CITRIX SYSTEMS INC
Form 10-Q
November 03, 2006

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2006

or

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

For the transition period from ______ to ______.

Commission File Number 0-27084

CITRIX SYSTEMS, INC.

(Exact name of registrant as specified in its charter)

Delaware	**75-2275152**
(State or other jurisdiction of incorporation or organization)	*(IRS Employer Identification No.)*
851 West Cypress Creek Road	
Fort Lauderdale, Florida	**33309**

(Address of principal executive offices) *(Zip Code)*

Registrant s Telephone Number, Including Area Code:

(954) 267-3000

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 x No ¨

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. (Check one):

x Large accelerated filer ¨ Accelerated filer ¨ Non-accelerated filer

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

As of October 30, 2006 there were 180,585,145 shares of the registrant s Common Stock, $.001 par value per share, outstanding.

CITRIX SYSTEMS, INC.

Form 10-Q

For the Quarterly Period Ended September 30, 2006

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PART I: FINANCIAL INFORMATION

ITEM 1. CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

CITRIX SYSTEMS, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS

	September 30, 2006 (unaudited)	December 31, 2005
	(In thousands, except par value)	
Assets		
Current assets:		
Cash and cash equivalents	**$ 216,539**	$ 484,035
Short-term investments	**240,598**	18,900
Accounts receivable, net of allowances of $3,834 and $4,382 at September 30, 2006 and December 31, 2005, respectively	**149,343**	142,015
Inventories, net	**5,415**	3,933
Prepaid expenses and other current assets	**43,055**	31,164
Current portion of deferred tax assets, net	**46,649**	46,410
Total current assets	**701,599**	726,457
Restricted cash equivalents and investments	**63,786**	63,728
Long-term investments	**279,198**	51,286
Property and equipment, net	**86,821**	73,727
Goodwill	**636,962**	591,994
Other intangible assets, net	**136,802**	137,333
Long-term portion of deferred tax assets, net	**42,470**	29,158
Other assets	**9,209**	7,973
	$ 1,956,847	$ 1,681,656
Liabilities and Stockholders Equity		
Current liabilities:		
Accounts payable	**$ 38,917**	$ 33,495
Accrued expenses	**121,727**	125,029
Income taxes payable		1,329
Current portion of deferred revenues	**293,212**	266,223
Total current liabilities	**453,856**	426,076
Long-term portion of deferred revenues	**21,250**	19,803
Long-term debt		31,000
Other liabilities	**7,234**	1,297
Commitments and contingencies		
Stockholders equity:		
Preferred stock at $.01 par value: 5,000 shares authorized, none issued and outstanding		
Common stock at $.001 par value: 1,000,000 shares authorized; 237,483 and 226,573 shares issued and outstanding at September 30, 2006 and December 31, 2005, respectively	**237**	226
Additional paid-in capital	**1,487,958**	1,189,460
Deferred compensation		(18,873)
Retained earnings	**1,082,373**	944,626
Accumulated other comprehensive income (loss)	**1,145**	(4,463)

	2,571,713	2,110,976
Less common stock in treasury, at cost (55,915 and 49,965 shares at September 30, 2006 and December 31, 2005, respectively)	**(1,097,206)**	(907,496)
Total stockholders equity	**1,474,507**	1,203,480
	$ 1,956,847	$ 1,681,656

See accompanying notes.

CITRIX SYSTEMS, INC.

CONDENSED CONSOLIDATED STATEMENTS OF INCOME

(Unaudited)

	Three Months Ended September 30, 2006	Three Months Ended September 30, 2005	Nine Months Ended September 30, 2006	Nine Months Ended September 30, 2005
Revenues:				
Product licenses	**$ 113,379**	$ 97,262	**$ 345,363**	$ 279,304
License updates	**102,854**	84,511	**296,475**	242,141
Online services	**39,055**	26,163	**105,821**	70,372
Technical services	**22,563**	19,011	**65,658**	48,249
Total net revenues	**277,851**	226,947	**813,317**	640,066
Cost of revenues:				
Cost of license revenues	**8,201**	4,828	**22,948**	8,473
Cost of services revenues	**11,320**	6,611	**33,131**	16,521
Amortization of core and product technology	**4,657**	4,477	**14,243**	11,488
Total cost of revenues	**24,178**	15,916	**70,322**	36,482
Gross margin	**253,673**	211,031	**742,995**	603,584
Operating expenses:				
Research and development	**39,432**	27,540	**111,314**	79,007
Sales, marketing and support	**118,027**	96,632	**343,966**	283,061
General and administrative	**42,957**	31,919	**122,371**	89,480
Amortization of other intangible assets	**4,360**	3,147	**12,542**	7,538
In-process research and development	**1,000**	7,000	**1,000**	7,000
Total operating expenses	**205,776**	166,238	**591,193**	466,086
Income from operations	**47,897**	44,793	**151,802**	137,498
Interest income	**12,525**	6,742	**30,429**	16,743
Interest expense	**(75)**	(1,060)	**(586)**	(1,084)
Other expense, net	**(373)**	(112)	**(970)**	(18)
Income before income taxes	**59,974**	50,363	**180,675**	153,139
Income taxes	**13,356**	9,410	**42,928**	45,740
Net income	**$ 46,618**	$ 40,953	**$ 137,747**	$ 107,399
Earnings per share:				
Basic	**$ 0.25**	$ 0.24	**$ 0.76**	$ 0.63
Diluted	**$ 0.25**	$ 0.23	**$ 0.73**	$ 0.61
Weighted average shares outstanding:				
Basic	**183,008**	172,870	**181,418**	170,921
Diluted	**188,882**	178,210	**188,829**	176,441

See accompanying notes.

CITRIX SYSTEMS, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

	Nine Months Ended September 30, 2006	2005
	(In thousands)	
Operating Activities		
Net income	**$ 137,747**	$ 107,399
Adjustments to reconcile net income to net cash provided by operating activities:		
Amortization of intangible assets	**26,785**	19,026
Depreciation and amortization of property and equipment	**19,543**	15,845
Stock-based compensation expense	**40,476**	1,386
In-process research and development	**1,000**	7,000
Provision for (recovery of) doubtful accounts	**1,639**	(101)
Provision for product returns	**3,044**	4,245
Provision for inventory reserves	**1,561**	245
Tax effect of stock-based compensation	**50,506**	19,306
Excess tax benefit from exercise of stock options	**(50,542)**	
Realized gain on investments		(658)
Other non-cash items	**197**	277
Total adjustments to reconcile net income to net cash provided by operating activities	**94,209**	66,571
Changes in operating assets and liabilities, net of the effects of acquisitions:		
Accounts receivable	**(10,737)**	963
Inventories	**(2,642)**	(768)
Prepaid expenses and other current assets	**(11,305)**	3,352
Other assets	**(1,157)**	211
Deferred tax assets, net	**(8,999)**	(3,475)
Accounts payable	**2,493**	(670)
Accrued expenses	**(6,164)**	(2,587)
Income taxes payable	**(1,330)**	21,002
Deferred revenues	**27,773**	24,861
Other liabilities	**5,702**	(2,952)
Total changes in operating assets and liabilities, net of the effects of acquisitions	**(6,366)**	39,937
Net cash provided by operating activities	**225,590**	213,907
Investing Activities		
Purchases of available-for-sale investments	**(625,207)**	(160,382)
Proceeds from sales of available-for-sale investments	**82,271**	396,580
Proceeds from maturities of available-for-sale investments	**93,844**	137,616
Purchases of property and equipment	**(35,513)**	(16,699)
Cash paid for acquisitions, net of cash acquired	**(60,968)**	(136,676)
Net cash (used in) provided by investing activities	**(545,573)**	220,439
Financing Activities		
Proceeds from issuance of common stock	**219,027**	60,933
Excess tax benefit from exercise of stock options	**50,542**	
Cash paid under stock repurchase programs	**(182,232)**	(135,533)
Proceeds from term loan and revolving credit facility		175,000
Payments on debt	**(34,850)**	(100,000)
Net cash provided by financing activities	**52,487**	400

Change in cash and cash equivalents		**(267,496)**		434,746
Cash and cash equivalents at beginning of period		**484,035**		73,485
Cash and cash equivalents at end of period	**$**	**216,539**	$	508,231
Supplemental non-cash investing activity:				
Increase (decrease) in restricted cash equivalents and investments	**$**	**58**	$	(85,309)
Supplemental non-cash financing activity:				
Fair value of stock issued in connection with acquisitions	**$**		$	154,507

See accompanying notes.

Citrix Systems, Inc.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

September 30, 2006

1. BASIS OF PRESENTATION

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States for interim financial information and with the instructions to Form 10-Q and Rule 10-01 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the United States for complete financial statements. All adjustments, which, in the opinion of management, are considered necessary for a fair presentation of the results of operations for the periods shown, are of a normal recurring nature and have been reflected in the condensed consolidated financial statements. The results of operations for the periods presented are not necessarily indicative of the results expected for the full year or for any future period partially because of the seasonality of the Company s business. Historically, the Company s fourth quarter revenue in any year is typically higher than the first quarter of the subsequent year. The information included in these condensed consolidated financial statements should be read in conjunction with Management s Discussion and Analysis of Financial Condition and Results of Operations contained in this report and the consolidated financial statements and accompanying notes included in the Citrix Systems, Inc. (the Company) Form 10-K for the year ended December 31, 2005.

Certain reclassifications have been made for consistent presentation.

2. SIGNIFICANT ACCOUNTING POLICIES

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the amounts reported in the condensed consolidated financial statements and accompanying notes. While the Company believes that such estimates are fair when considered in conjunction with the condensed consolidated financial statements and accompanying notes, the actual amount of such estimates, when known, will vary from these estimates.

Investments

Short and long-term investments at September 30, 2006 and December 31, 2005 primarily consist of corporate securities, government securities and municipal securities. Investments classified as available-for-sale are stated at fair value with unrealized gains and losses, net of taxes, reported in accumulated other comprehensive income (loss). In accordance with Statement of Financial Accounting Standards (SFAS) No. 95, *Statement of Cash Flows,* the Company classifies available-for-sale securities, including its investments in auction rate securities that are available to meet the Company s current operational needs, as short-term. The Company does not recognize changes in the fair value of its investments in income unless a decline in value is considered other-than-temporary in accordance with the Financial Accounting Standards Board (the FASB) Staff Position 115-1, *The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments*.

The Company minimizes its credit risk associated with investments by investing primarily in investment grade, highly liquid securities. The Company s policy is designed to limit exposure to any one issuer depending on credit quality. Periodic evaluations of the relative credit standing of those issuers are considered in the Company s investment strategy. The Company uses information provided by third parties to adjust the carrying value of certain of its investments and derivative instruments to fair value at the end of each period. Fair values are based on valuation models that use market quotes and, for certain investments, assumptions as to the creditworthiness of the entities issuing those underlying investments.

Inventory

Inventories are consistently stated at the lower of cost or market on a first-in, first-out basis and primarily consist of finished goods. When necessary, a provision has been made to reduce obsolete or excess inventories to market.

Revenue Recognition

The Company markets and licenses products primarily through multiple channels such as value-added resellers, channel distributors, system integrators, independent software vendors, its websites and original equipment manufacturers. The Company s product licenses are generally perpetual. The Company also separately sells license updates and services, which may include product training, technical support and consulting services, as well as online services.

The Company s software products are purchased by medium and small-sized businesses, with a minimal number of locations, and larger business enterprises with more complex multiserver environments that deploy the Company s software

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CITRIX SYSTEMS, INC.

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products on a departmental or enterprise-wide basis. Once the Company receives a product license agreement and purchase order, software activation keys that enable the feature configuration ordered by the end-user are delivered. Products may be delivered indirectly by a channel distributor, original equipment manufacturers or directly to the end-user by the Company via packaged product or download from the Company s website. The Company s appliance products are integrated with software that is essential to the functionality of the equipment. The Company provides unspecified software upgrades and enhancements related to the appliances through its maintenance contracts. Accordingly, for these appliances, the Company accounts for revenue in accordance with SOP No. 97-2, *Software Revenue Recognition, (as amended by SOP 98-4 and SOP 98-9)* and all related interpretations, as described in detail below.

Revenue is recognized when it is earned. The Company s revenue recognition policies are in compliance with SOP 97-2 and related amendments and interpretations. In addition, the Company s online services revenue is recognized in accordance with Emerging Issues Task Force (EITF) No. 00-3, *Application of AICPA Statement of Position 97-2 to Arrangements That Include the Right to Use Software Stored on Another Entity s Hardware*. The Company recognizes revenue when all of the following criteria are met: persuasive evidence of the arrangement exists; delivery has occurred and the Company has no remaining obligations; the fee is fixed or determinable; and collectibility is probable. The Company defines these four criteria as follows:

Persuasive evidence of the arrangement exists. The Company recognizes revenue on packaged products and appliances upon shipment to distributors and resellers. For packaged product and appliance sales, it is the Company s customary practice to require a purchase order from distributors and resellers who have previously negotiated a master packaged product distribution or resale agreement. For electronic and paper license arrangements, the Company typically requires a purchase order from the distributor, reseller or end-user (depending on the arrangement) and an executed product license agreement from the end-user. For technical support, product training and consulting services, the Company requires a purchase order and an executed agreement. For online services, the Company requires the customer or the reseller to electronically accept the terms of an online services agreement or execute a contract and generally submit a purchase order.

Delivery has occurred and the Company has no remaining obligations. For product license and appliance sales, the Company s standard delivery method is free-on-board shipping point. Consequently, it considers delivery of packaged products and appliances to have occurred when the products are shipped pursuant to an agreement and purchase order. The Company considers delivery of licenses under electronic licensing agreements to have occurred when the related products are shipped and the end-user has been electronically provided the software activation keys that allow the end-user to take immediate possession of the product. For product training and consulting services, the Company fulfills its obligation when the services are performed. For license updates, technical support and online services, the Company assumes that its obligation is satisfied ratably over the respective terms of the agreements, which are typically 12 to 24 months.

The fee is fixed or determinable. In the normal course of business, the Company does not provide customers the right to a refund of any portion of their license fees or extended payment terms. The Company sells license updates and services, which includes technical support, product training and consulting services, and online services separately and it determines vendor specific objective evidence (VSOE) of fair value by the price charged for each product when sold separately or applicable renewal rates.

Collectibility is probable. The Company determines collectibility on a customer-by-customer basis and generally does not require collateral. The Company typically sells product licenses and license updates to distributors or resellers for whom there are histories of successful collection. New customers are subject to a credit review process that evaluates their financial position and ultimately their ability to pay. Customers are also subject to an ongoing credit review process. If the Company determines from the outset of an arrangement that collectibility is not probable, revenue recognition is deferred until customer payment is received and the other parameters of revenue recognition described above have been achieved. Management s judgment is required in assessing the probability of collection, which is generally based on evaluation of customer specific information, historical experience and economic market conditions.

Net revenues include the following categories: Product Licenses, License Updates, Online Services and Technical Services. Product Licenses primarily represent fees related to the licensing of the Company s products. These revenues are reflected net of sales allowances and provisions for stock balancing return rights. License Updates consist of fees related to the Subscription Advantage program that are recognized ratably over the term of the contract, which is typically 12-24 months. Subscription Advantage is a renewable program that provides subscribers with automatic delivery of software upgrades, enhancements and maintenance releases when and if they become available during the term of subscription. Online Services revenues consist primarily of fees related to online service agreements and are recognized ratably over the contract

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term. Technical Services revenues are comprised of fees from technical support services which are recognized ratably over the contract term as well as revenues from product training and certification, and consulting services revenue related to implementation of the Company s products, which is recognized as the services are provided.

The Company licenses most of its products bundled with an initial subscription for license updates that provide the end-user with free enhancements and upgrades to the licensed product on a when and if available basis. Customers may also elect to purchase subscriptions for license updates, when not bundled with the initial product release or purchase, technical support, product training or consulting services. The Company allocates revenue to license updates and any other undelivered elements of the arrangement based on VSOE of fair value of each element and such amounts are deferred until the applicable delivery criteria and other revenue recognition criteria described above have been met. The balance of the revenue, net of any discounts inherent in the arrangement, is allocated to the delivered product using the residual method and recognized at the outset of the arrangement as the product licenses are delivered. If management cannot objectively determine the fair value of each undelivered element based on VSOE, revenue recognition is deferred until all elements are delivered, all services have been performed, or until fair value can be objectively determined.

In the normal course of business, the Company does not permit product returns, but it does provide most of its distributors with stock balancing and price protection rights. Stock balancing rights permit distributors to return products to the Company by the forty-fifth day of the fiscal quarter, subject to ordering an equal dollar amount of the Company s other products prior to the last day of the same fiscal quarter. Price protection rights require that the Company grant retroactive price adjustments for inventories of products held by distributors if it lowers prices for such products. The Company establishes provisions for estimated returns for stock balancing and price protection rights, as well as other sales allowances, concurrently with the recognition of revenue. The provisions are established based upon consideration of a variety of factors, including, among other things, recent and historical return rates for both, specific products and distributors, estimated distributor inventory levels by product, the impact of any new product releases and projected economic conditions. Actual product returns for stock balancing and price protection provisions incurred are, however, dependent upon future events, including the amount of stock balancing activity by distributors and the level of distributor inventories at the time of any price adjustments. The Company continually monitors the factors that influence the pricing of its products and distributor inventory levels and makes adjustments to these provisions when it believes actual returns and other allowances could differ from established reserves. The Company s ability to recognize revenue upon shipment to distributors is predicated on its ability to reliably estimate future stock balancing returns. If actual experience or changes in market condition impairs the Company s ability to estimate returns, it would be required to defer the recognition of revenue until the delivery of the product to the end-user. Allowances for estimated product returns amounted to approximately $1.6 million and $2.3 million at September 30, 2006 and December 31, 2005, respectively. The Company has not reduced and has no current plans to reduce its prices for inventory currently held by distributors. Accordingly, there were no reserves required for price protection at September 30, 2006 and December 31, 2005. The Company also records estimated reductions to revenue for customer programs and incentive offerings including volume-based incentives. If market conditions were to decline, the Company could take actions to increase its customer incentive offerings, which could result in an incremental reduction to revenue at the time the incentive is offered.

Accounting for Stock-Based Compensation

Plans

The Company s stock-based compensation program is a broad based, long-term retention program that is intended to attract and reward talented employees and align stockholder and employee interests. As of September 30, 2006, the Company had two stock-based compensation plans under which it was granting stock options, shares of non-vested stock and non-vested stock units. The Company is currently granting stock-based awards from its 2005 Equity Incentive Plan (as amended, the 2005 Plan) and 2005 Employee Stock Purchase Plan (the 2005 ESPP). Upon the 2006 acquisitions of Orbital Data Corporation (Orbital Data) and Reflectent Software, Inc. (Reflectent) the Company assumed Orbital Data Corporation s 2006 Restricted Stock Unit Plan, Orbital Data Corporation s 2002 Equity Incentive Plan, Reflectent Software, Inc. s 2003 Stock Plan and Reflectent Software, Inc. s Restricted Stock Unit Plan. The Company s Board of Directors has provided that no new awards will be granted under the Company s acquired stock plans. The Company s superseded and expired stock plans include the Amended and Restated 1995 Stock Plan, Second Amended and Restated 2000 Director and Officer Stock Option and Incentive Plan, Second Amended and Restated 1995 Non-Employee Director Stock Option Plan and Third Amended and Restated 1995 Employee Stock Purchase Plan (the 1995 ESPP). Awards previously granted under these plans and still outstanding, however, typically expire ten years from the date of grant and will continue to be subject to all the terms and conditions of such plans, as applicable. During the second quarter of 2006, the Company began awarding non-

CITRIX SYSTEMS, INC.

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vested stock units and non-vested stock awards with performance measures to certain key executives as part of its overall compensation program. In addition, during the second quarter of 2006, the Company also began awarding its non-employee directors non-vested stock units with service based vesting.

Under the terms of the 2005 Plan, the Company is authorized to grant incentive stock options (ISOs), non-qualified stock options (NSOs), non-vested stock, non-vested stock units, stock appreciation rights (SARs), performance units and to make stock-based awards to full and part-time employees of the Company and its subsidiaries or affiliates, where legally eligible to participate, as well as consultants and non-employee directors of the Company. The 2005 Plan provides for the issuance of a maximum of 15,500,000 shares of common stock of which 5,400,000 was authorized by the Company s Board of Directors in February 2006 and the Company s stockholders in May 2006. Under the 2005 Plan, ISOs must be granted at exercise prices no less than fair market value on the date of grant, except for ISOs granted to employees who own more than 10% of the Company s combined voting power, for which the exercise prices must be no less than 110% of the market value at the date of grant. NSOs and SARs must be granted at no less than market value on the date of grant, or in the case of SARs in tandem with options, at the exercise price of the related option. Non-vested stock awards may be granted for such consideration in cash, other property or services, or a combination thereof, as determined by the Compensation Committee of the Board of Directors of the Company. All stock-based awards are exercisable upon vesting. As of September 30, 2006, there were 36,144,516 shares of common stock reserved for issuance pursuant to the Company s stock-based compensation plans and the Company had authorization under its 2005 Plan to grant 8,644,115 additional stock-based awards at September 30, 2006.

The 2005 ESPP was originally adopted by the Board in March 2005 and approved by the Company s stockholders in May 2005. The 2005 ESPP replaced the Company s 1995 ESPP under which no more shares may be granted. Under the 2005 ESPP, all full-time and certain part-time employees of the Company are eligible to receive options to purchase common stock of the Company twice per year at the end of a six month payment period (a Payment Period). During each Payment Period, eligible employees who so elect may authorize payroll deductions in an amount no less than 1% nor greater than 10% of his or her base pay for each payroll period in the Payment Period. At the end of each Payment Period, the accumulated deductions are used to purchase shares of common stock from the Company up to a maximum of 12,000 shares for any one employee during a Payment Period. Shares are purchased at a price equal to 85% of the fair market value of the Company s common stock on the last business day of a Payment Period. Employees who, after exercising their rights to purchase shares of common stock under the 2005 ESPP, would own shares of 5% or more of the voting power of the Company s common stock, are ineligible to participate under the 2005 ESPP. The 2005 ESPP provides for the issuance of a maximum of 10,000,000 shares of common stock. As of September 30, 2006, 338,715 shares had been issued under the 2005 ESPP.

Adoption of SFAS No. 123R and Transition

Prior to January 1, 2006, the Company accounted for its stock-based compensation plans under the recognition and measurement provisions of Accounting Principles Board (APB) Opinion No. 25, *Accounting for Stock Issued to Employees*, and related interpretations, as permitted by SFAS No. 123, *Accounting for Stock-Based Compensation*. The Company did not recognize compensation cost related to stock options granted to its employees and non-employee directors that had an exercise price equal to or above the market value of the underlying common stock on the date of grant in its condensed consolidated statement of income prior to January 1, 2006. Effective January 1, 2006, the Company adopted the fair value recognition provisions of SFAS No. 123R, *Share-Based Payment*, and related interpretations using the modified-prospective transition method. Under that method, compensation cost recognized in the first quarter of 2006 includes (a) compensation cost for all stock-based awards granted prior to, but not yet vested as of January 1, 2006 based on the grant date fair value estimated in accordance with the original provisions of SFAS No. 123 and (b) compensation cost for all stock-based awards granted on or subsequent to January 1, 2006, based on the grant-date fair value estimated in accordance with the provisions of SFAS No. 123R. Results for prior periods have not been restated.

As a result of adopting SFAS No. 123R on January 1, 2006, the Company s income before income taxes and net income for the three months ended September 30, 2006, are $10.7 million and $8.3 million lower, respectively, and for the nine months ended September 30, 2006 $30.0 million and $24.3 million lower, respectively, than if the Company had continued to account for stock-based compensation under APB Opinion No. 25. The Company s earnings per share for the three months ended September 30, 2006 is $0.04 lower for both basic and diluted and for the nine months ended September 30, 2006 is $0.13 lower for both basic and diluted than if the Company had continued to account for stock-based compensation under APB Opinion No. 25.

Prior to the adoption of SFAS No. 123R, the Company presented all tax benefits from deductions resulting from the exercise of stock options as operating cash flows in its statement of cash flows. SFAS No. 123R requires that the portion of

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benefits resulting from tax deductions in excess of recognized compensation (the excess tax benefits) be presented as financing cash flows. The excess tax benefits were approximately $50.5 million for the nine months ended September 30, 2006 and would have been presented as an operating cash inflow prior to the adoption SFAS No. 123R. In addition, the Company previously presented deferred compensation as a separate component of stockholders equity. Upon adoption, of SFAS No. 123R, the Company reclassified the balance in deferred compensation to additional paid-in capital on its accompanying condensed consolidated balance sheet.

Pro Forma Information Under SFAS No. 123 for Periods Prior to January 1, 2006

The following table illustrates the effect on net earnings and earnings per share if the Company had applied the fair value recognition provisions of SFAS No. 123 to stock-based awards for the three and nine months ended September 30, 2005 (in thousands, except per share information):

	Three Months Ended September 30, 2005		Nine Months Ended September 30, 2005	
Net income:				
As reported	$	40,953	$	107,399
Add: Total stock-based employee compensation included in net income as reported, net of related tax effects		759		898
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects		(10,906)		(27,263)
Pro forma	$	30,806	$	81,034
Basic earnings per share:				
As reported	$	0.24	$	0.63
Pro forma	$	0.18	$	0.47
Diluted earnings per share:				
As reported	$	0.23	$	0.61
Pro forma	$	0.17	$	0.46

For purposes of the pro forma calculations, the fair value of each option was estimated on the date of the grant using the Black-Scholes option-pricing model, assuming no expected dividends, and the following assumptions:

	Stock Options granted during the Three Months ended September 30, 2005	Stock Options granted during the Nine Months ended September 30, 2005
Expected volatility factor	0.31	0.31 0.35
Approximate risk free interest rate	4.0%	3.7%-4.0%
Expected term (in years)	3.32	3.32

The Company estimated the expected volatility factor based upon implied and historical data. The approximate risk free interest rate was based on the implied yield available on U.S. Treasury zero-coupon issues with remaining terms equivalent to the Company s expected term. The expected term of the Company s stock options was based on the historical exercise patterns considering changes in vesting periods and contractual terms. The weighted average fair value of stock options granted during the three and nine months ended September 30, 2005 was $11.14 and $9.34, respectively. The total intrinsic value of stock options exercised during the three and nine months ended September 30, 2005 was $13.6 million and $36.5 million, respectively. Forfeitures were recognized as they occurred.

For purposes of the pro forma calculations, the fair value of each stock-based award related to the 1995 ESPP was estimated using the Black-Scholes option-pricing model, assuming no expected dividends, and the following assumptions:

	Three Months ended September 30, 2005	**Nine Months ended September 30, 2005**
Expected volatility factor	0.28	0.28 0.33
Approximate risk free interest rate	3.4%	2.5% 3.4%
Expected term	6 months	6 months

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The Company estimated the expected volatility factor based on historical data. The approximate risk free interest rate was based on the implied yield available on U.S. Treasury zero-coupon issues with remaining term equivalent to the Company s expected term. The expected term for the 1995 ESPP is the six month Payment Period. The weighted average fair value of the shares purchased under the 1995 ESPP during the three and nine months ended September 30, 2005 was $23.78 and $22.78, respectively.

Valuation and Expense Information under SFAS No. 123R

The Company recorded stock-based compensation costs of $40.5 million and recognized a tax benefit related to stock-based compensation of $50.5 million in the nine months ended September 30, 2006. As required by SFAS No. 123R, the Company estimates forfeitures of employee stock options and recognizes compensation cost only for those awards expected to vest. Forfeiture rates are determined based on historical experience. Estimated forfeitures are adjusted to actual forfeiture experience as needed.

Total stock-based compensation and related deferred tax asset recognized in the Company s consolidated statement of income is $14.8 million and $2.6 million, respectively, for the three months ended September 30, 2006 and $40.5 million and $6.6 million, respectively, for the nine months ended September 30, 2006. The detail of the total stock-based compensation recognized by income statement classification is as follows (in thousands):

Income Statement Classifications	**Three Months Ended September 30, 2006**	**Nine Months Ended September 30, 2006**
Cost of services revenues	**$ 398**	**$ 1,145**
Research and development	**4,405**	**12,785**
Sales, marketing and support	**5,675**	**16,321**
General and administrative	**4,367**	**10,225**
Total	**$ 14,845**	**$ 40,476**

In connection with the adoption of SFAS No. 123R, the Company estimated the fair value of each stock option on the date of grant using the Black-Scholes option-pricing model, applying the following assumptions and amortizing that value to expense over the option s vesting period using the ratable approach:

	Stock Options granted during the	
	Three Months ended September 30, 2006	**Nine Months ended September 30, 2006**
Expected volatility factor	**0.34**	**0.30-0.34**
Approximate risk free interest rate	**4.9%**	**4.5% -4.9%**
Expected term (in years)	**3.0**	**3.0**
Expected dividend yield	**0%**	**0%**

For purposes of determining the expected volatility factor, the Company considered implied volatility in two-year market-traded options of the Company s common stock based on third party volatility quotes in accordance with the provisions of Staff Accounting Bulletin (SAB) No. 107. The Company s decision to use implied volatility was based upon the availability of actively traded options on the Company s common stock and its assessment that implied volatility is more representative of future stock price trends than historical volatility. The approximate risk free interest rate was based on the implied yield available on U.S. Treasury zero-coupon issues with remaining terms equivalent to the Company s expected term on its options. The expected term of the Company s stock options was based on the historical employee exercise patterns considering changes in vesting periods and contractual terms. The Company also analyzed its historical pattern of option exercises based on certain demographic characteristics and determined that there were no meaningful differences in option exercise activity based on the demographic characteristics. The Company does not intend to pay dividends on its common stock in the foreseeable future. Accordingly, the Company used a dividend yield of zero in its option pricing model. The weighted average fair value of stock options granted during the three and nine months ended September 30, 2006 was $10.62 and $10.97, respectively.

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Stock Options

As part of the Company s acquisitions of Orbital Data and Reflectent (the 2006 Acquisitions), the Company assumed 186,642 options to purchase shares of its common stock, of which options to purchase 120,940 shares of common stock have a five year life and vest over three years at a rate of 33.3% of the shares underlying the option one year from date of grant and at a rate of 2.78% monthly thereafter. The remaining options assumed in the 2006 Acquisitions vest based on service at varying rates through April of 2007. All other options granted during the quarter were from the Company s 2005 Plan. Options granted from the 2005 Plan typically have a five year life and vest over three years at a rate of 33.3% of the shares underlying the option one year from date of grant and at a rate of 2.78% monthly thereafter. A summary of the status and activity of the Company s fixed option awards is as follows:

Options	**Number of Options**	**Weighted-Average Exercise Price**	**Weighted-Average Remaining Contractual Life**	**Aggregate Intrinsic Value (in thousands)**
Outstanding at December 31, 2005	34,305,837	$ 25.86	4.79	
Granted	4,575,471	34.17		
Exercised	(10,534,111)	19.95		
Forfeited or expired	(1,084,027)	29.38		
Outstanding at September 30, 2006	**27,263,170**	**29.41**	**3.96**	**$ 300,823**
Vested or expected to vest at September 30, 2006	**25,091,934**	**29.42**	**3.92**	**$ 283,531**
Exercisable at September 30, 2006	**18,224,589**	**30.51**	**3.75**	**$ 211,664**

The total intrinsic value of stock options exercised during the three and nine months ended September 30, 2006 was $16.4 million and $172.7 million, respectively.

Non-vested Stock

As part of the Company s acquisition of NetScaler, Inc. and Teros, Inc. (the 2005 Acquisitions), it assumed 25,179 shares of non-vested stock held by certain employees of the acquired companies. The non-vested stock assumed vests monthly based on service through October 2007 dependent upon the remaining vesting period of such non-vested stock at the time of the acquisition. As part of an overall retention program, the Company also granted 60,000 shares of non-vested stock to certain employees retained from the 2005 Acquisitions. Of the non-vested stock granted, 45,000 shares vest 50% on the first anniversary of the grant date and 50% on the second anniversary of the grant date, and the remaining 15,000 non-vested shares granted vest 50% on the first anniversary of the grant date and 50% eighteen months from the grant date. In addition to the non-vested stock the Company issued in conjunction with it 2005 Acquisitions, in 2006, the Company awarded non-vested stock from the 2005 Plan to a certain executive that vests upon achieving certain employee retention goals. If the retention goals are not achieved, no shares will be awarded and no compensation cost will be recognized and any previously recognized compensation cost will be reversed. The following table summarizes the Company s non-vested stock activity as of September 30, 2006:

	Number of Shares	Weighted-Average Fair Value at Grant Date
Non-vested at December 31, 2005	85,179	$ 26.52
Granted	25,940	35.00
Vested	(36,877)	27.52
Forfeited or expired	(8,000)	27.87
Non-vested at September 30, 2006	**66,242**	**29.12**

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Non-vested Stock Units

The Company assumed $2.8 million of non-vested stock units in conjunction with its 2005 Acquisitions. The non-vested stock units vest 33.33% at nine, twelve and eighteen months from the date of grant; however, if certain performance criteria are met, 33.33% of the non-vested stock units will vest in fourteen months instead of eighteen months. In accordance with the provisions of SFAS No. 123R, the Company will accelerate the expense recognition of these non-vested stock units when and if it is determined that it is probable the performance criteria will be achieved at the earlier date. The number of shares that will be issued on each vesting date is dependent upon the Company s stock price over the five consecutive trading days prior to the vesting date; provided, however that the number of shares issued pursuant to the non-vested stock units will not exceed 280,000 shares. The Company s policy is to recognize compensation cost for awards with only service conditions and a graded vesting schedule on a straight line basis over the requisite service period for the entire award. As part of the 2006 Acquisitions, the Company assumed 175,717 non-vested stock units, of which the majority vest based on service at a rate of 50% on the first anniversary of the grant date and 50% on the second anniversary of the grant date.

In addition, during 2006, the Company awarded certain key executives non-vested stock units from the 2005 Plan. The number of non-vested stock units underlying each award is determined one year after the date of the award based on achievement of a specific corporate operating income goal. If the performance goal is less than 90% attained, then no non-vested stock units will be issued pursuant to the authorized award. For performance at and above 90%, the number of non-vested stock units issued will be based on a graduated slope, with the maximum number of non-vested stock units issuable pursuant to the award capped at 125% of the base number of non-vested stock units set forth in the executive s award agreement. If the performance goal is met, the non-vested stock units will vest 33.33% on each anniversary subsequent to the date of the award. Each non-vested stock unit, upon vesting, will represent the right to receive one share of the Company s common stock. If the performance goals are not met, no compensation cost will be recognized and any previously recognized compensation cost will be reversed. During the second quarter of 2006, the Company also awarded non-vested stock units to its non-employee directors. These units vest monthly in equal installments based on service and, upon vesting, each stock unit will represent the right to receive one share of the Company s common stock.

The following table summarizes the Company s non-vested stock unit activity with performance measures as of September 30, 2006:

	Number of Shares	Weighted-Average Fair Value at Grant Date
Non-vested at December 31, 2005		$
Granted	269,897	33.97
Vested	(25,809)	29.28
Forfeited or expired	(6,855)	32.08
Non-vested at September 30, 2006	**237,233**	**34.54**

As of September 30, 2006, there was $74.3 million of total unrecognized compensation cost related to the stock options, non-vested stock and non-vested stock units. That cost is expected to be recognized over a weighted-average period of 2.0 years.

2005 ESPP

The Company estimated the fair value of the stock-based compensation related to the 2005 ESPP using the Black-Scholes option pricing model, applying the following assumptions and amortizing that value to expense over the vesting period:

	Three Months ended September 30, 2006	**Nine Months ended September 30, 2006**
Expected volatility factor	**0.37**	**0.27 0.37**
Approximate risk free interest rate	**5.1%**	**4.5% 5.1%**
Expected term	**6 months**	**6 months**
Expected dividend yield	**0%**	**0%**

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3. EARNINGS PER SHARE

Basic earnings per share is calculated by dividing income available to stockholders by the weighted-average number of common shares outstanding during each period. Diluted earnings per share is computed using the weighted average number of common and dilutive common share equivalents outstanding during the period. Dilutive common share equivalents consist of shares issuable upon the exercise of stock awards (calculated using the treasury stock method) during the period they were outstanding.

The following table sets forth the computation of basic and diluted earnings per share (in thousands, except per share information):

	Three Months ended September 30,		Nine Months ended September 30,	
	2006	**2005**	**2006**	**2005**
Numerator:				
Net income	**$ 46,618**	$ 40,953	**$ 137,747**	$ 107,399