fair value of intangible assets may be required. We periodically review the estimated remaining useful lives of our other intangible assets. In addition, a reduction in the estimate of remaining useful life could result in accelerated amortization expense or a write-down in future periods. As such, any future write-downs of these assets would adversely affect our gross and operating margins. We currently do not foresee changes to useful lives or write-downs to these assets.

Under our accounting policy we perform an annual review in the fourth quarter of each fiscal year, or more often if indicators of impairment exist. Triggering events for impairment reviews may be indicators such as adverse industry or economic trends, restructuring actions, lower projections of profitability, or a sustained decline in our market capitalization. Evaluations of possible impairment and, if applicable, adjustments to carrying values require us to estimate, among other factors, future cash flows, useful lives, and fair market values of our reporting units and assets. When we conduct our evaluation of goodwill, the fair value of goodwill is assessed using valuation techniques that require significant management judgment. Should conditions be different from management s last assessment, significant write-downs of goodwill may be required. In fiscal 2006, we performed such evaluation and found no impairment. However, any future write-downs of goodwill would adversely affect our operating margins. As of January 26, 2007, our assets included $601.3 million in goodwill. See Note 8, Goodwill and Purchased Intangible Assets, to our Condensed Consolidated Financial Statements.

During fiscal 2006, we adjusted goodwill by $3.5 million and $2.1 million relating to the tax benefits associated with the subsequent exercise of previously vested assumed Spinnaker and Decru options, respectively. Estimated future adjustments to goodwill related to the tax benefits associated with the subsequent exercise of previously vested assumed options by previous acquisitions are approximately $8.4 million, subject to future cancellations relating to employee terminations. During the second quarter of fiscal year 2007, we recorded a reduction of goodwill for $1.2 million in connection with the divestiture of certain NetCache assets. In the third quarter of fiscal 2007, we recorded goodwill of $115.0 million in connection with our Topio acquisition.

Accounting for Income Taxes

The determination of our tax provision is subject to judgments and estimates due to the complexity of the tax law that we are subject to in several tax jurisdictions. Earnings derived from our international business are generally taxed at rates that are lower than U.S. rates, resulting in a reduction of our effective tax rate. The ability to maintain our current effective tax rate is contingent upon existing tax laws in both the U.S. and 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. In addition, a decrease in the percentage of our total earnings from our international business or a change in the mix of international business among particular tax jurisdictions could increase our overall effective tax rate.

We account for income taxes in accordance with SFAS No. 109, *Accounting for Income Taxes.* SFAS No. 109 requires that deferred tax assets and liabilities be recognized for the effect of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. SFAS No. 109 also requires that deferred tax assets be reduced by a valuation allowance if it is more likely than not that some or all of the deferred tax asset will not be realized. We have provided a valuation allowance of $400.6 million as of January 26, 2007, compared to $431.2 million as of April 30, 2006 on certain of our deferred tax assets related to net operating loss carryforwards, conditional royalty carryforwards, and tax credit carryforwards attributable to the exercise of employee stock options. Under SFAS No. 123R, such amounts should not be realized until they result in a reduction of taxes payable.

We based our provision for income taxes on the expected tax treatment of transactions recorded in our financial statements. In determining our provision for income taxes, we interpret tax legislation in a number of jurisdictions. The provisions for income taxes have not changed significantly from our estimates. Further tax provision adjustments are not expected, but are possible in the event that our interpretation of tax legislation differs from that of the tax authorities.

We are currently undergoing federal income tax audits in the U.S. and several foreign tax jurisdictions. The rights to some of our intellectual property (IP) are owned by certain of our foreign subsidiaries, and payments are made between foreign and U.S. tax jurisdictions relating to the use of this IP. Recently, some other companies have had their foreign IP arrangements challenged as part of an examination. Our management does not believe, based upon information currently known to us, that the final resolution of any of our audits will have a material adverse effect upon our consolidated financial position and the results of operations and cash flows. However, if upon the conclusion of these audits the ultimate determination of our taxes owed in any of these tax jurisdictions is for an amount in excess of the tax provision we have recorded or reserved for, our overall effective tax rate may be adversely impacted in the period of adjustment.

We are required to adopt FIN No. 48 beginning May 1, 2007. FIN No. 48 is likely to cause greater volatility in income statements as more items are recognized discretely within income tax expense. We are currently evaluating the effect that the adoption of FIN No. 48 will have on our consolidated results of operations and financial condition but do not expect it to have a material impact.

Inventory Write-Downs

Our net inventory balance was $61.5 million as of January 26, 2007, compared to $64.5 million as of April 30, 2006. Inventories are stated at the lower of cost (first-in, first-out basis) or market. We perform an in-depth excess and obsolete analysis of our inventory based upon assumptions about future demand and market conditions. We adjust the inventory value based on estimated excess and obsolete inventories determined primarily by future demand forecasts. Although we strive for accuracy in our forecasts of future product demand, any significant unanticipated changes in demand or technological developments could have a significant impact on the value of our inventory and commitments, and on our reported results. If actual market conditions are less favorable than those projected, additional write-downs and other charges against earnings may be required. If actual market conditions are more favorable, we may realize higher gross margins in the period when the written-down inventory is sold. During the past few years, our inventory reserves have generally been sufficient to cover excess and obsolete exposure and have not required material changes in subsequent periods.

We record purchase commitment liabilities with our contract manufacturers and suppliers as a result of changes in demand forecasts or as we transition our products. As of January 26, 2007 and April 30, 2006, we did not have purchase commitment liabilities under such arrangements.

We engage in extensive, ongoing 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.

We are subject to a variety of federal, state, local, and foreign environmental regulations relating to the use, storage, discharge, and disposal of hazardous chemicals used during our manufacturing process or requiring design changes or recycling of products we manufacture. We will continue to monitor our environmental compliance and could incur higher costs, including additional reserves for excess component inventory.

Restructuring Accruals

In fiscal 2002, as a result of continuing unfavorable economic conditions and a reduction in IT spending rates, we implemented two restructuring plans, which included reductions in our workforce and a consolidation of our facilities. In fiscal 2006, we implemented the third restructuring plan related to the move of our global service center operations. In determining restructuring charges, we analyze our future business requirements in order to properly align and manage our business commensurate with our future revenue levels.

Our restructuring costs, and any resulting accruals, involve significant estimates made by management using the best information available at the time the estimates are made, some of which may be provided by third parties. In recording severance reserves, we accrue a liability when the following conditions have been met: employees rights to receive compensation are attributable to employees services already rendered, the obligation relates to rights that vest or accumulate, payment of the compensation is probable, and the amount can be reasonably estimated. In recording the facilities lease restructuring reserve, we make various assumptions, including the time period over which the facilities are expected to be vacant, expected sublease terms, expected sublease rates, anticipated future operating expenses, and expected future use of the facilities.

Our estimates involve a number of risks and uncertainties, some of which are beyond our control, including future real estate market conditions and our ability to successfully enter into subleases or lease termination agreements with terms as favorable as those assumed when arriving at our estimates. We regularly evaluate a number of factors to determine the appropriateness and reasonableness of our restructuring and lease loss accruals, including the various assumptions noted above. If actual results differ significantly from our estimates, we may be required to adjust our restructuring and lease loss accruals in the future. We estimated our facility and severance restructuring reserve to be $2.2 million as of January 26, 2007. Our fiscal 2006 facility restructuring reserve included a $1.0 million reduction related to the execution of a new sublease agreement for our Tewksbury facility net of related cost.

Impairment Losses on Investments

As of January 26, 2007, our short-term investments have been classified as available-for-sale and are carried at fair value. There have been no significant declines in fair value of investments that are considered to be other-than-temporary for any of the three years in the period ended January 26, 2007. The fair value of our available-for-sale investments reflected in the Consolidated Balance Sheets were $985.2 million and $1,102.8 million as of January 26, 2007 and April 30, 2006, respectively. Included in these balances were short-term and long-term restricted investments of $124.0 million and $56.2 million, respectively, as of January 26, 2007, and $136.7 million and $104.4 million, respectively, as of April 30, 2006. In addition, our available-for-sale investments also included an investment in a publicly held company of $9.1 million which was based on quoted market prices on January 26, 2007. We had no investments in publicly held companies as of April 30, 2006. We have not identified any of these declines to be other than temporary, as market declines of our investments have been caused by interest rate changes and were not due to credit worthiness. Because we have the ability and intent to hold these investments until maturity, we would not expect any significant decline in value of our investments caused by market interest rate changes.

All of our available-for-sale investments and non-marketable equity securities are subject to a periodic impairment review. Investments are considered to be impaired when a decline in fair value is judged to be other-than-temporary. This determination requires significant judgment. For publicly traded investments, impairment is determined based upon the specific facts and circumstances present at the time, including factors such as current economic and market conditions, the credit rating of the security s issuer, the length of time an investment s fair value has been below our carrying value, and our ability and intent to hold investments to maturity. If an investment s decline in fair value, caused by factors other than changes in interest rates, is deemed to be other-than-temporary, we would reduce its carrying value to its estimated fair value, as determined based on quoted market prices or liquidation values. For investments in publicly held companies, we recognize an impairment charge when the declines in the fair values of our investments in these companies are below their cost basis are judged to be other-than-temporary. The ultimate value realized on these investments in publicly held companies is subject to market price volatility until they are sold. We have no impairment losses on our available-for-sale investments for the third quarter and first nine months of fiscal 2007 and 2006.

For non-marketable equity securities, the impairment analysis requires the identification of events or circumstances that would likely have a significant adverse effect on the fair value of the investment, including, revenue and earnings trends, overall business prospects, limited capital resources, limited prospects of receiving additional financing, limited prospects for liquidity of the related securities, and general market conditions in the investees industry. Our investments in privately held companies were $9.8 million and $11.0 million as of January 26, 2007 and April 30, 2006, respectively. For the second quarter of fiscal 2007, we recorded an impairment of $2.0 million for an investment in a privately held company, and subsequently recorded a gain of $0.7 million in the third quarter of fiscal 2007. We have no impairment losses on our investments in privately held companies for the third quarter and first nine months of fiscal 2006.

Accounting for Stock-Based Compensation

We adopted SFAS No. 123R, *Share-Based Payment*, using the Black-Scholes option pricing model to value our employee stock options. The fair value of each option grant is estimated on the date of grant using the Black-Scholes option pricing model, and is not remeasured as a result of subsequent stock price fluctuations. Option pricing models require the input of highly subjective assumptions, including the expected stock price volatility, expected life, and forfeiture rate. We have chosen to base our estimate of future volatility using the implied volatility of traded options to purchase the Company s common stock as permitted by Staff Accounting Bulletin (SAB) No. 107. As of May 1, 2006, the contractual life of our stock options has been shortened to seven years from ten years for options issued on or after this date, and to the extent that the shorter life changes employees exercise behavior, it may change the expected term of an option going forward. SFAS No. 123R requires us to use estimated forfeitures, and therefore the adoption of SFAS No. 123R could have a material impact on the timing of and, based on the accuracy of estimates of future actual forfeitures, the amount of stock-based compensation expense. Any changes in these highly subjective assumptions may significantly impact the stock-based compensation expense for the future. Likewise, the shortening of the contractual life of our options could change the estimated exercise behavior in a manner other than currently expected.

We currently estimate that the impact of adopting SFAS No. 123R on our fiscal year ending April 30, 2007 will be between $0.33 and $0.40 per share.

Loss Contingencies

We are subject to the possibility of various loss contingencies arising in the course of business. We consider the likelihood of the loss or impairment of an asset or the incurrence of a liability as well as our ability to reasonably estimate the amount of loss in determining loss contingencies. An estimated loss contingency is accrued when it is probable that a liability has been incurred or an asset has been impaired and the amount of loss can be reasonably estimated. In the third quarter and first nine months of fiscal 2007 and 2006, we did not identify or accrue for any loss contingencies. We regularly evaluate current information available to us to determine whether such accruals should be adjusted.

New Accounting Standards

See Note 14 of the Condensed Consolidated Financial Statements for a full description of recent accounting pronouncements, including the respective expected dates of adoption and effects on results of operations and financial condition.

Results of Operations

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

	Three Months Ended		Nine Months Ended	
	January 26, 2007	January 27, 2006	January 26, 2007	January 27, 2006
Revenues:	100.0%	100.0%	100.0%	100.0%
Product	75.5	77.0	74.8	76.4
Software subscriptions	11.7	11.3	12.1	11.7
Service	12.8	11.7	13.1	11.9
Cost of Revenues:				
Cost of product	28.9	30.0	29.2	29.4
Cost of software subscriptions	0.4	0.4	0.4	0.4
Cost of service	9.8	8.7	9.6	8.9
Gross margin	60.9	60.9	60.8	61.3
Operating Expenses:				
Sales and marketing	32.4	28.6	31.7	29.3
Research and development	13.4	12.1	13.8	11.9
General and administrative	5.2	4.7	5.3	4.7
In process research and development				0.3
Restructuring charges (recoveries)				
Gain on sale of assets			(1.3)	
Total operating expenses	51.0	45.4	49.5	46.2
Income from Operations	9.9	15.5	11.3	15.1
Other Income (Expense), net:				
Interest income	2.3	1.8	2.6	1.9
Interest expense	(0.3)		(0.6)	
Other income	0.1	0.2	0.2	
Net (loss) gain on investments	0.1		(0.1)	
Total other income (expense), net	2.2	2.0	2.1	1.9
Income before Income Taxes	12.1	17.5	13.4	17.0
Provision for Income Taxes	3.0	3.3	3.0	2.9
Net Income	9.1%	14.2%	10.4%	14.1%

Discussion and Analysis of Results of Operations

Total Revenues Total revenues increased by 35.8% to $729.3 million for the third quarter of fiscal 2007, from $537.0 million for the same period in the prior year. Total revenues increased by 36.4% to $2,003.1 million for the first nine months of fiscal 2007, from $1,468.5 million for the same period a year ago.

Product Revenues Product revenues increased by 33.2% to $550.9 million for the third quarter of fiscal 2007, from $413.5 million for the same period in the prior year. Product revenues increased by 33.5% to $1,497.8 million for the first nine months of fiscal 2007, from $1,122.1 million for the same period a year ago.

Product revenues were impacted by the following factors:

Increased revenues from our current product portfolio. Product revenue grew $137.4 million for the third quarter of fiscal 2007 as compared to the same period in the prior year, with a $147.2 million increase due to unit volume and partially offset by a decrease of $11.0 million due to price and configuration on existing products. Product revenue grew $375.6 million for the first nine months of fiscal 2007 as compared to the same period in the prior year, with a $394.5 million increase due to unit volume and partially offset by a decrease of $21.0 million due to price and configuration of existing products. Price changes, volumes, and product model mix can have an effect on changes in product revenues; the impact on these forces is significantly affected by the configuration of systems shipped.

New products generated $114.3 million and $208.1 million in the third quarter and first nine months of fiscal 2007, respectively, primarily driven by FAS6000 series, FAS3070, and the VTL products.

Units shipped of the FAS3000 enterprise storage systems increased 39.6% and 104.2% for the third quarter and the first nine months of fiscal 2007, respectively, compared to the same periods in the prior fiscal year. The average capacity on revenue units of the FAS3000 series increased 196.7% and 130.4% for the third quarter and the first nine months of fiscal 2007, respectively, compared to the same periods in the prior fiscal year.

Increased enterprise penetration in primary and secondary storage, i.e., enterprise data centers, data protection, disaster recovery, archival, and compliance requirements contributed to the increase in petabytes shipped. Systems shipped with ATA drives increased to 55.2% of total petabytes shipped in the third quarter of fiscal 2007, from 47.2% in the same quarter a year ago. For the first nine months of fiscal 2007 and 2006, systems shipped with ATA drives accounted for 54.0% and 46.8% of total petabytes shipped, respectively.

Increase in software revenue from our application management suite, with products like Snap Manager® for Oracle®, Exchange, and SQL Server was also up 45.8% and 29.6% for the third quarter and first nine months of fiscal 2007, respectively, compared to the same period in the prior year, reflecting growth in our primary storage business.

Increased sales through indirect channels, including sales through our resellers, distributors, and OEM partners, represented 59.6% and 58.2% of total revenues for the third quarter and first nine months of fiscal 2007, respectively, and 56.9% and 56.0% of total revenues for the third quarter and first nine months of fiscal 2006, respectively.

Our petabytes shipped increased 116.3% year over year to a record 104 petabytes. This increase was driven by an increase in petabytes from 500 gigabyte Advanced Technology Attachment (ATA) drives. ATA drives accounted for 55.2% of our total petabytes shipped, and Fibre Channel petabytes were up 83.4% year over year, to 44.8% of our total shipped.

Price declines per petabyte for our hardware products as disks are a significant component of our storage systems. As performance has improved on our devices, the related price we can charge per petabyte of storage has decreased as well.

Revenues for our older products declined by $90.3 million and $278.8 million in the third quarter and first nine months of fiscal 2007, respectively, compared to the same periods in the prior year. This decrease in revenue was primarily due to a decline in revenue generated by FAS 900 series systems by 76.3% and 66.7%, respectively, in the third quarter and first nine months of fiscal 2007. NearStore R200 systems revenue decreased by 71.7% and 55.7%, respectively, in the third quarter and first nine months of fiscal 2007. In addition, revenue also declined by $0.9 million and $6.8 million, respectively, in the third quarter and first nine months of fiscal 2007 compared to the same periods in the prior year due to products that we no longer ship, including our NetCache products.

Our systems are highly configurable to respond to customer requirements in the open systems storage markets that we serve. As a result, the wide variation in customized configuration can significantly impact revenue, cost of revenues, and gross margin performance. Price changes, volumes, and product model mix can have an effect on changes in product revenues; the impact on these forces is significantly affected by the configuration of systems shipped.

While revenues generated from IBM and Decru® accounted for 5.9% and 1.3% of total revenue, respectively, for the third quarter of fiscal 2007, and 4.0% and 1.9% of total revenue, respectively, for the first nine months of fiscal 2007, we cannot assure you that IBM and Decru will continue to contribute meaningful revenue in future quarters. We also cannot assure you that we will be able to maintain or increase market demand for our products.

Software Subscriptions Revenues Software subscriptions revenues increased by 39.9% to $85.0 million for the third quarter of fiscal 2007, from $60.7 million for the same period a year ago, due primarily to a larger installed base of customers who have purchased rights to renewals and upgrades, and an increased number of new enterprise customers. Software subscriptions revenues increased by 41.1% to $242.1 million for the first nine months of fiscal 2007, from $171.5 million for the same period a year ago, also due primarily to a larger installed base of customers who have purchased rights to renewals and upgrades, and an increased number of new enterprise customers. Software subscriptions revenues represented 11.7% and 12.1% of total revenues for the third quarter and first nine months of fiscal 2007, and 11.3% and 11.7% of total revenues for third quarter and first nine months of fiscal 2006.

Service Revenues Service revenues, which include hardware support, professional services, and educational services, increased by 48.8% to $93.4 million for the third quarter of fiscal 2007, from $62.8 million in the same period a year ago. Service revenues increased by 50.6% to $263.3 million for the first nine months of fiscal 2007, from $174.9 million in the same period a year ago.

The increase in absolute dollars was due to the following factors:

> Professional service revenue increased by 51.6% and 52.3% in the third quarter and the first nine months of fiscal 2007 compared to the same period a year ago, due to an increasing number of enterprise customers, which typically purchase more complete and generally longer-term service packages than our non-enterprise customers.
>
> Service maintenance contracts increased by 47.7% and 50.1% in the third quarter and the first nine months of fiscal 2007, respectively, compared to the same periods a year ago due to a growing installed base resulted in new customer support contracts in addition to support contract renewals by existing customers.

While it is an element of our strategy to expand and offer more comprehensive global enterprise support and service solutions, we cannot assure you that service revenue will grow at the current rate in the remainder of fiscal 2007 or beyond.

A large portion of our service revenues is initially deferred and, in most cases, recognized ratably over the service obligation periods, which are typically one to three years. Service revenues represented 12.8% and 13.1% of total revenues for the third quarter and first nine months of fiscal 2007, respectively, and 11.7% and 11.9% of total revenues for the third quarter and first nine months of fiscal 2006, respectively.

International total revenues International total revenues (including United States exports) increased by 42.2% and 41.8% for the third quarter and first nine months of fiscal 2007, respectively, as compared to the same periods in fiscal 2006. Total revenues from Europe were $256.1 million and $642.4 million, or 35.1% and 32.1% of total revenues, respectively, for the third quarter and first nine months of fiscal 2007, compared to $177.3 million and $444.6, or 33.0% and 30.3% of total revenues, for the third quarter and first nine months of fiscal 2006. Total revenues from Asia were $83.9 million and $230.0 million, or 11.5% and 11.5% of total revenues, respectively, for the third quarter and first nine months of fiscal 2007, compared to $61.8 million and $170.5 million, or 11.5% and 11.6% of total revenues, respectively, for the same periods a year ago. The increase in international sales was primarily driven by the same factors outlined under the Total Revenue discussion, as compared to the same periods in the prior fiscal year.

We cannot assure you that we will be able to maintain or increase international revenues in the remainder of fiscal 2007 or beyond.

Product Gross Margin Product gross margin increased to 61.7% for the third quarter of fiscal 2007, from 61.0% for the same period a year ago. Product gross margin decreased to 60.9% for the first nine months of fiscal 2007, from 61.5% for the same period a year ago.

Product gross margin was impacted by:

SFAS 123R stock compensation expenses recorded in fiscal 2007

Sales price reductions due to competitive pricing pressure

Increased sales through certain indirect channels, which generate lower gross margins than our direct sales in certain geographic regions

Higher disk content with an expanded storage capacity for the higher-end storage systems, as resale of disk drives generates lower gross margin

Favorable add-on software mix with software licenses increasing by 38.9% and 38.4% in the third quarter and first nine months of fiscal 2007 compared to the same periods a year ago

Better disk utilization rates associated with sales of higher-margin management software products like FlexClone^{tm} and FlexVol$^{®tm}$ that run on the Data ONTAP$^{®}$ 7G operating system allowing customers to buy less disk storage

We expect that higher disk content associated with high-end and mid-range storage systems will negatively affect our gross margin in the future if not offset by increases in software revenue and new higher-margin products.

Stock-based compensation expense included in cost of product revenues was $0.9 million and $2.7 million for the third quarter and first nine months of fiscal 2007. Amortization of existing technology included in cost of product revenues was $4.6 million and $12.3 million for the third quarter and first nine months of fiscal 2007, respectively, and $3.9 million and $7.9 million for the third quarter and first nine months of fiscal 2006, respectively. Estimated future amortization of existing technology to cost of product revenues will be $5.3 million for the remainder of fiscal 2007, $21.1 million for fiscal year 2008, $20.4 million for fiscal year 2009, $15.9 million for fiscal year 2010, $6.3 million for fiscal year 2011, and none thereafter.

Software Subscriptions Gross Margin Software subscriptions gross margins increased slightly to 96.8% for the third quarter of fiscal 2007, from 96.5% for the same period a year ago. Software subscriptions gross margins increased slightly to 96.9% for the first nine months of fiscal 2007, from 96.4% for the same period a year ago.

Service Gross Margin Service gross margin decreased to 23.7% for the third quarter of fiscal 2007 as compared to 25.9% for the same period in fiscal 2006. Service gross margin increased to 27.2% for the first nine months of fiscal 2007 as compared to 25.3% for the same period in fiscal 2006. Cost of service revenue increased by 53.2% to $71.2 million for the third quarter of fiscal 2007 from $46.5 million for the same period a year ago. Cost of service revenue increased by 46.9% to $191.7 million for the first nine months of fiscal 2007 from $130.5 million for the same period a year ago. Stock-based compensation expense of $2.5 million and $7.6 million was included in the cost of service revenue for the third quarter and first nine months of fiscal 2007, respectively.

The change in service gross margin year over year was primarily impacted by an increase in services revenue, improved headcount utilization, and continued spending in our service infrastructure to support our increasing enterprise customer base. This spending included additional professional support engineers, increased support center activities, and global service partnership programs. Service gross margin will typically be impacted by factors such as timing of technical support service initiations and renewals and additional investments in our customer support infrastructure. In fiscal 2007, we expect service margin to experience some variability over time as we continue to build out our service capability and capacity to support our growing enterprise customers and new products.

Sales and Marketing Sales and marketing expenses consist primarily of salaries, commissions, advertising and promotional expenses, stock-based compensation expense, and certain customer service and support costs. Sales and marketing expenses increased 54.2% to $236.4 million for the third quarter of fiscal 2007, from $153.3 million for the same period a year ago. These expenses were 32.4% and 28.6% of total revenues for the third quarter of fiscal 2007 and fiscal 2006, respectively. Sales and marketing expenses increased 47.8% to $636.2 million for the first nine months of fiscal 2007, from $430.4 million for the same period a year ago. These expenses were 31.7% and 29.3% of total revenues for the first nine months of fiscal 2007 and 2006, respectively. The increase in absolute dollars was attributed to increased commission expenses resulting from increased revenues, higher performance-based payroll expenses due to higher profitability, higher partner program expenses, the continued worldwide investment in our sales and global service organizations associated with selling complete enterprise solutions, and stock-based compensation expense expenses recognized under adoption of SFAS No. 123R.

Stock-based compensation expense included in sales and marketing expenses for the third quarter and first nine months of fiscal 2007 was $17.3 million and $54.7 million. Compensation expenses related to stock options and restricted stock assumed in acquisitions was $1.3 million and $2.9 million for the third quarter and first nine months of fiscal 2006. Amortization of trademarks/tradenames and customer contracts/relationships included in sales and marketing expenses was $0.8 million and $0.7 million for the third quarter of fiscal 2007 and 2006, respectively, and was $2.0 million and $1.4 million for the first nine months of fiscal 2007 and 2006, respectively. Based on identified intangibles related to our acquisitions recorded at January 26, 2007, estimated future amortization such as trademarks, and customer relationships included in sales and marketing expenses will be $1.0 million for the remainder of fiscal 2007, $3.9 million for fiscal 2008, $3.8 million for fiscal 2009, $3.7 million for fiscal 2010, $2.7 million for fiscal 2011, and $2.5 million thereafter.

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. 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, stock-based compensation, prototype expenses, nonrecurring engineering charges, fees paid to outside consultants, and amortization of capitalized patents.

Research and development expenses increased 49.8% to $97.5 million for the third quarter of fiscal 2007, from $65.1 million for the same period in fiscal 2006. These expenses represented 13.4% and 12.1% of total revenues for the third quarters of fiscal 2007 and 2006, respectively. Research and development expenses increased 57.7% to $276.6 million for the first nine months of fiscal 2007, from $175.4 million for the same period in fiscal 2006. These expenses represented 13.8% and 11.9% of total revenues for the first nine months of fiscal 2007 and 2006, respectively. The increase in research and development expenses was primarily a result of increased headcount, ongoing operating impact of the acquisitions, ongoing support of current and future product development and enhancement efforts, higher performance-based payroll expenses due to higher profitability, and stock-based compensation expense recognized under adoption of SFAS No. 123R. For both the third quarter and first nine months of fiscal 2007 and 2006, no software development costs were capitalized.

Stock-based compensation expense included in research and development expenses for the third quarter and first nine months of fiscal 2007 was $12.3 million and $39.2 million. Compensation expenses related to stock option and restricted stock assumed in acquisitions was $2.5 million and $5.9 million for the third quarter and first nine months of fiscal 2006. Included in research and development expenses is capitalized patents amortization of $0.5 million and $1.5 million for the third quarter and first nine months of fiscal 2007, respectively, as compared to $0.5 million and $1.5 million for the third quarter and first nine months of fiscal 2006. Based on capitalized patents recorded at January 26, 2007, estimated future capitalized patents amortization expenses for the remainder of fiscal 2007 will be $0.5 million, $2.0 million for fiscal year 2008, $0.5 million in fiscal 2009, $0.2 million in fiscal 2010, and none thereafter.

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

We believe that our research and development expenses will increase in absolute dollars for the remainder of fiscal 2007, primarily due to ongoing costs associated with the development of new products and technologies, projected headcount growth, and the operating impact of potential future acquisitions.

General and Administrative General and administrative expenses increased 50.8% to $37.7 million for the third quarter of fiscal 2007, from $25.0 million for the same period a year ago. These expenses represented 5.2% and 4.7% of total revenues for the third quarter of fiscal 2007 and 2006, respectively. General and administrative expenses increased 54.9% to $105.3 million for the first nine months of fiscal 2007, from $68.0 million for the same period a year ago. These expenses represented 5.3% and 4.7% of total revenues for the first nine months of fiscal

2007 and 2006, respectively. This increase in absolute dollars was primarily due to higher performance-based payroll expenses due to higher profitability and higher headcount growth, higher stock-based compensation expense recognized under SFAS No. 123R, and higher legal expenses and professional fees for general corporate matters.

We believe that our general and administrative expenses will increase in absolute dollars for the remainder of fiscal 2007 due to projected general and administrative headcount growth. Stock-based compensation expense included in general and administrative expenses for the third quarter and first nine months of fiscal 2007 was $6.2 million and $20.5 million, respectively. Compensation expenses related to stock options and restricted stock assumed in acquisitions were $0.3 million and $0.7 million, respectively, for the third quarter and first nine months of fiscal 2006. Amortization of covenants not to compete included in general and administrative expenses was $0.2 million and $0.7 million for the third quarter and first nine months of fiscal 2007, respectively, as compared to $0.2 million and $2.0 million for the same periods a year ago. Based on identified intangibles related to our acquisitions recorded at January 26, 2007, estimated future amortization of covenants not to compete relating to our acquisitions will be $0.2 million in the remainder of fiscal 2007, $0.2 million for fiscal year 2008, and none thereafter.

Restructuring Charges In fiscal 2002, as a result of continuing unfavorable economic conditions and a reduction in information technology (IT) spending rates, we implemented two restructuring plans, which included reductions in our workforce and consolidations of our facilities. As of January 26, 2007, we have no outstanding balance in our restructuring liability for the first restructuring. The second restructuring related to the closure of an engineering facility and consolidation of resources to the Sunnyvale headquarters. In fiscal 2006, we implemented a third restructuring plan related to the move of our global services center operations from Sunnyvale to our new flagship support center at our Research Triangle Park facility in North Carolina.

Our restructuring estimates are reviewed and revised periodically and may result in a substantial charge or reduction to restructuring expense should different conditions prevail than were anticipated in previous management estimates. Such estimates included various assumptions such as the time period over which the facilities will be vacant, expected sublease terms, and expected sublease rates. During the third quarter of fiscal 2007, we did not record any reduction in restructuring reserve resulting from change in estimate of our third restructuring plan.

Of the reserve balance at January 26, 2007, $0.5 million was included in other accrued liabilities and the remaining $1.7 million was classified as long-term obligations. The balance of the reserve is expected to be paid by fiscal 2011.

The following analysis sets forth the changes in the restructuring reserve for each quarter of the three quarters in fiscal 2007 (in thousands):

	Facility Accrual	Severance-Related	Total
Reserve balance at April 30, 2005	$ 4,503	$	$ 4,503
Restructuring charges	281	859	1,140
Adjustments	(1,256)		(1,256)
Cash payments	(862)	(521)	(1,383)
Reserve balance at April 30, 2006	$ 2,666	$ 338	$ 3,004
Restructuring recoveries		(74)	(74)
Cash payments	(149)	(82)	(231)
Reserve balance at July 28, 2006	$ 2,517	$ 182	$ 2,699

Cash payments	(143)	(182)	(325)
Reserve balance at October 27, 2006	$ 2,374	$	$ 2,374
Cash payments	(143)		(143)
Reserve balance at January 26, 2007	$ 2,231	$	$ 2,231

Gain on sale of assets We recorded a gain of $25.3 million for the first nine months in fiscal 2007 as a result of the sale of certain assets to Blue Coat (see Note 12 of the Condensed Consolidated Financial Statements).

Interest Income Interest income was $17.1 million and $51.2 million for the third quarter and first nine months of fiscal 2007, respectively, as compared to $9.9 million and $28.6 million for the same periods a year ago. The increase in interest income was primarily driven by higher average interest rates on our investment portfolio. We expect interest income to increase compared to fiscal 2006 as a result of our cash and invested balances being reinvested in a higher interest-rate portfolio environment.

Interest Expense Interest expense was $2.3 million and $11.4 million for the third quarter and first nine months of fiscal 2007, respectively, as compared to minimal interest expenses for the same periods a year ago. The increase in fiscal 2007 was primarily due to interest incurred in connection with our debt.

Other Income Other income was $0.5 million and $3.2 million, respectively, for the third quarter and first nine months of fiscal 2007. Other income for the third quarter of fiscal 2007 included net exchange gains from foreign currency of $0.5 million. Other income for the first nine months of fiscal 2007 included net exchange gains from foreign currency of $1.3 million and other income of $1.9 million. Other income included net exchange gains from foreign currency of $1.0 million and $0.4 million for the third quarter and first nine months of fiscal 2006. We believe that period-to-period changes in foreign exchange gains or losses will continue to be impacted by hedging costs associated with our forward and option activities and forecast variance.

Net Gain (Loss) on Investments Net gain (loss) on investments included a write-down of $1.1 million related to the impairment of our investment in a privately held company for the first nine months of fiscal 2007.

Provision for Income Taxes For the third quarter and first nine months of fiscal 2007, we applied an annual effective tax rate of 24.9% and 22.3%, respectively, to pretax income versus 19.0% and 17.3%, respectively, for the comparable periods in the prior year. The increase to the effective tax rate for fiscal year 2007 is primarily attributable to the impact of SFAS No. 123R, which results in recording non-deductible compensation expense for certain of our stock option grants. Our estimate of the effective tax rate is based on the application of existing tax laws to current projections of our annual consolidated income, including projections of the mix of income (loss) earned among our entities and tax jurisdictions in which they operate.

The 2006 Tax Relief and Health Care Act was signed into law on December 20, 2006. One of the provisions of this law was the retroactive reinstatement of the research credit from January 1, 2006 and its extension through December 31, 2007. The effective tax rates for the third quarter and first nine months of fiscal 2007 reflected the benefits attributable to the extension of the research tax credit provisions.

Liquidity and Capital Resources

The following sections discuss the effects of changes in our balance sheet and cash flow, contractual obligations and other commercial commitments, stock repurchase program, capital commitments, and other sources and uses of cash flow on our liquidity and capital resources.

Balance Sheet and Operating Cash Flows

As of January 26, 2007, as compared to April 30, 2006, our cash, cash equivalents, and short-term investments decreased by $27.6 million to $1,295.3 million. We derive our liquidity and capital resources primarily from our cash flow from operations and from working capital. Working capital decreased by $155.6 million to $960.4 million as of January 26, 2007, compared to $1,116.0 million as of April 30, 2006.

During the first nine months of fiscal 2007, we generated cash flows from operating activities of $653.7 million, as compared with $382.4 million in the same period in fiscal 2006. We recorded net income of $208.1 million for the first nine months of fiscal 2007, as compared to $207.2 million for the same period a year ago. A summary of the significant changes in noncash adjustments affecting net income is as follows:

> Stock-based compensation expense was $124.7 million in the first nine months of fiscal 2007, compared to $9.4 million in the same period a year ago. The increase was attributed to the adoption of SFAS No. 123R.

Depreciation expense was $62.3 million and $46.2 million in the first nine months of fiscal 2007 and 2006, respectively. The increase was due to continued capital expansion to meet our business growth.

Amortization of intangibles was $15.0 million and $11.3 million in the first nine months of fiscal 2007 and 2006, respectively. The increase was attributed to the Decru and Topio acquisition.

Gain on sale of certain assets to Blue Coat was $25.3 million in the first nine months of fiscal 2007.

Excess tax benefits of $43.5 million relating to stock-based compensation upon the exercise of stock options.

In addition to net income and noncash adjustments for the first nine months of fiscal 2007, the primary factors that impacted the period-to-period change in cash flows relating to operating activities included the following:

An increase in deferred revenues of $263.4 million in the first nine months of fiscal 2007, due to higher software subscription and service billings attributable to the increase in larger enterprise customers, as well as renewals of existing maintenance agreements in the third quarter of fiscal 2007. The increase in deferred revenue of $144.7 million in the first nine months of fiscal 2006 was due to higher software subscription and service billings resulting from increased enterprise penetration.

Accrued compensation and related benefits increased by $16.9 million in the first nine months of fiscal 2007 and increased by $13.0 million in the same period in fiscal 2006, reflecting the timing of payroll accruals and payment.

Increase in income taxes payable of $31.5 million in the first nine months of fiscal 2007 was attributed to the tax provision of $59.6 million, which was offset by a $2.0 million tax refund and $30.3 million of income tax payments made for fiscal year 2006, of which $19.6 million was related to income tax on the foreign dividend repatriation. Income tax payable increased $39.6 million in the first nine months of fiscal 2006, primarily due to tax provision of $43.2 million, partially offset by tax payments of $5.6 million.

Net inventory decreased $3.5 million for the first nine months of fiscal 2007, primarily due to higher inventory at fiscal 2006 year end associated with the new FAS 6000 launch. The increase of $38.4 million in the first nine months of fiscal 2006 was due primarily to ramping up of purchased components in anticipation of revenue growth.

The above factors were partially offset by the effects of:

Increase in accounts receivable of $23.0 million in the first nine months of fiscal 2007 was due to higher revenue volume. Increase in accounts receivable of $70.2 million in the first nine months of fiscal 2006 was due primarily to less linear shipments in the third quarter of fiscal 2006.

We expect that cash provided by operating activities may fluctuate in future periods as a result of a number of factors, including fluctuations in our operating results, shipment linearity, accounts receivable collections, inventory management, and the timing of tax and other payments.

Cash Flows from Investing Activities

Capital expenditures for the first nine months of fiscal 2007 were $112.4 million as compared to $96.5 million for the same period a year ago. We received net proceeds of $69.5 million and $21.2 million in the first nine months of fiscal

2007 and 2006, respectively, for net purchases/redemptions of short-term investments. We redeemed $63.2 million of restricted investment and its interest income pledged with JP Morgan Chase to repay the Tranche A term loan with JP Morgan Chase. (See Note 5.) Investing activities in the first nine months of fiscal 2007 also included new investments in privately held companies of $1.3 million. In the third quarter of fiscal 2007, we acquired Topio, Inc. for a purchase price of approximately $146.4 million, which consisted the value of the assumed options, cash payments of $131.2 million, and related transaction costs. In the first nine months of fiscal 2007, we received $1.8 million from the sale of investments in privately held companies. In the second quarter of fiscal 2007, we received $23.9 million in cash in connection with the sale of certain assets to Blue Coat. In the first quarter of fiscal 2006, we acquired Alacritus for a purchase price of approximately $13.7 million, which consisted the value of the assumed options, cash payments of $11.0 million, and related transaction costs. In the second quarter of fiscal

2006, we acquired Decru for a purchase price of approximately $283.2 million, which consisted the value of the assumed options, net cash payments of $41.2 million, and related transaction costs.

Cash Flows from Financing Activities

We used $538.4 million and $249.2 million in the first nine months of fiscal 2007 and 2006, respectively, from net financing activities, which included repayment of debt, sales of common stock related to employee stock transactions, and common stock repurchases. We made a repayment of $148.9 million for our debt during the first nine months of fiscal 2007. We repurchased 17.0 million and 14.6 million shares of common stock at a total of $605.7 million and $390.1 million during the first nine months of fiscal 2007 and 2006, respectively. Other financing activities provided $177.4 million and $141.7 million in the first nine months of fiscal 2007 and 2006, respectively, from sales of common stock related to employee stock option exercises and employee stock purchases. Tax benefits, related to tax deductions in excess of the stock-based compensation expense recognized, of $43.5 million were presented as financing cash flows for the first nine months of fiscal 2007 in accordance with SFAS No. 123R. During the first nine months of fiscal 2007 and 2006, we withheld $4.7 million and $0.8 million in shares, respectively, from certain employees exercised shares of their restricted stock to reimburse for federal, state, and local withholding taxes obligations. The increase in the amounts withheld year over year was due to the release of Decru s assumed restricted stock units.

The change in cash flow from financing was primarily due to the effects of higher common stock repurchases partially offset by proceeds from the issuance of common stock under employee equity programs compared to the same period in the prior year. Net proceeds from the issuance of common stock related to employee participation in employee stock programs have historically been a significant component of our liquidity. The extent to which our employees participate in these programs generally increases or decreases based upon changes in the market price of our common stock. As a result, our cash flow resulting from the issuance of common stock related to employee participation in employee stock programs will vary.

Other Factors Affecting Liquidity and Capital Resources

The American Jobs Creation Act of 2004 (the Jobs Act) created a one-time incentive for U.S. corporations to repatriate accumulated income earned abroad by providing an 85% dividend-received deduction for certain dividends from certain non-U.S. subsidiaries. Primarily as a result of this one time repatriation incentive, we remitted $19.6 million of income taxes with the filing of our fiscal year 2006 federal income tax return, of which $18.7 million was paid during the first quarter of fiscal year 2007 and the remaining $0.9 million was paid in the third quarter of fiscal 2007.

For the first nine months of fiscal 2007 and 2006, the income tax benefit associated with dispositions of employee stock transactions was $92.6 million and $22.3 million, respectively. Of the $92.6 million, $65.8 million relates to tax benefits generated from stock option exercises during the first nine months of fiscal 2007 while the remaining $26.8 million relates to a reduction of accrued income taxes payable due to the utilization of net operating loss carryovers generated from stock options in prior years. If stock option exercise patterns change, we may receive less cash from stock option exercises and may not receive the same level of tax benefits in the future, which could cause our cash payments for income taxes to increase.

Stock Repurchase Program

On November 15, 2006, our Board approved a new stock repurchase program in which up to $800 million of additional shares may be purchased.

At January 26, 2007, $599.9 million remained available for future repurchases. The stock repurchase program may be suspended or discontinued at any time.

Debt

In March 2006, we received proceeds from a term loan totaling $300.0 million to finance a foreign dividend repatriation under the Jobs Act. (See Note 5 of the Condensed Consolidated Financial Statements.) The loan repayments of $63.9 million and $87.3 million are due in the remainder of fiscal 2007 and fiscal 2008. This debt was collateralized by restricted investments totaling $180.2 million as of January 26, 2007. In accordance with the payment terms of the loan agreement, interest payments will be approximately $1.6 million and $2.8 million in the remainder of fiscal 2007 and fiscal 2008, respectively. As of January 26, 2007, we were in compliance with the liquidity and leverage ratio as required by the Loan Agreement with the lenders.

Contractual Cash Obligations and Other Commercial Commitments

The following summarizes our contractual cash obligations and commercial commitments at January 26, 2007, and the effect such obligations are expected to have on our liquidity and cash flow in future periods, (in thousands):

Contractual Obligations:	**Remainder of 2007**	**2008**	**2009**	**2010**	**2011**	**Thereafter**	**Total**
Office operating lease payments(1)	$ 4,538	$ 19,650	$ 19,138	$ 16,250	$ 13,606	$ 36,387	$ 109,569
Real estate lease payments(2)		1,482	4,726	5,978	5,978	99,700	117,864
Equipment operating lease payments(3)	2,767	8,916	6,216	1,046	7	3	18,955
Venture capital funding commitments(4)	431	338	325	313	300	25	1,732
Capital expenditures(5)	3,990	256					4,246
Communications and maintenance(6)	6,012	15,635	10,697	4,128	223	3	36,698
Restructuring charges(7)	275	579	604	594	179		2,231
Debt(8)	65,496	90,110					155,606
Total Contractual Cash Obligations	$ 83,509	$ 136,966	$ 41,706	$ 28,309	$ 20,293	$ 136,118	$ 446,901

For purposes of the above table, contractual obligations for the purchase of goods and services are defined as agreements that are enforceable, legally binding on us, and subject us to penalties if we cancel the agreement. Some of the figures we include in this table are based on management s estimates and assumptions about these obligations, including their duration, the possibility of renewal or termination, anticipated actions by management and third parties, and other factors. Because these estimates and assumptions are necessarily subjective, the enforceable and legally binding obligations we will actually pay in future periods may vary from those reflected in the table.

Other Commercial Commitments:	**Remainder of 2007**	**2008**	**2009**	**2010**	**2011**	**Thereafter**	**Total**
Lines of Credit(9)	$ 450	$ 1,583	$	$	$	$ 362	$ 2,395

(1) We enter into operating leases in the normal course of business. We lease sales offices, research and development facilities, and other property and equipment under operating leases throughout the U.S. and internationally, which expire through fiscal year 2016. Substantially all lease agreements have fixed payment terms based on the passage of time and contain escalation clauses. Some lease agreements provide us with the option to renew the lease or to terminate the lease. Our future operating lease obligations would change if we were to exercise these options and if we were to enter into additional operating lease agreements. Facilities operating lease payments exclude the leases impacted by the restructurings. The amounts for the leases impacted by the restructurings are included in subparagraph (6) below. The net increase in the office operating lease payments was primarily due to a domestic lease extension and two new European leases during the third quarter of fiscal 2007.

(2) Included in the above contractual cash obligations pursuant to two financing arrangements with BNP Paribas LLC (BNP) are (a) lease commitments of $1.5 million in fiscal 2008; $4.7 million in fiscal 2009, $6.0 million

in each of the fiscal years 2010, 2011, and 2012, $4.5 million in fiscal 2013; and $1.3 million in fiscal 2014, which are based on the LIBOR rate at January 26, 2007 for a term of five years, and (b) at the expiration or termination of the lease, a supplemental payment obligation equal to our minimum guarantee of $88.0 million in the event that we elect not to purchase or arrange for sale of the buildings, see Note 15.

(3) Equipment operating leases include servers and IT equipment used in our engineering labs and data centers.

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

(5) Capital expenditures include worldwide contractual commitments to purchase equipment and to construct building and leasehold improvements, which will be recorded as Property and Equipment.

(6) We are required to pay based on a minimum volume under certain communication contracts with major telecommunication companies as well as maintenance contracts with multiple vendors. Such obligations expire in April 2010.

(7) These amounts are included on our Consolidated Balance Sheets under Long-term Obligations and Other Accrued Liabilities, which is comprised of committed lease payments and operating expenses net of committed and estimated sublease income.

(8) Included in these amounts are the JP Morgan Chase loan (see Note 5) on our Consolidated Balance Sheets under Current Portion of Long-Term Debt and Long-Term Debt. This amount also includes estimated interest payments of $1.6 million for the remainder of fiscal 2007 and $2.8 million for fiscal 2008. The decrease from April 30, 2006 represented a loan repayment of $148.9 million, plus interest of $8.8 million for the first nine months of fiscal 2007.

(9) The amounts outstanding under these letters of credit relate to workers compensation, a customs guarantee, a corporate credit card program, and a foreign rent guarantee.

On December 16, 2005, we entered into financing, construction, and leasing arrangements with BNP for office space to be located on land currently owned by us in Sunnyvale, California. These arrangements require us to lease our land to BNP for a period of 50 years to construct approximately 190,000 square feet of office space costing up to $38.5 million. After completion of construction, we will pay minimum lease payments, which vary based on London Interbank Offered Rate (LIBOR) plus a spread (5.78% at January 26, 2007) on the cost of the facilities. We expect to begin making lease payments on the completed buildings in September 2007 for a term of five years. We have the option to renew the lease for two consecutive five-year periods upon approval by BNP. Upon expiration (or upon any earlier termination) of the lease term, we must elect one of the following options: We may (i) purchase the building from BNP for $38.5 million, (ii) if certain conditions are met, arrange for the sale of the building by BNP to a third party for an amount equal to at least $32.7 million, and be liable for any deficiency between the net proceeds received from the third party and $32.7 million, or (iii) pay BNP a supplemental payment of $32.7 million, in which event we may recoup some or all of such payment by arranging for a sale of the building by BNP during the ensuing two-year period.

On December 14, 2006, we entered into additional financing, construction, and leasing arrangements with BNP for office space to be located on land currently owned by us in Sunnyvale, California. These arrangements require us to lease our land to BNP for a period of 50 years to construct approximately 190,000 square feet of office space and parking structure costing up to $65.0 million. After completion of construction, we will pay minimum lease payments, which vary based on LIBOR plus a spread (5.78% at January 26, 2007) on the cost of the facilities. We expect to begin making lease payments on the completed buildings in September 2008 for a term of five years. We have the option to renew the lease for two consecutive five-year periods upon approval by BNP. Upon expiration (or upon any earlier termination) of the lease term, we must elect one of the following options: We may (i) purchase the building from BNP for $65.0 million, (ii) if certain conditions are met, arrange for the sale of the building by BNP to a third party for an amount equal to at least $55.3 million, and be liable for any deficiency between the net proceeds received from the third party and $55.3 million, or (iii) pay BNP a supplemental payment of $55.3 million, in which event we may recoup some or all of such payment by arranging for a sale of the building by BNP during the ensuing two-year period.

Both leases also require us to maintain specified financial covenants with which we were in compliance as of January 26, 2007. Such specified financial covenants include a maximum ratio of Total Debt to Earnings Before

Interest, Taxes, Depreciation and Amortization (EBITDA), and a Minimum Unencumbered Cash and Short Term Investments.

As of January 26, 2007, the notional fair value of our foreign exchange forward and foreign currency option contracts totaled $387.3 million. We do not believe that these derivatives present significant credit risks, because the counterparties to the derivatives consist of major financial institutions, and we manage the notional amount of contracts entered into with any one counterparty. We do not enter into derivative financial instruments for speculative or trading purposes. Other than the risk associated with the financial condition of the counterparties, our maximum exposure related to foreign currency forward and option contracts is limited to the premiums paid on purchased options only.

During the second quarter of fiscal 2007, two shareholder derivative lawsuits were filed against various of our officers and directors and naming us as a nominal defendant. The suits allege improper practices relating to the timing of stock option grants. Management believes that the claims are without merit and intends to defend the actions vigorously.

In addition, we are subject to various legal proceedings and claims which may arise in the normal course of business. While the outcome of these legal matters is currently not determinable, we do not believe that any current litigation or claims will have a material adverse effect on our business, cash flow, operating results, or financial condition.

Capital Expenditure Requirements

We expect capital expenditures to increase in the future consistent with the growth in our business, as we continue to invest in people, land, buildings, capital equipment, and enhancements to our worldwide infrastructure. We expect that our existing facilities and those being developed in Sunnyvale, California, Research Triangle Park (RTP), North Carolina, and worldwide are adequate for our requirements over at least the next two years and that additional space will be available as needed. We expect to finance all our construction projects, including our contractual commitments, operating leases, and any required capital expenditures over the next few years through cash from operations and existing cash and investments.

Off-Balance Sheet Arrangements

As of January 26, 2007, our financial guarantees of $2.4 million that were not recorded on our balance sheet consisted of standby letters of credit related to workers compensation, a customs guarantee, a corporate credit card program, and a foreign rent guarantee.

As of January 26, 2007, the notional fair value of our foreign exchange forward and foreign currency option contracts totaled $387.3 million. We do not believe that these derivatives present significant credit risks, because the counterparties to the derivatives consist of major financial institutions, and we manage the notional amount of contracts entered into with any one counterparty. We do not enter into derivative financial instruments for speculative or trading purposes. Other than the risk associated with the financial condition of the counterparties, our maximum exposure related to foreign currency forward and option contracts is limited to the premiums paid.

We have entered into indemnification agreements with third parties in the ordinary course of business. Generally, these indemnification agreements require us to reimburse losses suffered by the third party due to various events, such as lawsuits arising from patent or copyright infringement. These indemnification obligations are considered off-balance sheet arrangements in accordance with FASB Interpretation 45, of FIN No. 45, *Guarantor s Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others.*

We have commitments related to two lease arrangements with BNP for approximately 380,000 square feet of office space to be located on land currently owned by us in Sunnyvale, California (as further described above under

Contractual Cash Obligations and Other Commercial Commitments). We have evaluated our accounting for these leases under the provisions of FIN No. 46R, and have determined the following:

BNP is a leasing company for BNP Paribas in the U.S. BNP is not a special purpose entity organized for the sole purpose of facilitating the lease to us. The obligation to absorb expected losses and receive expected residual returns rests with the parent BNP Paribas. Therefore, we are not the primary beneficiary of BNP as we do not absorb the majority of BNP s expected losses or expected residual returns; and

BNP has represented in the Closing Agreement (filed as Exhibit 10.40) that the fair value of the property leased to us by BNP is less than half of the total of the fair values of all assets of BNP, excluding any assets of BNP held within a silo. Further, the property leased to Network Appliance is not held within a silo. The definition of held within a silo means that BNP has obtained funds equal to or in excess of 95% of the fair value of the leased asset to acquire or maintain its investment in such asset through non-recourse financing or other contractual arrangements, the effect of which is to leave such asset (or proceeds thereof) as the only significant asset of BNP at risk for the repayment of such funds.

Accordingly, under the current FIN No. 46R standard, we are not required to consolidate either the leasing entity or the specific assets that we lease under the BNP lease. Assuming that this transaction will continue to meet the provisions of FIN No. 46R as new standards evolve over time, our future minimum lease payments under this real estates lease will amount to a total of $117.9 million reported under our Note 14 Commitments and Contingencies.

Liquidity and Capital Resource Requirements

Key factors affecting our cash flows include our ability to effectively manage our working capital, in particular, accounts receivable and inventories and future demand for our products and related pricing. We expect to incur higher capital expenditures in the near future to expand our operations. We will from time to time acquire products and businesses complementary to our business. In the future, we may continue to repurchase our common stock, which would reduce cash, cash equivalents, and/or short-term investments available to fund future operations and meet other liquidity requirements. Based on past performance and current expectations, we believe that our cash and cash equivalents, short-term investments, and cash generated from operations will satisfy our working capital needs, capital expenditures, stock repurchases, contractual obligations, and other liquidity requirements associated with our operations for at least the next twelve months.

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

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

Market Interest and Interest Income Risk

Interest and Investment Income As of January 26, 2007, we had available-for-sale investments of $985.2 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. These highly liquid investments, consisting primarily of government, municipal, corporate debt securities, and auction-rate securities, are subject to interest rate and interest income risk and will decrease in value if market interest rates increase. A hypothetical 10 percent increase in market interest rates from levels at January 26, 2007 would cause the fair value of these available-for-sale investments to decline by approximately $3.9 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.

Our investment portfolio also includes common stock holdings in Blue Coat (see Note 12 of the Condensed Consolidated Financial Statements). We are exposed to fluctuations in the market price of our investment in this company. At the same time, we are precluded from selling these shares until September 2007. As a result of these factors, the amount of income and cash flow that we ultimately realize from this investment may vary materially from the current unrealized amount. A hypothetical 10 percent decrease in the fair market value from fair market value at January 26, 2007 would cause the fair value of this investment to decrease by approximately $0.9 million.

Lease Commitments As of January 26, 2007, we have two arrangements with BNP to lease our land for a period of 50 years to construct approximately 380,000 square feet of office space and a parking structure costing up to $103.5 million. After completion of construction, we will pay minimum lease payments which vary based on London Interbank Offered Rate (LIBOR) plus a spread. We expect to pay lease payments on the first lease on September 2007 for a term of five years, and the second lease on September 2008 for a term of five years . We have the option to renew both leases for two consecutive five-year periods upon approval by BNP. A hypothetical 10 percent increase in market interest rates from levels at January 26, 2007 would increase our total lease payments under the initial five-year term by approximately $2.8 million. We do not currently hedge against market interest rate increases. As cash from operating cash flows is invested in a higher interest rate environment, it will offer a natural hedge against interest rate risk from our lease commitments in the event of a significant increase in market interest rate.

Debt Obligation We have an outstanding variable rate term loan totaling $151.1 million as of January 26, 2007. Under terms of these arrangements, we expect to make interest payments at LIBOR plus a spread. A hypothetical 10 percent increase in market interest rates from levels at January 26, 2007 would increase our total interest payments by approximately $0.8 million. We do not currently use derivatives to manage interest rate risk.

Equity Securities We have from time to time made cash investments in companies with distinctive technologies that are potentially strategically important to us. Our investments in non-marketable equity securities would be negatively affected by an adverse change in equity market prices, although the impact cannot be directly quantified. Such a change, or any negative change in the financial performance or prospects of the companies whose non-marketable securities we own, would harm the ability of these companies to raise additional capital and the likelihood of our being able to realize any gains or return of our investments through liquidity events such as initial public offerings, acquisitions, and private sales. These types of investments involve a high degree of risk, and there can be no assurance that any company we invest in will grow or be successful. We do not currently engage in any hedging activities to reduce or eliminate equity price risk with respect to such equity investment. Accordingly, we could lose all or part of this investment if there is an adverse change in the market price of the company we invest in. Our investments in non-marketable equity securities had a carrying amount of $9.8 million as of January 26, 2007 and $11.0 million as of April 30, 2006. If we determine that an other-than-temporary decline in fair value exists for a non-marketable equity security, we write down the investment to its fair value and record the related write-down as an investment loss in our Consolidated Statements of Income. In the second quarter of fiscal 2007, we recorded a non-cash, other-than-temporary write-down of $2.0 million related to an impairment of our investment in a privately held company and subsequently recorded a gain of $0.7 million in the third quarter of fiscal 2007.

Foreign Currency Exchange Rate Risk

We hedge risks associated with foreign currency transactions to minimize the impact of changes in foreign currency exchange rates on earnings. We utilize forward and option contracts to hedge against the short-term impact of foreign currency fluctuations on certain assets and liabilities denominated in foreign currencies. All balance sheet hedges are marked to market through earnings every period. We also use foreign exchange forward contracts to hedge foreign currency forecasted transactions related to certain sales and operating expenses. These derivatives are designated as cash flow hedges under SFAS No. 133. For cash flow hedges outstanding at January 26, 2007, the gains or losses were included in other comprehensive income.

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

The following table provides information about our foreign exchange forward and currency option contracts outstanding on January 26, 2007 (in thousands):

Currency	Buy/Sell	Foreign Currency Amount	Contract Value USD	Fair Value in USD
Forward contracts:				
CAD	Sell	9,580	$ 8,126	$ 8,126
ZAR	Sell	25,474	$ 3,481	$ 3,481
EUR	Sell	169,732	$ 219,862	$ 220,047
GBP	Sell	34,507	$ 67,511	$ 67,545
CHF	Sell	14,178	$ 11,331	$ 11,332
ILS	Sell	6,154	$ 1,446	$ 1,446
EUR	Buy	14,276	$ 18,534	$ 18,530
GBP	Buy	3,391	$ 6,661	$ 6,636
AUD	Buy	27,489	$ 21,248	$ 21,247
JPY	Buy	172,729	$ 1,428	$ 1,428
SEK	Buy	28,728	$ 4,089	$ 4,089
DKK	Buy	16,918	$ 2,935	$ 2,935
NOK	Buy	13,832	$ 2,188	$ 2,188
INR	Buy	112,495	$ 2,539	$ 2,539
Option contracts:				
EUR	Sell	9,000	$ 11,655	$ 11,745
GBP	Sell	2,000	$ 3,912	$ 3,948

Item 4. *Controls and Procedures*

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

Under the supervision and with the participation of our management, including our principal executive officer and principal financial officer, we conducted an evaluation of the effectiveness of the design and operation of our disclosure controls and procedures, as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended, as of January 26, 2007, the end of the fiscal period covered by this quarterly report (the Evaluation Date). Based on this evaluation, our principal executive officer and principal financial officer concluded as of the Evaluation Date that our disclosure controls and procedures were effective such that the information relating to Network Appliance, including our consolidated subsidiaries, required to be disclosed in our Securities and Exchange Commission (SEC) reports (i) is recorded, processed, summarized, and reported within the time periods specified in SEC rules and forms, and (ii) is accumulated and communicated to Network Appliance management, including our principal executive officer and principal financial officer, as appropriate to allow timely decisions regarding required disclosure.

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

PART II. OTHER INFORMATION

Item 1. *Legal Proceedings*

None

Item 1A. *Risk Factors*

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

Factors beyond our control could cause our quarterly results to fluctuate, which could adversely impact our common stock price.

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

Changes in general economic conditions and specific economic conditions in the computer, storage, and networking industries

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

A shift in federal government spending patterns

The possible effects of terrorist activity and international conflicts, which could lead to business interruptions and difficulty in forecasting

The level of competition in our target product markets

Our reliance on a limited number of suppliers due to industry consolidation, which could subject us to periodic supply-and-demand, price rigidity, and quality issues with our components

The size, timing, and cancellation of significant orders

Product configuration and mix

The extent to which our customers renew their service and maintenance contracts with us

Market acceptance of new products and product enhancements

Announcements, introductions, and transitions of new products by us or our competitors

Deferrals of customer orders in anticipation of new products or product enhancements introduced by us or our competitors

Changes in pricing by us in response to competitive pricing actions

Our ability to develop, introduce, and market new products and enhancements in a timely manner

Supply constraints

Technological changes in our target product markets

The levels of expenditure on research and development and sales and marketing programs

Our ability to achieve targeted cost reductions

Excess or inadequate facilities

Disruptions resulting from new systems and processes as we continue to enhance and adapt our system infrastructure to accommodate future growth

Future accounting pronouncements and changes in accounting policies

Seasonality

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

We derive a majority of our revenue in any given quarter from orders booked in the same quarter. Bookings typically follow intra-quarter seasonality patterns weighted towards the back end of the quarter. If we do not achieve bookings in the latter part of a quarter consistent with our quarterly financial targets, our financial results will be adversely impacted.

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

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

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

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

As we enter into new or emerging markets, we will likely increase demands on our service and support operations and may be exposed to additional competition. There can be no assurance that we can provide products, service, and support to effectively compete for these market opportunities. Further, provision of greater levels of services from us may result in a delay in the timing of revenue recognition.

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

The storage markets are intensely competitive and are characterized by rapidly changing technology. In the storage market, our primary and nearline storage system products, and our associated storage software portfolio compete primarily with storage system products and data management software from EMC, HDS, HP, IBM, and Sun/StorageTek. We also see Dell, Inc. as a competitor in the storage marketplace, primarily through their business partnership with EMC, allowing Dell to resell EMC storage hardware and software products. We have also historically encountered less-frequent competition from companies including Engenio Information Technologies, Inc. (formerly the Storage Systems Group of LSI Logic Corp.), Dot Hill Systems Corporation, and Xiotech Corporation. In the secondary storage market, which includes the disk-to-disk backup, compliance, and business continuity segments, our solutions compete primarily against products from EMC and Sun/StorageTek. Our

NearStore VTL appliances also compete with traditional tape backup solutions in the broader data backup/recovery space. Additionally, a number of new, privately held companies are currently attempting to enter the storage systems and data management software markets, the nearline and NearStore VTL storage markets, some of which may become significant competitors in the future.

We also develop and market network storage security products. With the acquisition of Decru, we have gained market share in the financial services, media, telecommunications, and pharmaceutical sectors as well several government agencies worldwide. Our future potential competitors could include developers of operating systems or hardware suppliers not currently offering competitive enterprise-wide security products. If any of those potential competitors begins to offer enterprise-wide security systems as a component of its product solution, demand for our storage security could decrease.

There has been a trend toward industry consolidation in our markets for several years. We expect this trend to continue as companies attempt to strengthen or hold their market positions in an evolving industry and as companies are acquired or are unable to continue operations. We believe that industry consolidation may result in stronger competitors that are better able to compete as sole-source vendors for customers. In addition, current and potential competitors have established or may establish cooperative relationships among themselves or with third parties. Accordingly, it is possible that new competitors or alliances among competitors may emerge and rapidly acquire significant market share. We cannot assure you that we will be able to compete successfully against current or future competitors. Competitive pressures we face could materially and adversely affect our operating results.

We rely on a limited number of suppliers, and any disruption or termination of these supply arrangements could delay shipment of our products and could materially and adversely affect our operating results.

We rely on a limited number of suppliers for components such as disk drives, computer boards and microprocessors utilized in the assembly of our products. In recent years, rapid industry consolidation has led to fewer component suppliers, which could subject us to periodic supply constraints and price rigidity.

Our reliance on a limited number of suppliers involves several risks, including:

- A potential inability to obtain an adequate supply of required components because we do not have long-term supply commitments
- Supplier capacity constraints
- Price increases
- Timely delivery
- Component quality

Component quality is particularly significant with respect to our suppliers of disk drives. In order to meet product performance requirements, we must obtain disk drives of extremely high quality and capacity. In addition, there are periodic supply-and-demand issues for disk drives, microprocessors, and semiconductor memory components, which could result in component shortages, selective supply allocations, and increased prices of such components. We cannot assure you that we will be able to obtain our full requirements of such components in the future or that prices of such components will not increase. In addition, problems with respect to yield and quality of such components and timeliness of deliveries could occur. Disruption or termination of the supply of these components could delay shipments of our products and could materially and adversely affect our operating results. Such delays could also damage relationships with current and prospective customers and suppliers.

In addition, we license certain technology and software from third parties that is incorporated into our products. If we are unable to obtain or license the technology and software on a timely basis, we will not be able to deliver products to our customers in a timely manner.

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

We currently rely on several contract manufacturers to manufacture most of our products. Our reliance on our third-party contract manufacturers reduces our control over the manufacturing process, exposing us to risks, including reduced control over quality assurance, production costs, and product supply. If we should fail to effectively manage our relationships with our contract manufacturers, or if our contract manufacturers experience delays, disruptions, capacity constraints, or quality control problems in their manufacturing operations, our ability to ship products to our customers could be impaired and our competitive position and reputation could be harmed. Qualifying a new contract manufacturer and commencing volume production are expensive and time-consuming. If we are required to change contract manufacturers or assume internal manufacturing operations, we may lose revenue and damage our customer relationships. If we inaccurately forecast demand for our products, we may have excess or inadequate inventory or incur cancellation charges or penalties, which could adversely impact our operating results. As of January 26, 2007, we have no purchase commitment under these agreements.

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

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

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

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

We are also exposed to unfavorable economic and market conditions and the uncertain geopolitical environment.

Our operating results may be adversely affected by unfavorable economic and market conditions and the uncertain geopolitical environment. A reduction in demand for storage and data management caused by weakening economic conditions and decreases in corporate spending will result in decreased revenues and lower revenue growth rates. The network storage market growth declined significantly beginning in the third quarter of fiscal 2001 through fiscal 2003, causing both our revenues and operating results to decline. If the storage and data management markets grow more slowly than anticipated, or if emerging standards other than those adopted by us become increasingly accepted by these markets, our operating results could be materially and adversely affected.

Recent turmoil in the geopolitical environment in many parts of the world, including terrorist activities and military actions, particularly the continuing tension in and surrounding Iraq, and changes in energy costs may continue to put pressure on global economic conditions. If the economic and market conditions in the United States and globally do not improve, or if they deteriorate, we may experience material impacts on our business, operating results, and financial condition.

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

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

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

Demand for storage and data management products

Discount levels and price competition

Direct versus indirect and OEM sales

Product and add-on software mix

The mix of services as a percentage of revenue

The mix and average selling prices of products

The mix of disk content

New product introductions and enhancements

Excess inventory purchase commitments as a result of changes in demand forecasts and possible product and software defects as we transition our products

The cost of components, manufacturing labor, and quality

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

Our effective tax rate may increase or fluctuate, which could increase our income tax expense and reduce our net income.

Our effective tax rate could be adversely affected by several factors, many of which are outside of our control, including:

Earnings being lower than anticipated in countries where we are taxed at lower rates as compared to the United States statutory tax rate

Material differences between forecasted and actual tax rates as a result of a shift in the mix of pre-tax profits and losses by tax jurisdiction, our ability to use tax credits, or effective tax rates by tax jurisdiction different than our estimates

Changing tax laws, accounting standards, including SFAS No. 123R, regulations, and interpretations in multiple tax jurisdictions in which we operate, as well as the requirements of certain tax rulings

An increase in expenses not deductible for tax purposes, including certain stock-based compensation expense, write-offs of acquired in-process research and development, and impairment of goodwill

The tax effects of purchase accounting for acquisitions and restructuring charges that may cause fluctuations between reporting periods

Changes in the valuation of our deferred tax assets and liabilities

Changes in tax laws or the interpretation of such tax laws

Tax assessments, or any related tax interest or penalties, could significantly affect our income tax expense for the period in which the settlements take place

A change in our decision to indefinitely reinvest foreign earnings

The price of our common stock could decline to the extent that our financial results are materially affected by an adverse change in our effective tax rate. We are currently undergoing federal income tax audits in the U.S. and several foreign tax jurisdictions. The rights to some of our intellectual property (IP) are owned by certain of our foreign subsidiaries, and payments are made between U.S. and foreign tax jurisdictions relating to the use of this IP. Recently, some other companies have had their foreign IP arrangements challenged as part of an examination. Our management does not believe, based upon information currently known to us, that the final resolution of any of our audits will have a material adverse effect upon our consolidated financial position and the results of operations and cash flows. If the ultimate determination of our taxes owed in any of these tax jurisdictions is for an amount in excess of the tax provision we have recorded or reserved for, our operating results, cash flows, and financial condition could be adversely affected.

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

As part of our strategy, we are continuously evaluating opportunities to buy other businesses or technologies that would complement our current products, expand the breadth of our markets, or enhance our technical capabilities. We may engage in future acquisitions that dilute our stockholders investments and cause us to use cash, to incur debt, or to assume contingent liabilities.

Acquisitions of companies entail numerous risks, and we may not be able to successfully integrate acquired operations and products or to realize anticipated synergies, economies of scale, or other value. Integration risks and issues may include, but are not limited to, key personnel retention and assimilation, management distraction, technical development, and unexpected costs and liabilities, including goodwill impairment charges. In addition, we may be unable to recover strategic investments in development stage entities. Any such problems could have a material adverse effect on our business, financial condition, and results of operation.

From time to time, we also make equity investments for the promotion of business and strategic objectives. We have already made strategic investments in a number of storage and data management-related technology companies. Equity investments may result in the loss of investment capital. The market price and valuation of our equity investments in these companies may fluctuate due to market conditions and other circumstances over which we have little or no control. To the extent that the fair value of these securities is less than our cost over an extended period of time, our results of operations and financial position could be negatively impacted. In the second quarter of fiscal 2007, we recorded a $2.0 million write-down relating to our investment in a technology company.

We cannot assure you that our OEM relationship with IBM will generate significant revenue.

In April 2005, we announced a strategic partner relationship with IBM. As part of the relationship, we entered into an original equipment manufacturing (OEM) agreement that enables IBM to sell IBM branded solutions based on Network Appliance^{tm} unified and open network attached storage (NAS) and iSCSI/IP SAN solutions, including NearStore and the NetApp V-Series systems, as well as associated software offerings. While this agreement is an element of our strategy to expand our reach into more customers and countries, we do not have an exclusive relationship with IBM, and there is no minimum commitment for any given period of time; therefore we cannot assure you that this relationship will contribute any revenue in future years. In addition, we have no control over the products that IBM selects to sell, or their release schedule and timing of those products; nor do we control their pricing. Revenues from IBM accounted for 5.9% and 4.0% of our total consolidated revenue for the three- and nine-month periods ended January 26, 2007. Revenues from IBM accounted for 1.0% of our total consolidated revenue for the fiscal year 2006. In the event that sales through IBM will increase, we may experience distribution channel conflicts between our direct sales force and IBM, or among our channel partners. If we fail to minimize channel conflicts, our operating results and financial condition could be harmed. In addition, since this agreement is relatively new, we do not have a history upon which to base our analysis of its future success.

Currently we do not and cannot assure you that this OEM relationship will generate significant revenue or that this strategic partnership will continue to be in effect for any specific period of time.

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

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

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

We cannot assure you that we are able to maintain existing resellers and attract new resellers, and that channel conflicts will not materially adversely affect our channel relationships. In addition, we do not have exclusive relationships with our resellers and accordingly there is a risk that those resellers may give higher priority to products of other suppliers, which could materially adversely affect our operating results.

We market and sell our storage solutions directly through our worldwide sales force and indirectly through channels such as value-added resellers, or VARs, systems integrators, distributors, OEMs, and strategic business partners, and we derive a significant portion of our revenue from these indirect channel partners. In the three-month period ended January 26, 2007, Fujitsu Siemens and our two-tier distribution partners, Arrow and Avnet, accounted for 3.8% and 10.5%, respectively, of our consolidated revenue. In the nine-month period ending January 27, 2006, Fujitsu Siemens and our two-tier distribution partners, Arrow and Avnet, accounted for 3.4% and 11.1%, respectively, of our consolidated revenue.

However, in order for us to maintain our current revenue sources and grow our revenue as we have forecasted, we must effectively manage our relationships with these indirect channel partners. To do so, we must attract and retain a sufficient number of qualified channel partners to successfully market our products. However, because we also sell our products directly to customers through our sales force, on occasion we compete with our indirect channels for sales of our products to our end customers, competition that could result in conflicts with these indirect channel partners and make it harder for us to attract and retain these indirect channel partners. At the same time, our indirect channel partners may offer products that are competitive to ours. In addition, because our reseller partners generally offer products from several different companies, including products of our competitors, these resellers may give higher priority to the marketing, sales, and support of our competitors products than ours. If we fail to effectively manage our relationships with these indirect channel partners to minimize channel conflict and continue to evaluate and meet our indirect sales partners needs with respect to our products, we will not be able to maintain or increase our revenue as we have forecasted, which would have a materially adverse affect on our business, financial condition, and results of operations. Additionally, if we do not manage distribution of our products and services and support effectively, or if our resellers financial conditions or operations weaken, our revenues and gross margins could be adversely affected.

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

We conduct business internationally. For the third quarter and first nine months of fiscal 2007, 46.6% and 43.6%, respectively, of our total revenues were from international customers (including U.S. exports). Accordingly, our future operating results could be materially and adversely affected by a variety of factors, some of which are beyond our control, including regulatory, political, or economic conditions in a specific country or region, trade protection measures and other regulatory requirements, government spending patterns, and acts of terrorism and international conflicts.

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

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

We receive significant tax benefits from sales to our non-U.S. customers. These benefits are contingent upon existing tax regulations in the U.S. and in the countries in which our international operations are located. Future changes in domestic or international tax regulations could adversely affect our ability to continue to realize these tax benefits. Our effective tax rate could also be adversely affected by different and evolving interpretations of existing law or regulations. Potentially adverse tax consequences could negatively impact the operating and financial results from international operations. International operations currently benefit from a tax ruling concluded in the Netherlands.

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

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

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

Our future operating results depend to a large extent on management s ability to successfully manage expansion and growth, including but not limited to expanding international operations, forecasting revenues, addressing new markets, controlling expenses, implementing and enhancing infrastructure, investing in people, facilities and capital equipment, and managing our assets. An unexpected decline in the growth rate of revenues without a corresponding and timely reduction in expense growth or a failure to manage other aspects of growth could materially and adversely affect our operating results.

In addition, continued expansion could strain our current management, financial, manufacturing, and other systems, and may require us to implement and improve those systems. If we experience any problems with any improvement or expansion of these systems, procedures, or controls, or if these systems, procedures or controls are not designed, implemented, or improved in a cost-effective and timely manner, our operations may be materially and adversely affected. In addition, any failure to implement, improve, and expand such systems, procedures, and controls in a timely and efficient manner could harm our growth strategy and materially and adversely affect our financial condition and ability to achieve our business objectives.

As we continue to grow our business, we are likely to incur costs earlier than some of the anticipated benefits which could harm our operating results. A significant percentage of our expenses are fixed, which could materially and adversely affect our net income.

We are increasing our investment in engineering, sales, service support and other functions to grow our business. We are likely to recognize the costs associated with these increased investments earlier than some of the anticipated benefits and the return on these investments may be lower, or may develop more slowly, than we expect, which could harm our business.

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

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

The market price for our common stock has experienced substantial volatility in the past, and several factors could cause the price to fluctuate substantially in the future. These factors include but are not limited to:

Fluctuations in our operating results

Fluctuations in the valuation of companies perceived by investors to be comparable to us

Economic developments in the storage and data management market as a whole

International conflicts and acts of terrorism

A shortfall in revenues or earnings compared to securities analysts expectations

Changes in analysts recommendations or projections

Announcements of new products, applications, or product enhancements by us or our competitors

Changes in our relationships with our suppliers, customers, and channel and strategic partners

General market conditions

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

We depend on the ability of our personnel, raw materials, equipment, and products to move reasonably unimpeded around the world. Our business could be materially and adversely affected as a result of a natural disaster, terrorist acts, or other catastrophic events.

Any political, military, world health (e.g., SARS, avian flu), or other issue which hinders this movement or restricts the import or export of materials could lead to significant business disruptions. Furthermore, any strike, economic failure, or other material disruption cased by fire, floods, hurricanes, power loss, power shortages, telecommunications failures, break-ins, and similar events could also adversely affect our ability to conduct business. If such disruptions result in cancellations of customer orders or contribute to a general decrease in economic activity or corporate spending on information technology, or directly impact our marketing, manufacturing, financial, and logistics functions, our results of operations and financial condition could be materially adversely affected. In addition, our headquarters are located in Northern California, an area susceptible to earthquakes. If any significant disaster were to occur, our ability to operate our business could be impaired.

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

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

Undetected software errors, hardware errors, or failures found in new products may result in loss of or delay in market acceptance of our products, which could increase our costs and reduce our revenues. Product quality problems could lead to reduced revenue, gross margins, and net income

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

If we fail to remedy a product defect, we may experience a failure of a product line, temporary or permanent withdrawal from a product or market, damage to our reputation, inventory costs, or product reengineering expenses, any of which could have a material impact on our revenue, margins, and net income.

In addition, we may be subject to losses that may result or are alleged to result from defects in our products, which could subject us to claims for damages, including consequential damages. Based on our historical experience, we believe that the risk of exposure to product liability claims is currently low. However, should we experience increased exposure to product liability claims, our business could be adversely impacted.

We are exposed to various risks related to legal proceedings or claims and protection of intellectual property rights, which could adversely affect our operating results.

We are a party to lawsuits in the normal course of our business. Litigation can be expensive, lengthy, and disruptive to normal business operations. Moreover, the results of complex legal proceedings are difficult to predict. An unfavorable resolution of a particular lawsuit could have a material adverse effect on our business, operating results, or financial condition.

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

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

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

Our business is subject to increasingly complex corporate governance, public disclosure, accounting, and tax requirements that have increased both our costs and the risk of noncompliance.

Because our common stock is publicly traded, we are subject to certain rules and regulations of federal, state, and financial market exchange entities charged with the protection of investors and the oversight of companies whose securities are publicly traded. These entities, including the Public Company Accounting Oversight Board, the SEC, and NASDAQ, have implemented new requirements and regulations and continue developing additional regulations and requirements in response to recent corporate scandals and laws enacted by Congress, most notably the Sarbanes-Oxley Act of 2002. Our efforts to comply with these new regulations have resulted in, and are likely to continue resulting in, increased general and administrative expenses and diversion of management time and attention from revenue-generating activities to compliance activities.

We have recently completed our evaluation of our internal controls over financial reporting as required by Section 404 of the Sarbanes-Oxley Act of 2002. Although our assessment, testing, and evaluation resulted in our conclusion that as of April 30, 2006, our internal controls over financial reporting were effective, we cannot predict the outcome of our testing in future periods. If our internal controls are ineffective in future periods, our business and reputation could be harmed. We may incur additional expenses and commitment of management s time in connection with further evaluations, either of which could materially increase our operating expenses and accordingly reduce our net income.

Because new and modified laws, regulations, and standards are subject to varying interpretations in many cases due to their lack of specificity, their application in practice may evolve over time as new guidance is provided by regulatory and governing bodies. This evolution may result in continuing uncertainty regarding compliance matters and additional costs necessitated by ongoing revisions to our disclosure and governance practices.

Our ability to forecast earnings is limited by the impact of new accounting requirements such as SFAS No. 123R.

The Financial Accounting Standards Board requires companies to recognize the fair value of stock options and other share-based payment compensation to employees as compensation expense in the statement of income. Option pricing models require the input of highly subjective assumptions, including the expected stock price volatility, expected life, and forfeiture rate. We have chosen to base our estimate of future volatility using the implied volatility of traded options to purchase the Company s common stock as permitted by SAB No. 107. As of May 1, 2006, the contractual life of our stock options has been shortened to seven years from ten years for options issued on or after this date, and to the extent that the shorter life changes employees exercise behavior, it may change the expected term of an option going forward. SFAS No. 123R requires us to use estimated forfeitures, and therefore the adoption of SFAS No. 123R could have a material impact on the timing of and, based on the accuracy of estimates of future actual forfeitures, the amount of stock-based compensation expense. Given the unpredictable nature of the Black Scholes variables and other management assumptions such as number of options to be granted, underlying strike price, and associated income tax impacts, it is very difficult to estimate stock-based compensation expense for any given quarter or year. Any changes in these highly subjective assumptions may significantly impact our ability to make accurate forecasts of future earnings and volatility of our stock price. If another party asserts that the fair value of our employee stock options is misstated, securities class action litigation could be brought against us, or the market price of our common stock could decline, or both could occur. As a result, we could incur significant losses, and our operating results may be below our expectations and those of investors and stock market analysts.

The U.S. government has contributed to our revenue growth and become an important customer for us.

The U.S. government has become an important customer for the storage market and for us, however, government demand is unpredictable and there is no guarantee of future revenue growth from the U.S. government. Government agencies are subject to budgetary processes and expenditure constraints that could lead to delays or decreased capital expenditures in IT spending on infrastructures. If the government or individual agencies within the government reduce or shift their capital spending pattern, our financial results may be harmed. We cannot assure you that revenue from the U.S. government will continue to grow in the future.

The General Services Administration (GSA) is currently auditing our records under the schedule contracts it had with us to verify our compliance with various contract provisions. If the audit determines that we did not comply with such provisions, we may be required to pay the GSA a potential settlement. The exact date for completion of the audit and the subsequent negotiation process is unknown and may not be concluded for some time. Our management does not believe, based upon information currently known to us, that the final resolution of our audit will have a material adverse effect upon our consolidated financial position and the results of operations and cash flows.

Item 2. *Unregistered Sales of Equity Securities and Use of Proceeds*

The table below sets forth information with respect to common repurchases by Network Appliance, Inc. for the third quarter of fiscal 2007:

Period	Shares Purchased	Average Price Paid per Share	Total Number of Shares Purchased as Part of the Repurchase Program(1)	Value of Shares That may yet be Purchased Under the Repurchase Program(2)
October 28, 2006 November 24, 2006		$	42,815,630	$ 41,748,253
November 25, 2006 December 22, 2006		$	42,815,630	$ 41,748,253
December 23, 2006 January 26, 2007	6,164,546	$ 39.22	48,980,176	$ 599,948,253
Total	6,164,546	$ 39.22	48,980,176	$ 599,948,253

(1) This amount represented total number of shares purchased under our publicly announced repurchase programs since inception.

(2) At January 26, 2007, $599,948,253 remained available for future repurchases. The stock repurchase program may be suspended or discontinued at any time.

On November 15, 2006, our Board approved a new stock repurchase program in which up to $800,000,000 of additional shares may be purchased.

Item 3. *Defaults Upon Senior Securities*

None

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

None

Item 5. *Other Information*

The information required by this item is incorporated by reference from our Proxy Statement for the 2006 Annual Meeting of Shareholders.

Item 6. *Exhibits*

2.1(6) Agreement and Plan of Merger of Network Appliance, Inc. (a Delaware corporation) and Network Appliance, Inc. (a California corporation) dated as of November 1, 2001.

2.2(9) Agreement and Plan of Merger dated as of November 3, 2003, by and among Network Appliance, Inc., Nagano Sub, Inc., and Spinnaker Networks, Inc.

2.3(9) Amendment to Merger Agreement, dated as of February 9, 2004, by and among Network Appliance, Inc., Nagano Sub, Inc., and Spinnaker Networks, Inc.

2.4(15) Agreement and Plan of Merger and Reorganization, dated as of June 15, 2005, by and among Network Appliance, Inc., Dolphin Acquisition Corp, and Decru, Inc.

3.1(6) Certificate of Incorporation of the Company dated as of November 1, 2001.

3.2(6) Bylaws of the Company dated as of November 1, 2001.

3.3(16) Certificate of Amendment to the Bylaws of the Company dated as of August 31, 2006.

4.1(6) Reference is made to Exhibits 3.1 and 3.2.

10.1(23)* The Company s Amended and Restated Employee Stock Purchase Plan.

10.2(14)* The Company s Amended and Restated 1995 Stock Incentive Plan.

10.3(2) The Company s Special Non-Officer Stock Option Plan.

10.4(7)* The Company s Amended and Restated 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.

10.15(5) 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 (8) Short Form Termination of Operative Documents, dated April 24, 2002, by and between BNP Leasing Corporation and the Company.

10.18(10)* Spinnaker Networks, Inc. 2000 Stock Plan.

10.19(12)* Alacritus, Inc. 2005 Stock Plan.

10.20(11)* The Company s Fiscal Year 2005 Incentive Compensation Plan.

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10.22(21) Form of Stock Option Agreement approved for use under the Company s amended and restated 1995 Stock Option Plan.

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10.28(21) Form of Stock Option Agreement approved for use under the Company s amended and restated 1999 Stock Option Plan (China).

10.29(21)	Form of Stock Option Agreement approved for use under the Company s amended and restated 1999 Stock Option Plan (Non-Employee Director Automatic Stock Option Annual).
10.30(21)	Form of Stock Option Agreement approved for use under the Company s amended and restated 1999 Stock Option Plan (Non-Employee Director Automatic Stock Option Initial).

10.31(21)	Form of Stock Option Agreement approved for use under the Company s amended and restated 1999 Stock Option Plan (France).
10.32(21)	Form of Stock Option Agreement approved for use under the Company s amended and restated 1999 Stock Option Plan (India).
10.33(21)	Form of Stock Option Agreement approved for use under the Company s amended and restated 1999 Stock Option Plan (United Kingdom).
10.34(17)	Form of Stock Option Grant Notice and Option Agreement under the Decru, Inc. Amended and Restated 2001 Equity Incentive Plan and the 2001 Equity Incentive Plan filed under Attachment II.
10.35(17)	Form of Stock Option Grant Notice and Option Agreement under the Decru, Inc. 2001 Equity Incentive Plan and the 2001 Equity Incentive Plan filed under Attachment II.
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10.38(18)	Asset Purchase Agreement dated June 20, 2003, by and between Auspex Systems, Inc. and the Company.
10.39(19)	Purchase and Sale Agreement dated July 27, 2004 by and between Cisco Systems, Inc. and the Company.
10.40(20)	Closing Certificate and Agreement, dated December 15, 2005, by and between BNP Leasing Corporation and the Company.
10.41(20)	Construction Management Agreement, dated December 15, 2005, by and between BNP Leasing Corporation and the Company.
10.42(20)	Lease Agreement, dated December 15, 2005, by and between BNP Leasing Corporation and the Company.
10.43(20)	Purchase Agreement, dated December 15, 2005, by and between BNP Leasing Corporation and the Company.
10.44(20)	Ground Lease, dated December 15, 2005, by and between BNP Leasing Corporation and the Company.
10.45(22)	Loan Agreement, dated March 31, 2006, by and between the Lenders party hereto and JP Morgan Chase Bank and Network Appliance Global Ltd.
10.46	Closing Certificate and Agreement, dated December 14, 2006, by and between BNP Leasing Corporation and the Company.
10.47	Construction Management Agreement, dated December 14, 2006, by and between BNP Leasing Corporation and the Company.
10.48	Lease Agreement, dated December 14, 2006, by and between BNP Leasing Corporation and the Company.
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10.51(24)*	SANPro Systems, Inc. 2001 U.S. Stock Option Plan.
10.52(24)*	Topio, Inc. 2004 Israeli Share Option Plan.
10.53	Master Confirmation, dated December 6, 2006, by and between JP Morgan Securities Inc. and the Company.
31.1	Certification of the Chief Executive Officer pursuant to Section 302(a) of the Sarbanes-Oxley Act of 2002, dated March 6, 2007.
31.2	Certification of the Chief Financial Officer pursuant to Section 302(a) of the Sarbanes-Oxley Act of 2002, dated March 6, 2007.

32.1	Certification of Chief Executive Officer pursuant to 18 U.S.C. section 1350, as adopted pursuant to section 906 of the Sarbanes-Oxley Act of 2002, dated March 6, 2007.
32.2	Certification of Chief Financial Officer pursuant to 18 U.S.C. section 1350, as adopted pursuant to section 906 of the Sarbanes-Oxley Act of 2002, dated March 6, 2007.

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

* Identifies management plan or compensatory plan or arrangement.

SIGNATURE

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

NETWORK APPLIANCE, INC.
(Registrant)

/s/ STEVEN J. GOMO
Steven J. Gomo
Executive Vice President of Finance and
Chief Financial Officer

Date: March 6, 2007

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