NETWORK APPLIANCE INC
Form 10-Q
March 07, 2006

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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 27, 2006

or

o **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15d) 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 (Check one:).
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 24, 2006
Common Stock	374,164,288

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PART I. FINANCIAL INFORMATION

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

NETWORK APPLIANCE, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS

(In thousands unaudited)

	January 27, 2006	April 30, 2005
ASSETS		
Current Assets:		
Cash and cash equivalents	$ 188,125	$ 193,542
Short-term investments	952,819	976,423
Accounts receivable, net of allowances of $6,201 at January 27, 2006 and $5,445 at April 30, 2005	367,490	296,885
Inventories	64,072	38,983
Prepaid expenses and other	35,768	32,472
Deferred income taxes	35,544	37,584
Total current assets	1,643,818	1,575,889
Property and Equipment, net	492,793	418,749
Goodwill	491,089	291,816
Intangible Assets, net	82,433	21,448
Other Assets	59,817	64,745
	$ 2,769,950	$ 2,372,647
LIABILITIES AND STOCKHOLDERS EQUITY		
Current Liabilities:		
Accounts payable	$ 99,720	$ 83,572
Income taxes payable	38,226	20,823
Accrued compensation and related benefits	113,067	100,534
Other accrued liabilities	66,790	53,262
Deferred revenue	336,944	261,998
Total current liabilities	654,747	520,189
Long-Term Deferred Revenue	256,528	187,180
Long-Term Obligations	3,427	4,474
Total liabilities	914,702	711,843

Stockholders Equity:		
Common stock (401,654 shares at January 27, 2006 and 381,509 shares at April 30, 2005)	402	381
Additional paid-in capital	1,743,879	1,347,352
Deferred stock compensation	(29,041)	(15,782)
Treasury stock (29,178 shares at January 27, 2006 and 14,566 shares at April 30, 2005)	(719,222)	(329,075)
Retained earnings	869,209	661,978
Accumulated other comprehensive loss	(9,979)	(4,050)
Total stockholders equity	1,855,248	1,660,804
	$ 2,769,950	$ 2,372,647

See accompanying notes to unaudited condensed consolidated financial statements.

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NETWORK APPLIANCE, INC.

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

	Three Months Ended		Nine Months Ended	
	January 27, 2006	January 28, 2005	January 27, 2006	January 28, 2005
Revenues:				
Product revenue	$ 474,236	$ 367,903	$ 1,293,642	$ 1,029,334
Service revenue	62,795	44,803	174,853	116,969
Total revenues	537,031	412,706	1,468,495	1,146,303
Cost of Revenues:				
Cost of product revenue	163,505	127,118	438,363	353,060
Cost of service revenue	46,502	33,454	130,530	94,990
Total cost of revenues	210,007	160,572	568,893	448,050
Gross margin	327,024	252,134	899,602	698,253
Operating Expenses:				
Sales and marketing	152,008	118,668	427,526	331,087
Research and development	62,622	43,603	169,462	122,957
General and administrative	24,742	20,136	67,349	54,888
In process research and development			5,000	
Stock compensation (1)	4,070	2,189	9,442	6,432
Restructuring charges (recoveries)	117	(270)	(495)	(270)
Total operating expenses	243,559	184,326	678,284	515,094
Income from Operations	83,465	67,808	221,318	183,159
Other Income (Expense), net:				
Interest income	9,891	6,031	28,590	16,216
Other income (expenses), net	1,001	(500)	453	(1,322)
Net gain on investments		41	101	41
Total other income, net	10,892	5,572	29,144	14,935
Income before Income Taxes	94,357	73,380	250,462	198,094
Provision for Income Taxes	17,964	13,253	43,231	35,776
Net Income	$ 76,393	$ 60,127	$ 207,231	$ 162,318
Net Income per Share:				
Basic	$ 0.21	$ 0.17	$ 0.56	$ 0.45

Diluted	$ 0.20	$ 0.16	$ 0.54	$ 0.43
Shares Used in per Share Calculations:				
Basic	371,768	362,563	370,069	359,031
Diluted	389,149	385,869	386,991	377,972
(1) Stock compensation includes:				
Sales and marketing	$ 1,325	$ 733	$ 2,851	$ 1,813
Research and development	2,465	1,281	5,929	4,020
General and administrative	280	175	662	599
	$ 4,070	$ 2,189	$ 9,442	$ 6,432

See accompanying notes to unaudited condensed consolidated financial statements.

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NETWORK APPLIANCE, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(In thousands unaudited)

	Nine Months Ended	
	January 27, 2006	January 28, 2005
Cash Flows from Operating Activities:		
Net income	$ 207,231	$ 162,318
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	46,175	39,869
In process research and development	5,000	
Amortization of intangible assets	11,329	6,999
Amortization of patents	1,487	1,352
Stock compensation	9,442	6,432
Net gain on investments	(101)	(70)
Net loss on disposal of equipment	1,318	907
Allowance for doubtful accounts	921	325
Deferred income taxes	14	730
Deferred rent	301	228
Changes in assets and liabilities:		
Accounts receivable	(70,153)	(40,065)
Inventories	(38,397)	(12,383)
Prepaid expenses and other assets	(6,590)	3,011
Accounts payable	16,072	15,355
Income taxes payable	39,606	24,577
Accrued compensation and related benefits	12,992	16,508
Other accrued liabilities	970	8,008
Deferred revenue	144,737	110,534
Net cash provided by operating activities	382,354	344,635
Cash Flows from Investing Activities:		
Purchases of investments	(450,555)	(669,562)
Redemptions of investments	471,755	456,387
Increase in restricted cash	(1,997)	
Purchases of property and equipment	(96,476)	(64,756)
Proceeds from sales of investments	130	347
Purchases of equity securities	(7,100)	(125)
Purchase of business, net of cash acquired	(53,747)	
Net cash used in investing activities	(137,990)	(277,709)
Cash Flows from Financing Activities:		

Proceeds from sale of common stock related to employee stock transactions		141,725		153,460
Tax withholding payments reimbursed by restricted stock		(794)		(43)
Repurchases of common stock		(390,147)		(132,993)
Net cash provided by (used in) financing activities		(249,216)		20,424
Effect of Exchange Rate Changes on Cash and Cash Equivalents		(565)		1,695
Net Increase (Decrease) in Cash and Cash Equivalents		(5,417)		89,045
Cash and Cash Equivalents:				
Beginning of period		193,542		92,328
End of period	$	188,125	$	181,373
Noncash Investing and Financing Activities:				
Conversion of evaluation inventory to fixed assets	$	14,393	$	8,468
Deferred stock compensation, net of reversals	$	2,897	$	512
Income tax benefit from employee stock transactions	$	22,334	$	27,829
Acquisition of property and equipment on account	$	11,158	$	
Stock issued for acquisition	$	191,874	$	
Options assumed for acquired business	$	38,456	$	
Supplemental cash flow information:				
Income taxes paid	$	5,625	$	11,975
Income taxes refund	$	2,345	$	10,588

See accompanying notes to unaudited condensed consolidated financial statements.

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NETWORK APPLIANCE, INC.

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

1. The Company

Based in Sunnyvale, California, Network Appliance was incorporated in California in April 1992 and reincorporated in Delaware in November 2001. Network Appliance, Inc. is a leading supplier of enterprise storage and data management software and hardware products and services. Its 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.

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 first nine months of fiscal 2006 and 2005 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, 2005. The results of operations for the three and nine-month periods ended January 27, 2006 are not necessarily indicative of the operating results to be expected for the full fiscal year or future operating periods. In the following notes to our interim condensed consolidated financial statements, Network Appliance Inc. is also referred to as we , our and us .

3. Use of Estimates

The preparation of the interim condensed consolidated financial statements in conformity with generally accepted accounting principles 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 Compensation

We account for stock-based compensation in accordance with the provisions of Accounting Principle Board Opinion (APB) No. 25, *Accounting for Stock Issued to Employees,* (APB No. 25) and comply with the disclosure provisions of Statement of Financial Accounting Standards (SFAS) No. 123, *Accounting for Stock-Based Compensation* (SFAS No. 123). Deferred compensation recognized under APB No. 25 is amortized ratably

NETWORK APPLIANCE, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

to expense over the vesting periods. We account for stock options issued to non-employees in accordance with the provisions of SFAS No. 123 under the fair value based method.

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

We recorded $4,070 and $9,442 of deferred compensation expense for the three and nine-month periods ended January 27, 2006, respectively, and $1,968 and $5,963 for the three and nine-month periods ended January 28, 2005, respectively, primarily related to the amortization of deferred stock compensation from unvested options assumed in the Decru, Alacritus and Spinnaker acquisitions, the retention escrow shares relative to Spinnaker, the grant of stock options to certain highly compensated employees below fair value at the date of grant (discontinued as of December 31, 2004) and the award of restricted stock to certain employees. The net increase in stock compensation expenses reflected primarily higher stock compensation relating to the Decru acquisition and restricted stock awards.

Based on deferred stock compensation recorded at January 27, 2006, estimated future deferred stock compensation amortization for the remainder of fiscal year 2006, fiscal years 2007, 2008, 2009 and 2010 are expected to be $3,925, $14,669, $8,449 and $1,731 and $268, respectively, and none thereafter.

We recorded charges of $45 and $56, in compensation expense, in the three and nine-month periods ending January 27, 2006, respectively, and $221 and $469 in the three and nine-month periods ending January 28, 2005, respectively, for the fair value of options granted to a member of the Board of Directors in recognition for services performed outside of the normal capacity of a board member.

Had compensation expense been determined based on the fair value at the grant date for awards, consistent with the provisions of SFAS No. 123, the impact on net income and net income per share would be as follows:

	Three Months Ended		Nine Months Ended	
	January 27, 2006	January 28, 2005	January 27, 2006	January 28, 2005
Net income as reported	$ 76,393	$ 60,127	$ 207,231	$ 162,318
Add: stock based employee compensation expense included in reported net income under APB No. 25, net of related tax effects	2,442	1,181	5,665	3,578
Deduct: total stock based compensation determined under fair value based method for all awards, net of related tax effects	(24,860)	(21,172)	(74,224)	(61,641)
Pro forma net income	$ 53,975	$ 40,136	$ 138,672	$ 104,255
Basic net income per share, as reported	$ 0.21	$ 0.17	$ 0.56	$ 0.45

Diluted net income per share, as reported	$	0.20	$	0.16	$	0.54	$	0.43
Basic net income per share, pro forma	$	0.15	$	0.11	$	0.37	$	0.29
Diluted net income per share, pro forma	$	0.14	$	0.10	$	0.36	$	0.28

NETWORK APPLIANCE, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

5. Inventories

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

	January 27, 2006	April 30, 2005
Purchased components	$ 30,029	$ 15,784
Work in process		686
Finished goods	34,043	22,513
	$ 64,072	$ 38,983

6. Goodwill and Intangible Assets

Goodwill is reviewed annually for impairment (or more frequently if indicators of impairment arise). We completed our annual impairment assessment in fiscal 2005 and concluded that goodwill was not impaired. In the nine month period ended January 27, 2006, there were no indicators that would suggest the impairment of goodwill and intangible assets.

During May 2005, we acquired Alacritus Inc. (Alacritus) and recorded goodwill of $5,844 and intangible assets of $5,700 resulting from the allocation of the purchase price. See Note 14, Business Combinations. In the second quarter of fiscal 2006, the Alacritus goodwill was increased by $479 to reflect an adjustment for the deferred tax impact on deferred stock compensation.

During August 2005, we acquired Decru, Inc. (Decru) and recorded goodwill of $192,949 and intangible assets of $68,100 resulting from the allocation of the purchase price. See Note 14, Business Combinations.

Identified intangible asset balances as of January 27, 2006 and April 30, 2005 are summarized as follows:

	Amortization Period (Years)	January 27, 2006 Gross Assets	Accumulated Amortization	Net Assets	April 30, 2005 Gross Assets	Accumulated Amortization	Net Assets
Intangible Assets:							
Patents	5	$ 10,040	$ (4,952)	$ 5,088	$ 10,040	$ (3,467)	$ 6,573
Existing technology	4 5	91,025	(28,432)	62,593	33,525	(20,512)	13,013
Trademarks/tradenames	3 6	5,080	(515)	4,565	280	(111)	169
Customer contracts/relationships	1.5 5	10,700	(1,900)	8,800	1,100	(885)	215

Covenants not to compete	1.5	2	9,510	(8,123)	1,387	7,610	(6,132)	1,478
Total Intangible Assets, Net			$ 126,355	$ (43,922)	$ 82,433	$ 52,555	$ (31,107)	$ 21,448

Amortization expense for identified intangible assets is summarized below:

	Three Months Ended		**Nine Months Ended**	
	January 27, 2006	**January 28, 2005**	**January 27, 2006**	**January 28, 2005**
Patents	$ 495	$ 451	$ 1,487	$ 1,352
Existing technology	3,866	858	7,920	2,574
Other identified intangibles	940	1,475	3,409	4,425
	$ 5,301	$ 2,784	$ 12,816	$ 8,351

NETWORK APPLIANCE, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Based on the identified intangible assets recorded at January 27, 2006, the future amortization expense of identified intangibles for the remainder of fiscal 2006, the next four fiscal years and thereafter is as follows:

Year Ending April,	**Amount**
Remainder of Fiscal 2006	$ 5,301
2007	21,188
2008	20,364
2009	17,946
2010	13,133
Thereafter	4,501
Total	$ 82,433

7. 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 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. For the three and nine-month periods ended January 28, 2005, net gains generated by hedged assets and liabilities totaled $748 and $5,021, respectively, and were offset by losses on the related derivative instruments of $1,388 and $6,596, respectively.

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

Forecasted Transactions. We use currency forward contracts to hedge exposures related to forecasted sales and operating expenses denominated in 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 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 27, 2006 and January 28, 2005, we did not record any gains or losses related to forecasted transactions that did not occur or became improbable.

As of January 27, 2006, our notional fair values of foreign exchange forward and foreign currency option contracts totaled $305,585. We do not believe that these derivatives present significant credit risks, because the

NETWORK APPLIANCE, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

counterparties to the derivatives consist of major financial institutions, and we manage the notional amount of contracts entered into with several counterparties. 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 forward points and premiums paid.

8. Earnings Per Share

Basic net income per share is computed by dividing income available to common stockholders by the weighted average number of common shares outstanding excluding unvested restricted stock for that period. Diluted net income per share is computed giving effect to all dilutive potential common 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 options were antidilutive in the three and nine-month periods ended January 27, 2006 and January 28, 2005 as their exercise prices were above the average market prices in such periods. For the three-month periods ended January 27, 2006 and January 28, 2005, 18,450 and 13,121 shares of common stock options with a weighted average exercise price of $47.83 and $57.67, respectively, were excluded from the diluted net income per share computation. For the nine-month periods ended January 27, 2006 and January 28, 2005, 18,881 and 14,873 shares of common stock options with a weighted average exercise price of $48.04 and $54.05, respectively, were excluded from the diluted net income per share computation.

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

	Three Months Ended		Nine Months Ended	
	January 27, 2006	January 28, 2005	January 28, 2005	January 27, 2006
Net Income (Numerator):				
Net income, basic and diluted	$ 76,393	$ 60,127	$ 207,231	$ 162,318
Shares Used in Per Share Calculations (Denominator):				
Weighted average common shares outstanding	372,289	363,071	370,543	359,561
Weighted average common shares outstanding subject to repurchase	(521)	(508)	(474)	(530)
Shares used in basic computation	371,768	362,563	370,069	359,031
Weighted average common shares outstanding subject to repurchase	521	508	474	530
	16,860	22,798	16,448	18,411

Common shares issuable upon exercise of stock options								
Shares used in diluted computation		389,149		385,869		386,991		377,972
Net Income Per Share:								
Basic	$	0.21	$	0.17	$	0.56	$	0.45
Diluted	$	0.20	$	0.16	$	0.54	$	0.43

NETWORK APPLIANCE, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

9. Stockholders Equity

Stock Repurchase Program

As of April 30, 2005, $20,925 was available for the repurchase of common shares under the Stock Repurchase Program. On May 24, 2005, our Board approved an incremental stock repurchase program in which up to $300,000 of additional shares may be repurchased. In November 2005, our Board of Directors approved a new $650,000 stock repurchase program which amount includes the $76,361 remaining from all prior authorizations (i.e., the net additional approval amount, without taking into account remaining amounts approved in prior periods, is $573,639).

Share repurchase activities for the three and nine-months ended January 27, 2006 and January 28, 2005, were as follows:

	Three Months Ended		Nine Months Ended	
	January 27, 2006	January 28, 2005	January 27, 2006	January 28, 2005
Shares repurchased	5,025	1,532	14,612	5,580
Cost of shares repurchased	$ 145,583	$ 49,980	$ 390,147	$ 132,993
Average price per share	$ 28.97	$ 32.62	$ 26.70	$ 23.83

At January 27, 2006, $504,417 remained available for repurchases under the plan.

Since the inception of the stock repurchase program through January 27, 2006, we have purchased a total of 29,178 shares of our common stock at an average price of $24.65 per share for an aggregate purchase price of $719,222.

Comprehensive Income

The components of comprehensive income, were as follows:

	Three Months Ended		Nine Months Ended	
	January 27, 2006	January 28, 2005	January 27, 2006	January 28, 2005
Net income	$ 76,393	$ 60,127	$ 207,231	$ 162,318
Currency translation adjustment	(12)	448	(1,996)	30
Change in unrealized gain (loss) on investments	1,327	143	(4,492)	(1,562)
Change in unrealized gain (loss) on derivatives	352	(2,691)	559	(2,789)
Comprehensive income	$ 78,060	$ 58,027	$ 201,302	$ 157,997

The components of accumulated other comprehensive loss were as follows:

	January 27, 2006	April 30, 2005
Accumulated translation adjustments	$ (714)	$ 1,283
Accumulated unrealized loss on available-for-sale investments	(9,935)	(5,444)
Accumulated unrealized gain on derivatives	670	111
Total accumulated other comprehensive loss	$ (9,979)	$ (4,050)

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NETWORK APPLIANCE, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

10. Restructuring Charges

In fiscal 2002, as a result of continuing unfavorable economic conditions and a reduction in IT spending rates, we implemented two restructuring plans, which included reductions in workforce and consolidations of facilities. As of January 27, 2006, 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 the second quarter of 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.

During the first quarter of fiscal 2006, we recorded a reduction in restructuring reserve of $1,256 resulting from the execution of new sublease agreement for our Tewksbury facility. 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 second and third quarter of fiscal 2006, we recorded a restructuring charge of $645 and $117, primarily attributed to severance-related amounts and relocation expenses related to the move of our global services center operations.

The following analysis sets forth the changes in the restructuring reserve for the three months ended January 27, 2006:

	Facility Accrual	Severance-Related	Total
Reserve balance at April 30, 2004	$ 5,208	$	$ 5,208
Cash payments	(705)		(705)
Reserve balance at April 30, 2005	4,503		4,503
Cash payments	(90)		(90)
Adjustments	(1,256)		(1,256)
Reserve balance at July 29, 2005	3,157		3,157
Restructuring charges	281	364	645
Cash payments	(451)	(341)	(792)
Reserve balance at October 28, 2005	2,987	23	3,010
Restructuring charges		117	117
Cash payments	(175)	(17)	(192)
Reserve balance at January 27, 2006	$ 2,812	$ 123	$ 2,935

Of the restructuring reserve balance at January 27, 2006, $681 was included in other accrued liabilities and the remaining $2,254 was classified as long-term obligations, relating to the facility charges for the second restructuring and the global services center restructuring charges.

11. Short-Term Investments

All our investments are classified as available for sale at January 27, 2006 and April 30, 2005. Available-for-sale investments with original maturities of greater than three months are classified as short-term investments, as these investments generally consist of highly marketable securities that are intended to be available to meet current cash requirements. Investment securities classified as available-for-sale are reported at fair market value, and net unrealized gains or losses are recorded in accumulated other comprehensive loss, a separate component of stockholders equity. Realized gains or losses on sales of investments are computed based upon

NETWORK APPLIANCE, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

specific identification and are included in interest income and other, net. For all periods presented, realized gains and losses on available-for-sale investments were not material. Management evaluates investments on a regular basis to determine if an other-than-temporary impairment has occurred and there were none as of January 27, 2006. The unrealized losses on these investments at January 27, 2006 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 27, 2006.

12. New Accounting Pronouncements

In June 2004, the FASB ratified Emerging Issues Task Force Issue (EITF) No. 03-1, *The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments.* EITF 03-1 includes new guidance for evaluating and recording impairment losses on debt and equity investments, as well as new disclosure requirements for investments that are deemed to be temporarily impaired. In September 2004, the Financial Accounting Standards Board (FASB) approved the issuance of a FASB Staff Position to delay the recognition and measurement provisions of EITF 03-1. In June 2005, the FASB decided not to provide additional guidance on the meaning of other-than-temporary impairment under EITF 03-1. The FASB directed the staff to issue FASB Staff Position Paper (FSP) 115-1, *The Meaning of Other-Than-Temporary Impairment and its Application to Certain Investments* (FSP 115-1), superseding EITF 03-1. FSP 115-1 will replace the accounting guidance on the determination of whether an investment is other-than-temporarily impaired as set forth in EITF 03-1 with references to existing other-than-temporary impairment guidance. In November 2005, the FASB issued FASB Staff Position FSP 115-1 which addresses the determination as to when an investment is considered impaired, whether that impairment is other-than-temporary, and the measurement of an impairment loss. This FSP also includes accounting considerations subsequent to the recognition of an other-than-temporary impairment and requires certain disclosures about unrealized losses that have not been recognized as other-than-temporary impairments. The guidance in this FSP amends FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities and APB Opinion No. 18, The Equity Method of Accounting for Investments in Common Stock. The guidance in FSP 115-1 shall be applied to reporting periods beginning after December 15, 2005. We are required to adopt FSP 115-1 beginning January 28, 2006. We are currently evaluating the effect that the adoption of FSP 115-1 will have on our consolidated results of operations and financial condition but do not expect it to have a material impact.

In October 2005, the FASB issued FASB Staff Position (FSP) FSP Nos. FAS 13-1, *Accounting for Rental Costs Incurred during a Construction Period*, (FSP 13-1) addresses the accounting for rental costs associated with operating leases that are incurred during a construction period. The adoption of the provisions of FSP 13-1 is not expected to have a material impact on our financial position or results of operations.

In June 2005, the FASB issued SFAS No. 154 *Accounting Changes and Error Corrections: a Replacement of Accounting Principles Board Opinion No. 20 (APB 20) and FASB Statement No 3* (SFAS No. 154). SFAS No. 154 requires retrospective application for voluntary changes in accounting principle unless it is impracticable to do so. Retrospective application refers to the application of a different accounting principle to previously issued financial statements as if that principle had always been used. SFAS No. 154 s retrospective-application requirement replaces APB 20 s requirement to recognize most voluntary changes in accounting principle by including in net income of the period of the change the cumulative effect of changing to the new accounting principle. This Statement defines

retrospective application as the application of a different accounting principle to prior accounting periods as if that principle had always been used or as the adjustment of previously issued financial statements to reflect a change in the reporting entity. This Statement also redefines restatement as the revising of previously issued financial statements to reflect the correction of an error. The requirements are effective for accounting changes made in fiscal years beginning after December 15, 2005 and will only impact the consolidated financial statements in periods in which a change in accounting principle is made.

NETWORK APPLIANCE, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

In March 2005, the FASB issued Interpretation No. 47, *Accounting for Conditional Asset Retirement Obligation.* (Interpretation No. 47). Interpretation No. 47 clarifies that an entity must record a liability for a conditional asset retirement obligation if the fair value of the obligation can be reasonably estimated. Interpretation No. 47 also clarifies when an entity would have sufficient information to reasonably estimate the fair value of an asset retirement obligation. Interpretation No. 47 is effective no later than the end of the fiscal year ending after December 15, 2005. We are currently evaluating the provision and do not expect that our adoption in the fourth quarter of fiscal 2006 will have a material impact on our results of operations or financial condition.

In March 2005, the Securities and Exchange Commission (SEC) issued Staff Accounting Bulletin (SAB) No. 107, which provides guidance on the implementation of Statement of Financial Accounting Standards (SFAS) No. 123R, *Share-Based Payments* (SFAS No. 123R) (see discussion below). In particular, SAB No. 107 provides key guidance related to valuation methods (including assumptions such as expected volatility and expected term), the accounting for income tax effects of share-based payment arrangements upon adoption of SFAS No. 123R, the modification of employee share options prior to the adoption of SFAS No. 123R, the classification of compensation expense, capitalization of compensation cost related to share-based payment arrangements, first-time adoption of SFAS No. 123R in an interim period, and disclosures in Management s Discussion and Analysis subsequent to the adoption of SFAS No. 123R. SAB No. 107 became effective on March 29, 2005. It did not have a material impact on our consolidated financial statements.

In December 2004, the FASB issued SFAS No. 123R. Generally, the requirements of SFAS No. 123R are similar to those of SFAS No. 123. However, SFAS No. 123R requires companies to now recognize all share-based payments to employees, including grants of employee stock options, in their statements of operations based on the fair value of the payments. Pro forma disclosure will no longer be an alternative. The effective date of the new standard for our consolidated financial statements is the first quarter of fiscal 2007, which begins on May 1, 2006.

SFAS No. 123R permits public companies to adopt its requirements using one of two methods: (1) a modified prospective method under which compensation cost is recognized beginning with the effective date based on the requirements of SFAS No. 123R for all share-based payments granted after the effective date and based on the requirements of SFAS No. 123 for all awards granted to employees prior to the effective date of SFAS No. 123R that are unvested on the effective date; or (2) a modified retrospective method which includes the requirements of the modified prospective method and also permits companies to restate either all prior periods presented or prior interim periods of the year of adoption using the amounts previously calculated for pro forma disclosure under SFAS No. 123. We have not yet determined which method we will select for our adoption of SFAS No. 123R.

As permitted by SFAS No. 123, we currently account for share-based payments to employees using APB No. 25 s intrinsic value method and, as such, generally recognizes no compensation cost for employee stock options through our consolidated statements of operations but rather, discloses the effect in its consolidated financial statement footnotes. Accordingly, the adoption of SFAS No. 123R s fair value method will have a significant impact on our reported results of operations. However, the impact of the adoption of SFAS No. 123R cannot be quantified at this time because it will depend on levels of share-based payments granted in the future as well as other variables that effect the fair market value estimates, which cannot be forecasted at this time.

In January 2005, the FASB issued FASB Staff Position (FSP) No. FAS 109-1, *Application of SFAS No. 109 to the Tax Deduction on Qualified Production Activities Provided by the American Jobs Creation Act of 2004.* (FSP No. 109-1)

This FSP provides guidance for the accounting of a deduction provided to U.S. manufacturing companies and is effective immediately. We believe the adoption of this position currently will not have a material effect on our financial position or results of operations. However, there is no assurance that there will not be a material impact in the future.

In December 2004, the FASB issued FSP No. FAS 109-2, *Accounting and Disclosure Guidance for the Foreign Earnings Repatriation Provision within the American Jobs Creation Act of 2004* (FSP No. 109-2). The American Jobs Creation Act introduces a special one-time dividends received deduction on the repatriation of

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certain foreign earnings to U.S. companies, provided certain criteria are met. FSP No. 109-2 provides accounting and disclosure guidance on the impact of the repatriation provision on a company s income tax expense and deferred tax liability. We are currently studying the impact of the one-time favorable foreign dividend provision and intend to complete the analysis by the end of our fourth quarter of fiscal 2006. Accordingly, we have not adjusted income tax expense or deferred tax liability to reflect the tax impact of any repatriation of non-U.S. earnings.

In November 2004, the FASB issued SFAS No. 151 *Inventory Costs* (SFAS No. 151). This statement amends the guidance in ARB No. 43, Chapter 4, Inventory Pricing, to clarify the accounting for abnormal amounts of idle facility expense, freight, handling costs, and wasted material (spoilage). SFAS No. 151 requires that those items be recognized as current-period charges. In addition, this Statement requires that allocation of fixed production overhead to costs of conversion be based upon the normal capacity of the production facilities. The provisions of SFAS No. 151 are effective for inventory cost incurred in fiscal years beginning after June 15, 2005. As such, we are required to adopt these provisions at the beginning of fiscal 2007, which begins on May 1, 2006. We do not expect the adoption of SFAS No. 151 to have a material impact on our consolidated financial statements.

13. Commitments and Contingencies

The following summarizes our commitments and contingencies at January 27, 2006, and the effect such obligations may have on our future periods:

Contractual Obligations:	**2006**	**2007**	**2008**	**2009**	**2010**	**Thereafter**	**Total**
Rent operating lease payments(1)	$ 3,981	$ 13,979	$ 13,627	$ 13,358	$ 10,133	$ 28,779	$ 83,857
Equipment operating lease payments(1)	1,516	5,849	5,167	2,873	16		15,421
Lease payments(2)			1,651	1,981	1,981	37,017	42,630
Venture capital funding commitments(3)	100	402	389	377	364	381	2,013
Purchase commitments and other(4)	1,348	600					1,948
Capital Expenditures(5)	10,858	7,711					18,569
Communications & Maintenance(6)	3,169	7,439	5,267	1,521	169		17,565
Total Contractual Cash Obligations	$ 20,972	$ 35,980	$ 26,101	$ 20,110	$ 12,663	$ 66,177	$ 182,003

Other Commercial Commitments:	**2006**	**2007**	**2008**	**2009**	**2010**	**Thereafter**	**Total**
Letters of Credit(7)	$ 450	$	$	$	$	$ 337	$ 787
Restricted Cash(8)	1,828	302	748	676	53	2,224	5,831
Total Commercial Commitments	$ 2,278	$ 302	$ 748	$ 676	$ 53	$ 2,561	$ 6,618

(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 2015. 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. Sublease income of $58 has been included as a reduction of the payment amounts shown in the table. Rent operating lease payments in the table exclude lease

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payments which are accrued as part of our 2002 restructurings and include only rent lease commitments that are over one year.

(2) On December 16, 2005, we (the Lessee) entered into financing, construction and leasing arrangements with BNP Paribas LLC (BNP) (the Lessor), for office space to be located on land currently owned by us in Sunnyvale, California. This arrangement requires us to ground lease our land to BNP for a period of 50 years to construct approximately 190,000 square feet of office space with $38,500 construction allowance provided by BNP, and, after completion of construction to pay minimum lease payments which vary based on London Interbank Offered Rate (LIBOR) plus a spread (5.15% at January 27, 2006). We expect to pay lease payments on the completed buildings from BNP on June 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 the 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 2 year period.

Included in the above contractual cash obligations are (a) lease commitments of $1,651 in fiscal 2008, $1,981 in each of the fiscal years 2009, 2010, 2011, 2012 and $330 in fiscal 2013, which are based on the LIBOR rate at January 27, 2006, for a term of 5 years, and (b) at the expiration or termination of the lease, a supplemental payment obligation equal to $32,725 in the event that we elect not to purchase or arrange for a sale of the building.

The lease also requires us to maintain specified financial covenants with which we were in compliance as of January 27, 2006. 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.

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

(4) Amounts included in purchase commitments and other are (a) agreements to purchase component inventory from our suppliers and/or contract manufacturers that are non-cancelable and legally binding against us and (b) commitment related to utilities contracts. Purchase commitments and other exclude (a) purchases of goods and services we expect to consume in the ordinary course of business in the next 12 months; (b) open purchase orders that represent an authorization to purchase rather than a binding agreement; (c) agreements that are cancelable without penalty and costs that are not reasonably estimable at this time.

(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 and a corporate credit card program.

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

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

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NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

that they will not be utilized in future operations. To the extent that such forecasts are not achieved, our commitments and associated accruals may change.

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

14. Business Combinations

Acquisition of Decru

On August 26, 2005, we completed our acquisition of Decru, Inc. (Decru), a Delaware corporation that develops and sells encryption software and appliances which encrypt network data. The acquisition resulted in the issuance of approximately 8,270 shares of our common stock with a fair value of approximately $191,874, approximately 1,907 stock options and restricted stock with a fair value of approximately $36,142 and the payment of approximately $54,482 in cash (of which approximately $34,049 has been placed in escrow to secure the Decru stockholders indemnification obligations to us pursuant to the Merger Agreement), and $711 acquisition-related transaction costs, for a total purchase price of approximately $283,209. The common stock issued in the acquisition was valued at $23.20 per share using a measurement date of August 11, 2005 in accordance with EITF 99-12, *Determination of the Measurement Date for the Market Price of Acquirer Securities Issued in a Purchase Business Combination.* The options were valued using the Black-Scholes option pricing model with the following inputs: volatility factor of 69%, expected life of 3.8 years, risk-free interest rate of 2.9%, and a market value for Network Appliance s stock of $23.20 per share, which was determined as described above. A summary of the total purchase price is as follows:

	Decru
Common stock issued	$ 191,874
Cash consideration	54,482
Stock options assumed	36,142
Acquisition-related transaction costs	711
	$ 283,209

In accordance with SFAS 141, we have preliminarily allocated the purchase price to the estimated tangible and intangible assets acquired and liabilities assumed, including in-process research and development, based on their estimated fair values. The excess purchase price over those fair values is recorded as goodwill. Decru s technology will augment our data protection and security solutions and provide for a wide variety of deployments with vendors storage systems in NAS, DAS, SAN, iSCSI, and even tape backup environments, which will allow us to pursue expanded market opportunities. These opportunities, along with the ability to leverage the Decru 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 impairment. Purchased intangibles with finite lives will be amortized over their

NETWORK APPLIANCE, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

respective estimated useful lives on a straight line basis. The purchase price has been preliminarily allocated as follows:

Purchase Price Allocation:	**Decru**	**Amortization Period (Years)**
Fair value of tangible assets acquired	$ 16,516	
Intangible assets:		
Existing Technology Hardware	30,100	5
Existing Technology Software	10,600	4
Patents and Core Technology	11,800	5
Reseller Agreement and Related Relationship	2,400	5
Customer/Distributor Relationships	7,200	5
Non compete agreements	1,200	2
Trademarks and tradenames	4,800	6
Goodwill	192,949	
In process research and development	5,000	Expensed
Fair value of liabilities assumed	(3,087)	
Deferred stock compensation	18,549	
Deferred income taxes	(14,818)	
	$ 283,209	

Useful lives are primarily based on the underlying assumptions used in the discounted cash flow models. The allocation is preliminary and subject to change if we obtain additional information concerning the fair values of certain acquired assets and liabilities of Decru.

Net Tangible Assets

Decru s assets and liabilities as of August 26, 2005 were reviewed and adjusted, if required, to their estimated fair value. Included in net tangible assets acquired above is $13,277 of cash assumed in connection with the Decru acquisition.

Amortizable Intangible Assets

Our valuation specialists valued the identified intangible assets utilizing a discounted cash flow (DCF) model, which uses forecasts of future revenues and expenses related to the intangible assets. We are amortizing these intangible assets over 2-6 years on a straight-line basis.

In-process Research and Development (IPR&D)

Of the total purchase price, $5,000 has been allocated to in-process research and development (IPR&D) and was expensed in the quarter ended October 28, 2005. Projects that qualify as IPR&D represent those that have not yet reached technological feasibility and which have no alternative future use. Technological feasibility is established when an enterprise has completed all planning, designing, coding, and testing activities that are necessary to establish that a product can be produced to meet its design specifications including functions, features, and technical performance requirement. The value of IPR&D was determined by estimating the stage of completion and risk associated with IPR&D to determine the level of discount rate to be applied, estimating costs to develop the purchased IPR&D into commercially viable products, estimating the resulting net cash flows from the projects when completed and discounting the net cash flows to their present value based on the percentage of completion of the IPR&D projects.

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NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Acquisition of Alacritus

On May 2, 2005, we acquired Alacritus, Inc., a privately held company based in Pleasanton, California, that develops and sells disk-based virtual tape library software for data protection solutions. Under terms of the agreement, we paid Alacritus $11,000 in cash and assumed options to acquire 79 shares of common stock at an average price of $26.37 per share and 43 shares of restricted stock units at $0 per share. We also incurred certain transaction costs and assumed certain operating assets and liabilities. The historical operations of Alacritus were not significant.

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

	Alacritus
Cash consideration	$ 11,000
Common stock issued	
Stock options assumed	2,314
Acquisition-related transaction costs	337
	$ 13,651

Purchase Price Allocation:	**Alacritus**	**Amortization Period (Years)**
Fair value of tangible assets acquired	$ 67	
Intangible assets:		
Existing/Core Technology	5,000	5
Non compete agreements	700	2
Goodwill	5,844	
Fair value of liabilities assumed	(810)	
Deferred stock compensation	1,199	
Deferred income taxes	1,651	
	$ 13,651	

In accordance with FASB Interpretation No. 44, *Accounting for Certain Transactions involving Stock Compensation*, we recorded the intrinsic value, measured as the difference between the grant price and fair market value on the acquisition consummation date, of unvested options and restricted stock units assumed in the Alacritus and Decru acquisitions as deferred stock compensation. Such deferred stock compensation which aggregated $1,199 for Alacritus

and $18,549 for Decru, are recorded as a separate component of stockholders equity in the accompanying condensed consolidated balance sheet and will be amortized over the vesting term of the related options. In connection with the Decru merger, we assumed all options to purchase Decru common stock granted under the Decru, Inc. 2001 Equity Incentive Plan that were outstanding at the closing of the Merger, which options shall be exercisable for an aggregate of 1,907 shares of our Common Stock at an average price of $11.86 per share.

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

This Quarterly Report on Form 10-Q contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended (the Exchange Act), and are subject to the safe harbor provisions set forth in the Exchange Act. Forward-looking statements usually contain the words estimate, intend, plan, predict, seek, may, will, should, would, believe, or similar expressions and variations or negatives of these words. In addition, any statements that refer to expectations, projections or other characterizations of future events or

NETWORK APPLIANCE, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

circumstances, including any underlying assumptions, are forward-looking statements. All forward-looking statements, including, but not limited to, (1) our expectation that units shipped of the FAS 960, FAS 940 and FAS 920 will continue to decline and gradually be replaced by FAS 3000 units; (2) our expectation that the decline in our high-end products will be mitigated by the introduction of our next-generation high-end products; (3) our belief that our new NearStore® Virtual Tape Library solution will further expand our market opportunity; (4) our expectation that the introduction of our new high-end products, targeted for shipping before the end of our fiscal 2006, will increase both performance and capacity and restore the balance between the sales of our mid-range and high-end products; (5) our plan to invest in the people, processes and systems necessary to best optimize our revenue growth and long-term profitability; (6) our expectation that higher disk content associated with high-end storage systems may negatively affect our gross margin; (7) our estimates regarding future amortization of exiting technology to cost of products revenues relating to our acquisitions; (8) our expectation that service margins will be in the mid 20% range for fiscal 2006; (9) our estimates regarding future amortization of trademarks, tradenames, customer contracts and relationships relating to our acquisitions and included in sales and marketing expenses; (10) our expectation that we will continue to add sales and professional services capacity; (11) our expectation that we will increase sales and marketing expenses commensurate with future revenue growth; (12) our estimates regarding future capitalized patents amortization expenses; (13) our belief that our future performance will depend in on our ability to maintain and enhance our current product line, develop new products, maintain technological competitiveness, and meet an expanding range of customer requirements; (14) our intention to continuously broaden our existing product offerings and introduce new products; (15) our expectation that we will continuously support current and future product development and enhancement efforts and incur corresponding charges; (16) our belief that our research and development expenses will increase in absolute dollars for the remainder of fiscal 2006; (17) our belief that our general and administrative expenses will increase in absolute terms in the remainder of fiscal 2006; (18) our estimates regarding future amortization of covenants not to compete relating to our acquisitions; (19) our expectation that the research and development costs to bring Decru products to technological feasibility will not have a material impact on our future results of operations of our financial condition; (20) our expectation regarding estimated future deferred stock compensation amortization expenses and future amortization of intangible assets; (21) our expectation that interest income will increase in fiscal 2006; (22) our belief that period-to-period changes in foreign exchange gain or losses will continue to be impacted by hedging costs associated with our forward and option activities; (23) our expectation that cash provided by operating activities may fluctuate in future periods as a result of a number of factors; (24) our expectation that we may repatriate foreign earnings and pay taxes under the Jobs Act and our expectation of the amount to be repatriated and the consequent tax liability; (25) our expectations regarding our contractual cash obligations and other commercial commitments at January 27, 2006 for the remainder of fiscal 2006 and fiscal years 2007 through 2010 and thereafter; (26) our expectation that we will complete construction on our Sunnyvale facility by approximately June 2007 and that our estimates regarding future minimum lease payments for the lease term; (27) our expectation that capital expenditures will increase consistent with our business growth; (28) 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, including operating leases, and any required capital expenditures over the next few years will be funded through cash from operations and existing cash and investments; (29) our belief that foreign currency hedging contracts will not subject us to significant credit risk; (30) our belief that our existing liquidity and capital resources are sufficient to fund our operations for at least the next twelve months; (31) our belief that the accounting policies included herein are the policies that most frequently require us to make estimates and judgments, and are therefore critical ; (32) our belief that the principal competitive factors affecting our markets include certain product benefits and global service and support; (33) our intent to regularly introduce new products and product enhancements; (34) the possibility that we may need to increase our materials purchases, contract manufacturing capacity and internal test and quality functions to meet anticipated demand; (35) our intention

to continue to establish and maintain business relationships with technology companies; (36) the possibility that we may continue to engage in future acquisitions; (37) our expectation that we will increasingly rely on our indirect sales channel for a significant portion of our revenue; (38) our expectation that the ultimate costs to resolve any outstanding legal

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claims or proceedings will not be material to our business; (39) our expectation that companies in the appliance market will increasingly be subject to infringement claims as the industry grows; (40) our expectation that the value of our investments will not decline significantly because of changes in market interest rates, (41) our expectation that our investments in emerging technologies will contribute to our long term growth; and (42) our expectation that we will acquire products and businesses complementary to our business, 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. Actual results could vary from our forward looking statements and as a result of important factors, including those described in the Risk Factors included on page 35.

Third Quarter Fiscal 2006 Overview

We achieved growth in revenue and profitability during the three-month period ended January 27, 2006, driven primarily by our FAS 3000 midrange product line. Product revenues growth was across all geographies. The increase in product revenues year over year was specifically attributable to increased software licenses and software subscriptions, an increase in units shipped of the new FAS 3000 series, and sales of add-on storage shelves, partially offset by declines in units shipped of our FAS 960, FAS 940, FAS 920 and R200 products.

We expect unit shipments of the FAS 960, FAS 940, and FAS 920 to continue to decline in the remainder of fiscal 2006 and be gradually replaced by the FAS 3000 series products. However, this shift to the FAS 3000 may negatively impact our revenue in the near term as the dollar value of our FAS 3000 sales may be lower compared to sales of our FAS 960 and R200 products. In the longer term, we expect this decline in the high-end products to be mitigated by the introduction of our next-generation high-end products, which is targeted for shipping in the fourth quarter of fiscal 2006. We also expect this introduction will increase both performance and capacity compared to the FAS 980, and will restore the balance between the sales of our high-end and mid-range products. Additionally, we believe that our new NearStore Virtual Tape Library solution will further expand our market opportunity as we can now provide Disk-to-Disk backup solutions for all open systems enterprise primary storage.

We continue to make progress in penetrating and expanding our business in enterprise data centers with mission critical partners, expanding our product line innovations to broaden our addressable market, such as flexible volumes, data encryption and virtual tape library. In the remainder of fiscal 2006 we expect to introduce our new high-end products and deliver our next-generation operating system with enhanced storage grid architecture.

Continued revenue growth is dependent on the introduction and market acceptance of our new products. If we fail to timely introduce new products or 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 a decline in revenue. We plan to continue 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 2006 Financial Performance

Our revenues for the three-month period ended January 27, 2006, were $537.0 million, a 30.1% increase over the three-month period ended January 28, 2005. Our revenues for the nine-month period ended January 27, 2006, were $1,468.5 million, a 28.1% increase over the nine-month period ended January 28, 2005. This year-over-year increase in revenue primarily from our new mid-range FAS 3020 and FAS 3050 was partially offset by a decline in revenue of our FAS 960, FAS 940, FAS 920 and NearStore R200 products compared to the same periods a year ago.

Our overall gross margins were 60.9% and 61.3% respectively, in the three and nine-month periods ended January 27, 2006 compared to 61.1% and 60.9%, respectively, in the same periods ended January 28, 2005.

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Overall gross margin for the three and nine-month periods ended January 27, 2006 reflected higher amortization of existing technology from our acquisitions which was partially offset by a favorable change in product and add-on software mix.

Net income for the three-month period ended January 27, 2006 increased 27.1% to $76.4 million compared to net income of $60.1 million for the same period a year ago. Net income for the nine-month period ended January 27, 2006 increased 27.7% to $207.2 million compared to net income of $162.3 million for the same period a year ago.

With the exception of long-term restructuring and deferred rent liabilities totaling $3.4 million, our balance sheet as of January 27, 2006 remains debt-free. Cash, cash equivalents and investments declined to $1,140.9 million, compared to $1,170.0 million as of April 30, 2005, due primarily to cash repurchases of our common stock of $390.1 million and net cash paid of $41.2 million in connection with the Decru acquisition partially offset by cash generated from operations. Days Sales Outstanding increased to 62 days as of January 27, 2006 compared to 60 days as of April 30, 2005. Inventory turns were 12.9 times and 17.9 times as of January 27, 2006 and April 30, 2005, respectively. Deferred revenue increased to $593.5 million as of January 27, 2006 from $449.2 million reported as of April 30, 2005 due to higher software subscription and service billings attributable to our continuing shift toward larger enterprise customers. Capital purchases of plant, property and equipment for the nine-month period ended January 27, 2006 were $96.5 million.

Results of Operations

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

	Three Months Ended		Nine Months Ended	
	January 27, 2006	January 28, 2005	January 27, 2006	January 28, 2005
Revenues:	100.0%	100.0%	100.0%	100.0%
Product revenue	88.3	89.1	88.1	89.8
Service revenue	11.7	10.9	11.9	10.2
Cost of Revenues:				
Cost of product revenue	30.4	30.8	29.8	30.8
Cost of service revenue	8.7	8.1	8.9	8.3
Gross margin	60.9	61.1	61.3	60.9
Operating Expenses:				
Sales and marketing	28.3	28.8	29.2	28.8
Research and development	11.7	10.6	11.5	10.7
General and administrative	4.6	4.9	4.6	4.8
In process research and development			0.3	

Stock compensation	0.8	0.5	0.6	0.6
Restructuring recoveries		(0.1)		
Total operating expenses	45.4	44.7	46.2	44.9
Income from Operations	15.5	16.4	15.1	16.0

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NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

	Three Months Ended		Nine Months Ended	
	January 27, 2006	January 28, 2005	January 27, 2006	January 28, 2005
Other Income (Expense), net:				
Interest income	1.8	1.5	1.9	1.4
Other income (expenses), net	0.2	(0.1)		(0.1)
Net gain on investments				
Total other income, net	2.0	1.4	1.9	1.3
Income before Income Taxes	17.5	17.8	17.0	17.3
Provision for Income Taxes	3.3	3.2	2.9	3.1
Net Income	14.2%	14.6%	14.1%	14.2%

Discussion and Analysis of Results of Operations

Product Revenues Product revenues increased by 28.9% to $474.2 million for the three-month period ended January 27, 2006, from $367.9 million for the same period in fiscal 2005. Product revenues increased by 25.7% to $1,293.6 million for the nine-month period ended January 27, 2006, from $1,029.3 million for the same period in fiscal 2005.

Product revenues were favorably impacted by the following factors:

- increased revenues from our new and current product portfolio, and in particular, FAS 3020, FAS 3050, and FAS 270 filer products and add-on software;

- increased sales of software subscriptions, which represented 11.3% and 11.7% of total revenues for the three and nine-month periods ended January 27, 2006, respectively, and 10.6% and 10.5% of total revenues for the three and nine-month periods ended January 28, 2005, respectively;

- increased sales through indirect channels, which includes sales through our resellers, distributors and OEM partners, representing 56.9% and 56.0% of total revenues for the three and nine-month periods ended January 27, 2006, respectively, and 50.4% of total revenues for both the three and nine-month periods ended January 28, 2005; and

- increased sales of add-on storage shelves due to data volume growth and year end buying surge.

Product revenues were negatively impacted by the following factors:

a mix shift to our new midrange FAS 3000 series, causing a decline in unit shipments and revenues from our FAS 960, FAS 940 and NearStore R200 products;

lower average selling prices associated with the new FAS 3000 series using a mix of ATA and fibre channel drives;

lower-cost-per-megabyte disks; and

declining average selling prices and unit sales of our older products.

The overall increase in product revenues for the nine-month period ended January 27, 2006 as compared to the same period ended January 28, 2005 was generally attributed to the same offsetting factors as cited above for the three-month periods ended January 27, 2006 and January 28, 2005. In addition, for the nine-month period ended January 27, 2006, product revenues were also positively impacted by increased revenues from our high-end FAS 980 product.

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The Decru acquisition and the IBM OEM relationship did not have a significant impact on the revenue for the three and nine-month periods ended January 27, 2006. There can be no assurance that IBM and Decru will 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.

Service Revenues Service revenues, which include hardware support, professional services, and educational services, increased by 40.2% to $62.8 million in the three-month period ended January 27, 2006, from $44.8 million in the same period in fiscal 2005. Service revenues increased by 49.5% to $174.9 million in the nine-month period ended January 27, 2006, from $117.0 million in the same period in fiscal 2005.

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

- an increasing number of enterprise customers which typically purchase more complete and generally longer-term service packages than our non-enterprise customers;
- a growing installed base resulting in new customer support contracts in addition to support contract renewals by existing customers; and
- growth in professional services revenue.

While it is an element of our strategy to expand and offer a more comprehensive, global enterprise support and service solution, we cannot assure you that service revenue will grow at the current rate in the remainder of fiscal 2006.

Service revenues are generally deferred and, in most cases, recognized ratably over the service obligation periods, which are typically one to three years. Service revenues represented 11.7% and 11.9% of total revenues for the three and nine-month periods ended January 27, 2006, respectively, and 10.9% and 10.2% of total revenues for the three and nine-month periods ended January 28, 2005, respectively.

International total revenues International total revenues (including United States exports) increased by 27.8% and 25.0% for the three and nine-month periods ended January 27, 2006, respectively, as compared to the same periods in fiscal 2005. International total revenues were $239.1 million and $615.1 million, respectively, or 44.5% and 41.9% of total revenues, respectively, for the three and nine-month periods ended January 27, 2006. International total revenues were $187.1 million and $492.0 million, respectively, or 45.3% and 42.9% of total revenues, respectively, for the three and nine-month periods ended January 28, 2005. The increase in international sales in absolute dollars was primarily a result of European and Asia Pacific net revenue growth, driven by increased demand for our solutions, new customers and higher storage spending in certain geographic regions as compared to the same periods in the prior fiscal year. We cannot assure you that we will be able to maintain or increase international revenues in the remainder of fiscal 2006.

Product Gross Margin Product gross margins were 65.5% and 65.4% for the three-month periods ended January 27, 2006, and January 28, 2005, respectively. Product gross margin increased to 66.1% for the nine-month period ended January 27, 2006, from 65.7% for the nine-month period ended January 28, 2005.

Product gross margin was favorably impacted by:

- favorable product and add-on software mix;
- better disk utilization rates associated with sales of higher-margin management software products like FlexClone™ and FlexVol™ that run on the Data ONTAP® 7G operating system allowing customers to buy less disk storage but buy more of the high-value, high-margin systems and associated software to manage their data;
- growth in software subscription upgrades and software licenses due primarily to a larger installed base and an increasing number of new enterprise customers.

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Product gross margin was negatively impacted by:

- sales price reductions due to competitive pricing pressure and selective pricing discounts;
- increased sales through indirect channels, which may have a lower gross margin than our direct sales in certain geographic regions;
- increase in the amount of relatively lower margin add-on storage shelves sold; and
- lower average selling price of certain add-on software options.

Higher disk content associated with high-end storage systems may negatively affect our gross margin in the future if not offset by increases in software revenue or new higher-margin products.

Amortization of existing technology included in cost of product revenues was $3.9 million and $7.9 million for the three and nine-month periods ended January 27, 2006, respectively, and $0.9 million and $2.6 million for the three and nine-month periods ended January 28, 2005, respectively. Based on existing technology recorded at January 27, 2006, estimated future amortization of existing technology to cost of product revenues relating to our acquisitions will be $3.9 million for the remainder of fiscal 2006, $15.5 million for fiscal years 2007 and 2008, $14.7 million for fiscal year 2009; $10.3 million for fiscal year 2010; and $2.8 million thereafter.

Service Gross Margin Service gross margin increased to 25.9% in the three-month period ended January 27, 2006, as compared to 25.3% in the three-month period ended January 28, 2005. Service gross margin increased to 25.3% in the nine-month period ended January 27, 2006 as compared to 18.8% in the nine-month period ended January 28, 2005. Cost of service revenue increased by 39.0% to $46.5 million in the three-month period ended January 27, 2006, from $33.5 million in the same period in fiscal 2005. Cost of service revenue increased by 37.4% to $130.5 million in the nine-month period ended January 27, 2006, from $95.0 million in the same period in fiscal 2005.

The improvement in service gross margin for the three and nine-month periods ended January 27, 2006 compared to the same periods in fiscal 2005 was primarily due to an increase in services revenue and improved headcount utilization. The increase in the service gross margin was partially offset by the 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 experience some variability over time due to the timing of technical support service initiations and renewals and additional investments in our customer support infrastructure. In fiscal 2006, we expect service margin to be in the mid 20% range, as we continue to scale our service programs and offerings, particularly professional services.

Sales and Marketing Sales and marketing expenses consist primarily of salaries, commissions, advertising and promotional expenses, and certain customer service and support costs. Sales and marketing expenses increased 28.1% to $152.0 million for the three-month period ended January 27, 2006, from $118.7 million for the same period in fiscal 2005. These expenses were 28.3% and 28.8% of total revenues for the three-month periods ended January 27, 2006 and January 28, 2005, respectively. Sales and marketing expenses increased 29.1% to $427.5 million for the

nine-month period ended January 27, 2006, from $331.1 million for the same period in fiscal 2005. These expenses were 29.2% and 28.8% of total revenues for the nine-month periods ended January 27, 2006 and January 28, 2005, 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, and the continued worldwide investment in our sales and global service organizations associated with selling complete enterprise solutions.

Amortization of trademarks/tradenames and customer contracts/relationships relating to our acquisitions included in sales and marketing expenses was $0.7 million and $0.2 million for the three-month periods ended January 27, 2006 and January 28, 2005, respectively, and was $1.4 million and $0.6 million for the nine-month

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periods ended January 27, 2006 and January 28, 2005, respectively. Based on the intangibles recorded at January 27, 2006, estimated future amortization of trademarks, tradenames, customer contracts and relationships relating to our acquisitions and included in sales and marketing expenses will be $0.7 million for the remainder of fiscal 2006, $2.8 million for fiscal 2007, $2.7 million for fiscal 2008, 2009 and 2010 and $1.7 million thereafter.

Sales and marketing headcount increased to 2,160 at January 27, 2006 from 1,748 at January 28, 2005. We expect to continue to selectively add sales capacity in an effort to expand domestic and international markets, introduce new products, establish and expand new distribution channels, and increase product and company awareness. We expect to increase our sales and marketing expenses commensurate with future revenue growth.

Research and Development Research and development expenses consist primarily of salaries and benefits, prototype expenses, non-recurring engineering charges, fees paid to outside consultants and amortization of capitalized patents.

Research and development expenses increased 43.6% to $62.6 million for the three-month period ended January 27, 2006, from $43.6 million for the same period ended January 28, 2005. These expenses represented 11.7% and 10.6% of total revenues for the three-month periods ended January 27, 2006 and January 28, 2005, respectively. Research and development expenses increased 37.8% to $169.5 million for the nine-month period ended January 27, 2006 from $123.0 million for the same period ended January 28, 2005. These expenses represented 11.5% and 10.7% of total revenues for the nine-month periods ended January 27, 2006 and January 28, 2005, 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, and higher performance-based payroll expenses due to higher profitability. Research and development headcount increased to 1,095 as of January 27, 2006 compared to 811 as of January 28, 2005 primarily due to new hires and employees from the Decru acquisition. For both the three and nine-month periods ended January 27, 2006 and January 28, 2005, no software development costs were capitalized.

Included in research and development expenses is capitalized patents amortization of $0.5 million and $1.5 million for the three and nine-month periods ended January 27, 2006, respectively, as compared to $0.5 million and $1.4 million, respectively, for the three and nine-month periods ended January 28, 2005. Based on capitalized patents recorded at January 27, 2006, estimated future capitalized patents amortization expenses for the remainder of fiscal 2006 will be $0.5 million, $2.0 million for fiscal years 2007 and 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 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 introduce new products that expand our solutions portfolio.

We believe that our research and development expenses will increase in absolute dollars for fiscal 2006, 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 as compared to fiscal 2005.

General and Administrative General and administrative expenses increased 22.9% to $24.7 million for the three-month period ended January 27, 2006, from $20.1 million for the same period in fiscal 2005. These expenses represented 4.6% and 4.9% of total revenues for the three-month periods ended January 27, 2006 and January 28, 2005, respectively. General and administrative expenses increased 22.7% to $67.3 million for the nine-month period ended January 27, 2006, from $54.9 million for the same period in fiscal 2005. These expenses represented 4.6% and 4.8% of total revenues for the nine-month periods ended January 27, 2006 and January 28, 2005, respectively. This increase in absolute dollars was primarily due to higher legal expenses and professional fees for

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general corporate matters including patents, higher performance-based payroll expenses due to higher profitability and higher headcount growth.

General and administrative headcount increased to 514 at January 27, 2006 from 405 at January 28, 2005. We believe that our general and administrative expenses will increase in absolute dollars for fiscal 2006 due to projected general and administrative headcount growth. Amortization of covenants not to compete included in general and administrative expenses was $0.2 million and $2.0 million for the three and nine-month periods ended January 27, 2006, respectively, as compared to $1.3 million and $3.8 million for the three and nine-month periods ended January 28, 2005, respectively. Based on the intangibles recorded at January 27, 2006, estimated future amortization of covenants not to compete relating to our acquisitions will be $0.2 million in the remainder of fiscal 2006, $1.0 million for fiscal year 2007, $0.2 million for fiscal 2008 and none thereafter.

In-process Research and Development We recorded in-process research and development charges of $5.0 million in the second quarter of fiscal 2006 related to the acquisition of Decru. The purchase price of the transaction was allocated to the acquired assets and liabilities based on their estimated fair values as of the date of the acquisition. Approximately $5.0 million was allocated to in-process research and development and charged to operations, because the acquired technology had not reached technological feasibility and had no alternative uses. The value was determined by estimating the costs to develop the acquired in-process technology into commercially viable products, estimating the resulting future net cash flows from such projects, and discounting the net cash flows back to their present value. The discount rate included a factor that took into account the uncertainty surrounding the successful development of the acquired in-process technology. These estimates are subject to change, given the uncertainties of the development process, and no assurance can be given that deviations from these estimates will not occur. Research and development costs to bring the products from Decru to technological feasibility are not expected to have a material impact on our future results of operations or financial condition.

Stock Compensation Stock compensation expenses were $4.1 million and $9.4 million in the three and nine-month periods ended January 27, 2006, respectively, as compared to $2.2 million and $6.4 million in the three and nine-month periods ended January 28, 2005, respectively. The net increase in deferred compensation expense year over year reflected higher deferred compensation expense amortization from newly issued restricted stock awards and assumed options from the Alacritus and Decru acquisitions partially offset by the terminated deferred salary compensation program and fully amortized WebManage assumed options. Based on deferred stock compensation recorded at January 27, 2006, estimated future deferred stock compensation amortization expenses are $3.9 million in the remainder of fiscal 2006, $14.7 million in fiscal 2007, $8.4 million in fiscal 2008, $1.7 million in fiscal 2009 and $0.3 million in fiscal 2010 and none thereafter.

Beginning May 1, 2006, we are required to adopt SFAS No. 123R and expense employee stock options in our financial statements. Adoption of SFAS No. 123R will have a significant impact on our reported results of operations. However, the impact of the adoption of SFAS No. 123R cannot be quantified at this time because it will depend on levels of share-based payments granted in the future as well as other variables that will affect the fair market value estimates, which cannot be forecasted at this time.

Restructuring Charges In fiscal 2002, as a result of continuing unfavorable economic conditions and a reduction in IT spending rates, we implemented two restructuring plans, which included reductions in workforce and consolidations of facilities. As of January 27, 2006, 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 the second quarter of 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.

During the first quarter of fiscal 2006, we recorded a reduction in restructuring reserve of $1.3 million resulting from the execution of new sublease agreement for our Tewksbury facility. Our restructuring estimates are reviewed and revised periodically and may result in a substantial charge or reduction to restructuring expense should different

NETWORK APPLIANCE, INC.

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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 second and third quarter of fiscal 2006, we recorded a restructuring charge of $0.6 and $0.1 million, primarily attributed to severance-related amounts and relocation expenses related to the move of our global services center operations.

The following analysis sets forth the changes in the restructuring reserve for the three months ended January 27, 2006:

	Facility Accrual	Severance-Related	Total
Reserve balance at April 30, 2004	$ 5,208	$	$ 5,208
Cash payments	(705)		(705)
Reserve balance at April 30, 2005	4,503		4,503
Cash payments	(90)		(90)
Adjustments	(1,256)		(1,256)
Reserve balance at July 29, 2005	3,157		3,157
Restructuring charges	281	364	645
Cash payments	(451)	(341)	(792)
Reserve balance at October 28, 2005	2,987	23	3,010
Restructuring charges		117	117
Cash payments	(175)	(17)	(192)
Reserve balance at January 27, 2006	$ 2,812	$ 123	$ 2,935

Of the reserve balance at January 27, 2006, $0.7 million was included in other accrued liabilities and the remaining $2.3 million was classified as long-term obligations, relating to the facility charges for the second restructuring and the global services center restructuring charges.

Interest Income Interest income was $9.9 million and $28.6 million for the three and nine-month periods ended January 27, 2006, respectively, as compared to $6.0 million and $16.2 million for the three and nine-month periods ended January 28, 2005, respectively. The increase in interest income was primarily driven by higher average interest rates on our investment portfolio. We expect overall interest income to increase for fiscal 2006 as a result of rising average interest rates, partially offset by lower cash and invested balances due primarily to cash repurchases of our common stock.

Other Income (Expense), Net Other Income (Expense), Net, included net exchange gains from foreign currency transactions of $1.0 million and $0.4 million for the three and nine-month periods ended January 27, 2006, respectively. Net exchange losses were $0.6 million and $1.6 million in the three and nine-month periods ended January 28, 2005. We believe that period-to-period changes in foreign exchange gain or losses will continue to be impacted by hedging costs associated with our forward and option activities and forecast variance.

Provision for Income Taxes For the three and nine-month periods ended January 27, 2006, we applied annual tax rates of 19.0% and 17.3%, respectively, to pretax income as compared to 18.1% for the same periods in the prior year. The tax rates for the three and nine-month periods ended January 27, 2006 benefited from discrete provision for income tax items totaling $0.6 million and $5.2 million, respectively. The benefit from the discrete items is attributable primarily to a R&D tax credit study commissioned by us that generated a one time incremental benefit related to prior fiscal years. These rates also reflect a favorable foreign tax ruling for our principal European subsidiary. Our estimate is based on existing tax laws and our current projections of income (loss) and distributions

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

Liquidity and Capital Resources

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, other sources and uses of cash flow and potential tax opportunities on our liquidity and capital resources.

Balance Sheet and Other Cash Flows

As of January 27, 2006, as compared to April 30, 2005, our cash, cash equivalents, and short-term investments decreased by $29.0 million to $1,140.9 million due primarily to cash repurchases of our common stock of $390.1 million and net cash paid of $41.2 million in connection with the Decru acquisition, partially offset by cash generated from operations. We derive our liquidity and capital resources primarily from our cash flow from operations and from working capital. Working capital decreased by $66.6 million to $989.1 million as of January 27, 2006, compared to $1,055.7 million as of April 30, 2005 due primarily to a decrease in cash and short-term investments as well as an increase in current liabilities due primarily to a higher deferred revenue balance, partially offset by higher accounts receivable and inventory balances.

During the nine-month period ended January 27, 2006, we generated cash flows from operating activities of $382.4 million as compared with $344.6 million in the same period in fiscal 2005. The largest driver of this increase was the net income of $207.2 million for the nine-month period ended January 27, 2006, as compared to $162.3 million in the same period in fiscal 2005. In addition to higher net income and noncash adjustments in the nine months ended January 27, 2006, the primary factors that impacted the period-to-period change in cash flows relating to operating activities were the following:

- An increase in deferred revenues from higher software subscription and service billings attributable to our continuing shift toward larger enterprise customers, as well as renewals of existing maintenance agreements; and
- Increased income taxes payable, primarily reflecting higher profitability in the nine-month period ended January 27, 2006 as compared to the same period in the prior year and lower tax payments offset by lower tax refunds as compared to the same period in the prior year.

The above factors were partially offset by the effects of:

- Increased accounts receivable balances due primarily to a shipping profile weighted towards the second half of the third quarter of fiscal 2006;
- An increase in inventories due primarily to higher consigned inventory for the IBM sales and increased configured units to meet revenue growth; and

Increased prepaid expenses in the nine-month period ended January 27, 2006, as compared to a decrease in the same period a year ago due to a tax refund of $9.0 million in connection with a carryback of net operating losses generated in fiscal 2000.

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.

Capital expenditures for the nine-month period ended January 27, 2006 were $96.5 million as compared to $64.8 million in the same period a year ago. We received net proceeds of $21.2 million and used net proceeds of $213.2 million in the nine-month periods ended January 27, 2006 and January 28, 2005, respectively, for net purchases/redemptions of short-term investments. Investing activities in the nine-month period ended January 27,

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NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

2006 also included new investments in privately held companies of $7.1 million. In the first quarter of fiscal 2006, we acquired Alacritus for a purchase price of approximately $13.7 million, including 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, including assumed options, net cash payments of $41.2 million and related transaction costs.

We used $249.2 million and received $20.4 million in the nine-month periods ended January 27, 2006 and January 28, 2005, respectively, from net financing activities, which included sales of common stock related to employee stock transactions net of common stock repurchases. We repurchased 14.6 million and 5.6 million shares of common stock for a total cost of $390.1 million and $133.0 million during the nine-month periods ended January 27, 2006 and January 28, 2005, respectively. Other financing activities provided $141.7 million and $153.5 million in the nine-month periods ended January 27, 2006 and January 28, 2005, respectively, which related to sales of common stock related to employee stock transactions. During the nine-month period ended January 27, 2006, we withheld $0.8 million from certain employees exercised shares of their restricted stock to reimburse for federal, state, and local withholding taxes obligations.

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

Other Sources and Uses of Cash and Tax Opportunities

The American Jobs Creation Act of 2004 (the Jobs Act) created a temporary 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. The deduction is subject to a number of limitations, and we are currently considering recently issued Treasury and IRS guidance on the application of the deduction. We are not yet in a position to decide whether, and to what extent, foreign earnings that have not yet been remitted to the U.S. may be repatriated. Based on the analysis to date, however, it is reasonably possible that as much as a $355.0 million dividend might be repatriated, with a respective tax liability of up to $15.0 million. We expect to be in a position to finalize our analysis by the end of our fourth quarter of fiscal 2006.

In November 2005, our Board of Directors approved a new stock repurchase program in which up to an additional $650.0 million of shares of our outstanding common stock may be purchased, which amount includes approximately $76.4 million remaining from all prior authorizations (i.e., the net additional approval amount, without taking into account remaining amounts approved in prior periods, is $573.6 million). At January 27, 2006, $504.4 million of shares remained available for repurchases under the plan.

For the nine-month periods ended January 27, 2006 and January 28, 2005, we recorded tax benefits, in the form of reduced payments, of $22.3 million and $27.8 million, respectively, associated with disqualifying dispositions of employee stock options. If stock option exercise patterns change, we may receive less cash from stock option exercises and may not receive the same level of tax benefits in the future, which could cause our cash payments for

income taxes to increase.

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NETWORK APPLIANCE, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Contractual Cash Obligations and Other Commercial Commitments

The following summarizes our contractual cash obligations and commercial commitments at January 27, 2006, and the effect such obligations are expected to have on our liquidity and cash flow in future periods, (in thousands):

Contractual Obligations:	**2006**	**2007**	**2008**	**2009**	**2010**	**Thereafter**	**Total**
Rent operating lease payments(1)	$ 3,981	$ 13,979	$ 13,627	$ 13,358	$ 10,133	$ 28,779	$ 83,857
Equipment operating lease payments(1)	1,516	5,849	5,167	2,873	16		15,421
Lease payments(2)			1,651	1,981	1,981	37,017	42,630
Venture capital funding commitments(3)	100	402	389	377	364	381	2,013
Purchase commitments and other(4)	1,348	600					1,948
Capital Expenditures(5)	10,858	7,711					18,569
Communications & Maintenance(6)	3,169	7,439	5,267	1,521	169		17,565
Restructuring Charges(7)	173	565	579	603	637	378	2,935
Total Contractual Cash Obligations	$ 21,145	$ 36,545	$ 26,680	$ 20,713	$ 13,300	$ 66,555	$ 184,938

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, 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:	**2006**	**2007**	**2008**	**2009**	**2010**	**Thereafter**	**Total**
Letters of Credit(8)	$ 450	$	$	$	$	$ 337	$ 787
Restricted Cash(9)	1,828	302	748	676	53	2,224	5,831
Total Commercial Commitments	$ 2,278	$ 302	$ 748	$ 676	$ 53	$ 2,561	$ 6,618

(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 2015. 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. Sublease income of $0.1 million has been included as a reduction of the payment amounts shown in the table. Facilities operating lease payments exclude the leases impacted by the restructurings. The amounts for the leases impacted by the restructurings are included in subparagraph (7) below.

(2) On December 16, 2005, we (the Lessee) entered into financing, construction and leasing arrangements with BNP (the Lessor), for office space to be located on land currently owned by us in Sunnyvale, California. This arrangement requires us to ground lease our land to BNP for a period of 50 years to construct approximately 190,000 square feet of office space with $38.5 million construction allowance provided by BNP, and, after

NETWORK APPLIANCE, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

completion of construction to pay minimum lease payments which vary based on London Interbank Offered Rate (LIBOR) plus a spread (5.15% at January 27, 2006). We expect to pay lease payments on the completed buildings from BNP on June 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 the 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 2 year period.

Included in the above contractual cash obligations are (a) lease commitments of $1.7 million in fiscal 2008, $2.0 million in each of the fiscal years 2009, 2010, 2011, 2012 and $0.3 million in fiscal 2013, which are based on the LIBOR rate at January 27, 2006 for a term of 5 years, and (b) at the expiration or termination of the lease, a supplemental payment obligation equal to $32.7 million in the event that we elect not to purchase or arrange for a sale of the building.

The lease also requires us to maintain specified financial covenants with which we were in compliance as of January 27, 2006. 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.

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

(4) Amounts included in purchase commitments and other are (a) agreements to purchase component inventory from our suppliers and/or contract manufacturers that are non-cancelable and legally binding against us and (b) commitment related to utilities contracts. Purchase commitments and other exclude (a) purchases of goods and services we expect to consume in the ordinary course of business in the next 12 months; (b) open purchase orders that represent an authorization to purchase rather than a binding agreement; (c) agreements that are cancelable without penalty and costs that are not reasonably estimable at this time.

(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. The restructuring estimated sublease income included various assumptions such as the time period over which the facilities will be vacant, expected sublease terms, and expected sublease rates.

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

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

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), and worldwide are adequate for our requirements over at least the next two years and that additional space

NETWORK APPLIANCE, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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 27, 2006, we have $0.8 million letters of credit that are related to workers compensation, a customs guarantee, and a corporate credit card program and were not recorded on our balance sheet.

As of January 27, 2006, the notional fair values of our foreign exchange forward and foreign currency option contracts totaled $305.6 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 forward points and premiums paid.

We offer both recourse and nonrecourse lease financing arrangements to our customers. Under the terms of recourse leases, which are generally three years or less, we remain liable for the aggregate unpaid remaining lease payments to the third-party leasing company in the event that any customers were to default. We initially defer 100% of the recourse lease receivable and recognize revenue over the term of the lease as the lease payments become due. As of January 27, 2006, and April 30, 2005, the maximum recourse exposure under such leases totaled approximately $9.4 million and $7.0 million, 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.

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 45, *Guarantor s Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others.*

We have commitments related to a lease arrangement with BNP for approximately 190,000 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 this lease under the provisions of FIN 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 10.3) 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.

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NETWORK APPLIANCE, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Accordingly, we are not required to consolidate either the leasing entity or the specific assets that we lease under the BNP lease. See above in Contractual Obligations and Note 13, for our future minimum lease payments under all leases at January 27, 2006.

As of January 27, 2006, except for operating leases and other contractual obligations outlined under the Contractual Cash Obligations table, we do not have any off-balance sheet financing arrangements or liabilities, retained or contingent interests in transferred assets, or any obligation arising out of a material variable interest in an unconsolidated entity. We also do not have any majority-owned subsidiaries that are not included in the consolidated financial statements. Additionally, we do not have any interest in or relationship with, any special purpose entities.

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 through at least the next 12 months.

Critical Accounting Estimates and Policies

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

We believe that the following accounting policies are critical as defined by the Securities and Exchange Commission, in that they are both highly important to the portrayal of our financial condition and results, and require difficult management judgments and assumptions about matters that are inherently uncertain. We also have other important policies, including those related to derivative instruments and concentration of credit risk. However, these policies do not meet the definition of critical accounting policies because they do not generally require us to make estimates or judgments that are difficult or subjective. These policies are discussed in the Notes to the Consolidated Financial Statements, which are included in our Annual Report on Form 10-K for the fiscal year ended April 30, 2005.

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

- revenue recognition and allowances;

valuation of goodwill and intangibles;

accounting for income taxes;

inventory write-down and reserves;

restructuring accruals;

impairment losses on investments;

NETWORK APPLIANCE, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

accounting for stock-based compensation; and

loss contingencies.

These accounting estimates and policies should be read in conjunction with the audited consolidated financial statements and accompanying notes included in our Annual Report on Form 10-K for the year ended April 30, 2005.

New Accounting Standards

See Note 12 of the Consolidated Condensed 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.

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 and 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

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NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

- 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, our operating results could be materially and adversely affected.

Our future growth depends upon the successful development and introduction of new hardware and software products. Due to the complexity of storage subsystems and Internet caching devices, and the difficulty in gauging the engineering effort required to produce new products, such products are subject to significant technical risks. However,

we cannot assure you that any of our new products will achieve market acceptance. Additional product introductions in future periods may also impact our sales of existing products. In addition, our new products must respond to technological changes and evolving industry standards. If we are unable, for technological or other reasons, to develop and introduce new products in a timely manner in response to changing market conditions or customer requirements, or if such products do not achieve market acceptance, our operating results could be materially 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.

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

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

In the storage market, our storage system products and associated data management software portfolio compete primarily with storage systems and data management software offered by EMC Corporation, Hitachi Data Systems, Hewlett-Packard Company, IBM Corporation, and Sun Microsystems, Inc. We also view Dell, Inc. as an emerging competitor in the storage marketplace, primarily due to a business partnership that has been established between Dell and EMC, allowing Dell to resell EMC storage hardware and software products. In addition, we have historically encountered less-frequent competition from companies including Engenio Information Technologies, Inc. (the storage systems group of LSI Logic Corp.), StorageTek Technology Corporation (now operating as a subsidiary of Sun Microsystems), Dot Hill Systems Corporation, and Xiotech Corporation. In the nearline/secondary storage market, which includes the disk-to-disk backup and regulated data storage segments, our NearStore appliances compete primarily against products from EMC and StorageTek and other traditional tape backup solutions in the broader data backup and recovery space.

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

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

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

Increased competition could also result in price reductions, reduced gross margins, and loss of market share, any of which could materially and adversely affect our operating results. Our competitors may be able to respond more quickly than we can to new or emerging technologies and changes in customer requirements or devote greater resources to the development, promotion, sale, and support of their products. In addition, current and potential competitors have established or may establish cooperative relationships among themselves or with third parties. Accordingly, it is possible that new competitors or alliances among competitors may emerge and rapidly acquire significant market share. We cannot assure you that we will be able to compete successfully against current or future competitors. Competitive pressures we face could materially 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 of several key components utilized in the assembly of our products. We purchase our disk drives through several suppliers. We purchase computer boards and microprocessors from a limited number of suppliers. Our reliance on a limited number of suppliers involves several risks, including:

A potential inability to obtain an adequate supply of required components because we do not have long-term supply commitments

NETWORK APPLIANCE, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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.

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 27, 2006, 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, data management and content delivery markets. If these markets do not continue to grow at the rates at which we forecast growth, our operating results will be materially and adversely impacted.

All of our products address the storage, data management and content delivery markets. Accordingly, our future financial performance will depend in large part on continued growth in the storage, data management and content delivery markets and on our ability to adapt to emerging standards in these markets. We cannot assure you that the markets for storage, data management and content delivery will continue to grow or that emerging standards

NETWORK APPLIANCE, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

in these markets will not adversely affect the growth of UNIX, Windows, and the World Wide Web server markets upon which we depend.

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

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

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, data management and content delivery products
- Discount levels and price competition
- Direct versus indirect sales
- Product and add-on software mix
- The mix of services as a percentage of revenue
- The mix and average selling prices of products
- The mix of disk content

New product introductions and enhancements

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

The cost of components, manufacturing labor, and quality

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

NETWORK APPLIANCE, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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 realize anticipated synergies, economies of scale, or other value. Integration risks and issues may include, but 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.

Our ability to increase our revenues depends on expanding our direct sales operations and reseller distribution channels and continuing to provide excellent global service and support. If we are unable to effectively develop, retain, and expand our global sales and service workforce or to establish and cultivate relationships with our indirect reseller and distribution channels, our ability to grow and increase revenue could be harmed.

In an effort to gain market share and support our global customers, we will need to expand our worldwide direct sales operations and global service and support infrastructure to support new and existing enterprise customers. Expansion of our direct sales operations, reseller/distribution channels, and global service and support operations may not be successfully implemented, and the cost of any expansion may exceed the revenues generated.

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 derive a significant portion of our revenue from these indirect channel partners. However, in order for us to maintain our current revenue sources and grow our revenue as we have forecasted, we must effectively manage our relationships with these indirect channel partners. To do so, we must attract and retain a sufficient number of qualified channel partners to successfully market our products. However, because we also sell our products directly to customers through our sales force, on occasion we compete with our indirect channels for sales of our products to our end customers, competition that could result in conflicts with these indirect channel partners and make it harder for us to attract and retain these indirect channel partners. At the same time, our indirect channel partners may develop and offer products of their own that are competitive to ours. Or, because our reseller partners generally offer products from several different companies, including products of our competitors, these resellers may give higher priority to the marketing, sales, and support of our competitors products than ours. If we fail to manage effectively our relationships

with these indirect channel partners to minimize channel conflict and continue to evaluate and meet our indirect sales partners needs with respect to our products, we will not be able to maintain or increase our revenue as we have forecasted, which would have a materially adverse affect on our business, financial condition, and results of operations. 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.

NETWORK APPLIANCE, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

We conduct business internationally. For the three and nine-month periods ended January 27, 2006, 44.5% and 41.9%, respectively, of our total revenues was 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. 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 flow. 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. 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.

Potentially adverse tax consequences could also negatively impact the operating and financial results from international operations. International operations currently benefit from a tax ruling concluded in the Netherlands.

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

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

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

NETWORK APPLIANCE, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

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

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

We experienced growth in the first nine months of fiscal 2006, fiscal 2005 and 2004. Our future operating results depend to a large extent on management s ability to successfully manage expansion and growth, including but not limited to, expanding international operations, forecasting revenues, addressing new markets, controlling expenses, implementing and enhancing infrastructure, systems and processes, and managing our assets. In addition, an unexpected decline in the growth rate of revenues without a corresponding and timely reduction in expense growth or a failure to manage other aspects of growth could materially and adversely affect our operating results.

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

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

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

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

NETWORK APPLIANCE, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

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

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

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

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

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

NETWORK APPLIANCE, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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 changing laws and regulations, environmental legislation and public disclosure that have increased both our costs and the risk of noncompliance. Failure to comply with these new regulations could have an adverse effect on our business and stock price.

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 January 27, 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.

We also face increasing complexity in our product design and procurement operations as we adjust to new and upcoming requirements relating to the materials composition of many of our products. The European Union (EU) has adopted two directives to facilitate the recycling of electrical and electronic equipment sold in the EU. The first of these is the Waste Electrical and Electronic Equipment (WEEE) directive, which directs EU member states to enact laws, regulations, and administrative provisions to ensure that producers of electrical and electronic equipment are financially responsible for specified collection, recycling, treatment, and environmentally sound disposal of products placed on the market after August 13, 2005, and from products in use prior to that date that are being replaced. The EU has also adopted the Restriction on the Use of Certain Hazardous Substances in Electrical and Electronic Equipment (RoHS) directive. The RoHS directive restricts the use of lead, mercury, and certain other substances in electrical and electronic products placed on the market in the European Union after July 1, 2006.

In connection with our compliance with such environmental laws and regulations, we could incur substantial costs (including excess component inventory) and be subject to disruptions to our operations and logistics. In addition, we will need to ensure that we can manufacture compliant products, and that we can be assured a supply of compliant components from suppliers. Similar laws and regulations have been or may be enacted in other regions, including in the United States, China, and Japan. Other environmental regulations may require us to reengineer our products to utilize components that are more environmentally compatible, and such reengineering and component substitution may result in additional costs to us. Although we do not anticipate any material adverse effects based on the nature of our operations and the effect of such laws, there is no assurance that such existing laws or future laws will not have a

material adverse effect on our business.

NETWORK APPLIANCE, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Changes in financial accounting standards or practices may cause adverse unexpected fluctuations and affect our reported business and financial results.

In December 2004 the FASB issued SFAS No. 123R (revised 2004), which will require us, beginning in the first quarter of fiscal 2007, to expense employee stock options for financial reporting purposes. Adoption of SFAS No. 123R will result in lower reported earnings per share, which could negatively impact our future stock price. In addition, this could also impact our ability or future practice of utilizing broad-based employee stock plans to attract, reward, and retain employees, which could also adversely impact our operations.

In addition, the FASB requires certain valuation models to estimate the fair value of employee stock options. These models, including the Black-Scholes option-pricing model, use varying methods, inputs, and assumptions selected across companies. 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 of these changes, we could incur losses, and our operating results and gross margins 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. However, government demand is unpredictable, and there is no guarantee of future revenue growth from the U.S. government.

The U.S. government has become an important customer for the storage market and for us. 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.

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

We are exposed to market risk related to fluctuations in interest rates 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 27, 2006, we had short-term investments of $952.8 million. Our investment portfolio primarily consists of highly liquid investments with original maturities at the date of purchase of greater than three months, which are classified as available-for-sale and investment in marketable equity securities in primarily technology companies. These highly liquid investments, consisting primarily of government and corporate debt securities, 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 27, 2006 would cause the fair value of these short-term investments to decline by approximately $3.3 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.

Foreign Currency Exchange Rate Risk

We hedge risks associated with foreign currency transactions in order to minimize the impact of changes in foreign currency exchange rates on earnings. We utilize forward and option contracts to hedge against the short-term impact of foreign currency fluctuations on certain assets and liabilities denominated in foreign currencies. All

NETWORK APPLIANCE, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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 27, 2006, 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 option contracts outstanding on January 27, 2006 (in thousands):

Currency	Buy/Sell	Foreign Currency Amount	Contract Value USD	Fair Value in USD
Forward contracts:				
CAD	Sell	17,272	$ 15,032	$ 15,032
CHF	Sell	2,362	$ 1,844	$ 1,844
EUR	Sell	146,497	$ 178,356	$ 177,874
GBP	Sell	32,928	$ 58,395	$ 58,223
ILS	Sell	14,495	$ 3,124	$ 3,124
ZAR	Sell	9,229	$ 1,494	$ 1,508
AUD	Buy	11,886	$ 8,913	$ 8,913
DKK	Buy	9,215	$ 1,496	$ 1,496
EUR	Buy	11,700	$ 14,312	$ 14,207
GBP	Buy	2,775	$ 4,940	$ 4,906
NOK	Buy	8,308	$ 1,248	$ 1,248
SEK	Buy	19,884	$ 2,611	$ 2,611
Option contracts:				
EUR	Sell	9,000	$ 10,918	$ 11,030
GBP	Sell	2,000	$ 3,536	$ 3,569

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

NETWORK APPLIANCE, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

of 1934, as amended, as of January 27, 2006, 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 s management, including our principal executive officer and principal financial officer, as appropriate to allow timely decisions regarding required disclosure.

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

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PART II. OTHER INFORMATION

Item 1. ***Legal Proceedings***

None

Item 1A. ***Risk Factors***

The information required by this item is on page 35.

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

The table below sets forth activity in the third quarter of fiscal 2006:

Period	Shares Purchased	Average Price Paid per Share	Total Number of Shares Purchased as Part of the Repurchase Program(1)	Approximate Dollar Value of Shares That May yet Be Purchased Under the Repurchase Program(2)
October 29, 2005 November 25, 2005		$	24,152,324	$ 650,000,000
November 26, 2005 December 23, 2005	4,825,463	$ 29.02	28,977,787	$ 509,955,012
December 24, 2005 January 27, 2006	200,000	$ 27.69	29,177,787	$ 504,416,692

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

(2) In May 2005, our Board of Directors approved an incremental stock repurchase program in which up to $300,000,000 of additional shares of our outstanding common stock may be purchased. In November 2005, our Board of Directors approved a new $650,000,000 stock repurchase program which amount includes the $76,361,270 remaining from all prior authorizations. The stock repurchase program may be suspended or discontinued at any time.

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 2005 Annual Meeting of Stockholders.

Item 6. ***Exhibits***

2.1(3)	Agreement and Plan of Merger, dated as of November 3, 2003, by and among Network Appliance, Inc., Nagano Sub, Inc., and Spinnaker Networks, Inc.
2.2(3)	Amendment to Merger Agreement, dated as of February 9, 2004, by and among Network Appliance, Inc., Nagano Sub, Inc., and Spinnaker Networks, Inc.
2.3(8)	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(1)	Certificate of Incorporation of the Company.
3.2(1)	Bylaws of the Company.
3.3(6)	Certificate of Amendment to the Bylaws of the Company.
4.1(1)	Reference is made to Exhibits 3.1 and 3.2.
4.2(4)	Spinnaker Networks, Inc. 2000 Stock Plan.

4.3(7)	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.
4.4(7)	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.
4.5(7)	Form of Early Exercise Stock Purchase Agreement under the Decru, Inc. 2001 Equity Incentive Plan.
4.6(7)	Form of Restricted Stock Bonus Grant Notice and Agreement under the Decru, Inc. 2001 Equity Incentive Plan.
10.1(2)	Asset Purchase Agreement dated June 20, 2003, by and between Auspex Systems, Inc. and the Company.
10.2(5)	Purchase and Sale Agreement dated July 27, 2004 by and between Cisco Systems, Inc. and the Company.
10.3	Closing Certificate and Agreement, dated December 15, 2005, by and between BNP Leasing Corporation and the Company.
10.4	Construction Management Agreement, dated December 15, 2005, by and between BNP Leasing Corporation and the Company.
10.5	Lease Agreement, dated December 15, 2005, by and between BNP Leasing Corporation.
10.6	and the Company. Purchase Agreement, dated December 15, 2005, by and between BNP Leasing Corporation and the Company.
10.7	Ground Lease, dated December 15, 2005, by and between BNP Leasing Corporation and the Company.
31.1	Certification of Chief Executive Officer pursuant to Securities Exchange Act Rules 13a-15(e) and 15d-15(e) as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002, dated March 7, 2006.
31.2	Certification of Chief Financial Officer pursuant to Securities Exchange Act Rules 13a-15(e) and 15d-15(e) as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002, dated March 7, 2006.
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 7, 2006.
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 7, 2006.

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

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

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

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

(5) Previously filed as an exhibit with the Company s Quarterly Report on Form 10-Q dated August 31, 2004.

(6) Previously filed as an exhibit with the Company s Current Report on Form 8-K dated May 4, 2005.

(7) Previously filed as an exhibit with the Company s Form S-8 registration statement dated September 2, 2005.

(8) Previously filed as an exhibit with the Company s Quarterly Report on Form 10-Q dated September 2, 2005.

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 7, 2006

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