CISCO SYSTEMS INC
Form 10-Q
May 24, 2007
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

(Mark one)

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

For the quarterly period ended April 28, 2007

OR

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

For the transition period from ______ to ______

Commission file number 0-18225

CISCO SYSTEMS, INC.

(Exact name of Registrant as specified in its charter)

California	**77-0059951**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification Number)**

170 West Tasman Drive

San Jose, California 95134

(Address of principal executive office and zip code)

(408) 526-4000

(Registrant s telephone number, including area code)

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

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

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

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

As of May 17, 2007, 6,071,255,443 shares of the registrant s common stock were outstanding.

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FORM 10-Q for the Quarter Ended April 28, 2007

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements (Unaudited)

CISCO SYSTEMS, INC.

CONSOLIDATED STATEMENTS OF OPERATIONS

(in millions, except per-share amounts)

(Unaudited)

	Three Months Ended		Nine Months Ended	
	April 28, 2007	April 29, 2006	April 28, 2007	April 29, 2006
NET SALES:				
Product	$ 7,481	$ 6,155	$ 21,520	$ 17,183
Service	1,385	1,167	3,969	3,317
Total net sales	8,866	7,322	25,489	20,500
COST OF SALES:				
Product	2,685	2,193	7,728	5,718
Service	534	403	1,493	1,180
Total cost of sales	3,219	2,596	9,221	6,898
GROSS MARGIN	5,647	4,726	16,268	13,602
OPERATING EXPENSES:				
Research and development	1,144	1,041	3,321	3,003
Sales and marketing	1,830	1,547	5,242	4,431
General and administrative	378	298	1,082	858
Amortization of purchased intangible assets	97	99	298	214
In-process research and development	1	88	7	90
Total operating expenses	3,450	3,073	9,950	8,596
OPERATING INCOME	2,197	1,653	6,318	5,006
Interest income, net	189	142	518	464
Other income, net	33	17	94	17
Interest and other income, net	222	159	612	481
INCOME BEFORE PROVISION FOR INCOME TAXES	2,419	1,812	6,930	5,487
Provision for income taxes	545	412	1,527	1,451
NET INCOME	$ 1,874	$ 1,400	$ 5,403	$ 4,036

Net income per share basic	$ 0.31	$ 0.23	$ 0.89	$ 0.65
Net income per share diluted	$ 0.30	$ 0.22	$ 0.86	$ 0.64
Shares used in per-share calculation basic	6,034	6,160	6,052	6,184
Shares used in per-share calculation diluted	6,244	6,289	6,255	6,300

See Notes to Consolidated Financial Statements.

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CISCO SYSTEMS, INC.

CONSOLIDATED BALANCE SHEETS

(in millions, except par value)

(Unaudited)

	April 28, 2007	July 29, 2006
ASSETS		
Current assets:		
Cash and cash equivalents	$ 5,457	$ 3,297
Investments	16,879	14,517
Accounts receivable, net of allowance for doubtful accounts of $172 at April 28, 2007 and $175 at July 29, 2006	3,238	3,303
Inventories	1,289	1,371
Deferred tax assets	1,755	1,604
Prepaid expenses and other current assets	1,922	1,584
Total current assets	30,540	25,676
Property and equipment, net	3,695	3,440
Goodwill	9,493	9,227
Purchased intangible assets, net	1,909	2,161
Other assets	3,198	2,811
TOTAL ASSETS	$ 48,835	$ 43,315
LIABILITIES AND SHAREHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 864	$ 880
Income taxes payable	1,525	1,744
Accrued compensation	1,791	1,516
Deferred revenue	4,854	4,408
Other accrued liabilities	2,938	2,765
Total current liabilities	11,972	11,313
Long-term debt	6,478	6,332
Deferred revenue	1,485	1,241
Other long-term liabilities	373	511
Total liabilities	20,308	19,397
Minority interest	9	6
Shareholders equity:		
Preferred stock, no par value: 5 shares authorized; none issued and outstanding		
Common stock and additional paid-in capital, $0.001 par value: 20,000 shares authorized; 6,054 and 6,059 shares issued and outstanding at April 28, 2007 and July 29, 2006, respectively	28,411	24,257

Accumulated deficit	(457)	(617)
Accumulated other comprehensive income	564	272
Total shareholders equity	28,518	23,912
TOTAL LIABILITIES AND SHAREHOLDERS EQUITY	$ 48,835	$ 43,315

See Notes to Consolidated Financial Statements.

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CISCO SYSTEMS, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS

(in millions)

(Unaudited)

	Nine Months Ended April 28, 2007	Nine Months Ended April 29, 2006
Cash flows from operating activities:		
Net income	$ 5,403	$ 4,036
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	1,039	856
Employee share-based compensation expense	709	839
Share-based compensation expense related to acquisitions and investments	27	75
Provision for doubtful accounts	6	22
Deferred income taxes	(302)	(79)
Excess tax benefits from share-based compensation	(648)	(385)
In-process research and development	7	90
Net gains and impairment charges on investments	(154)	(74)
Other		31
Change in operating assets and liabilities, net of effects of acquisitions:		
Accounts receivable	60	(588)
Inventories	82	179
Prepaid expenses and other current assets	(355)	(228)
Lease receivables, net	(131)	(98)
Accounts payable	(17)	(86)
Income taxes payable	535	273
Accrued compensation	275	65
Deferred revenue	690	414
Other liabilities	140	240
Net cash provided by operating activities	7,366	5,582
Cash flows from investing activities:		
Purchases of investments	(15,342)	(17,154)
Proceeds from sales and maturities of investments	13,438	14,539
Acquisition of property and equipment	(912)	(595)
Acquisition of businesses, net of cash and cash equivalents acquired	(387)	(5,347)
Change in investments in privately held companies	(81)	(158)
Purchase of minority interest of Cisco Systems, K.K. (Japan)		(25)
Other	(87)	(31)
Net cash used in investing activities	(3,371)	(8,771)
Cash flows from financing activities:		
Issuance of common stock	3,719	1,282
Repurchase of common stock	(6,281)	(5,478)
Issuance of debt		6,481
Excess tax benefits from share-based compensation	648	385
Other	79	14

Net cash (used in) provided by financing activities	(1,835)	2,684
Net increase (decrease) in cash and cash equivalents	2,160	(505)
Cash and cash equivalents, beginning of period	3,297	4,742
Cash and cash equivalents, end of period	$ 5,457	$ 4,237

See Notes to Consolidated Financial Statements.

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CISCO SYSTEMS, INC.

CONSOLIDATED STATEMENTS OF SHAREHOLDERS EQUITY

(in millions)

(Unaudited)

Nine Months Ended April 29, 2006	Shares of Common Stock	Common Stock and Additional Paid-In Capital	Retained Earnings	Accumulated Other Comprehensive Income	Total Shareholders Equity
BALANCE AT JULY 30, 2005	6,331	$ 22,394	$ 506	$ 274	$ 23,174
Net income			4,036		4,036
Change in unrealized gains and losses on investments, net of tax				8	8
Other				80	80
Comprehensive income					4,124
Issuance of common stock	128	1,282			1,282
Repurchase of common stock	(296)	(1,057)	(4,421)		(5,478)
Tax benefits from employee stock incentive plans		418			418
Purchase acquisitions	1	187			187
Employee share-based compensation expense		833			833
Share-based compensation expense related to acquisitions and investments		75			75
BALANCE AT APRIL 29, 2006	6,164	$ 24,132	$ 121	$ 362	$ 24,615

Nine Months Ended April 28, 2007	Shares of Common Stock	Common Stock and Additional Paid-In Capital	Accumulated Deficit	Accumulated Other Comprehensive Income	Total Shareholders Equity
BALANCE AT JULY 29, 2006	6,059	$ 24,257	$ (617)	$ 272	$ 23,912
Net income			5,403		5,403
Change in unrealized gains and losses on investments, net of tax				155	155
Other				137	137
Comprehensive income					5,695
Issuance of common stock	238	3,719			3,719
Repurchase of common stock	(243)	(1,038)	(5,243)		(6,281)
Tax benefits from employee stock incentive plans		733			733
Purchase acquisitions		6			6
Employee share-based compensation expense		707			707
		27			27

Share-based compensation expense related to acquisitions and investments					
BALANCE AT APRIL 28, 2007	6,054	$ 28,411	$ (457)	$ 564	$ 28,518

Supplemental Information

In September 2001, the Company s Board of Directors authorized a stock repurchase program. As of April 28, 2007, the Company s Board of Directors had authorized an aggregate repurchase of up to $47 billion of common stock under this program. For additional information regarding stock repurchases, see Note 9 to the Consolidated Financial Statements. The purchase price of shares of common stock repurchased was reflected as (i) a reduction to retained earnings until retained earnings were zero and then as an increase to accumulated deficit and (ii) a reduction of common stock and additional paid-in capital. Issuance of common stock and the tax benefit related to employee stock incentive plans are recorded in shareholders equity as an increase to common stock and additional paid-in capital. The stock repurchases since the inception of this program are summarized in the table below (in millions):

	Shares of Common Stock	Common Stock and Additional Paid-In Capital	Retained Earnings (Accumulated Deficit)	Accumulated Other Comprehensive Income	Total Shareholders Equity
Repurchases of common stock	2,174	$ 7,332	$ 34,397	$	$ 41,729

See Notes to Consolidated Financial Statements.

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CISCO SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

1. Description of Business

Cisco Systems, Inc. (the Company or Cisco) designs, manufactures, and sells networking and other products related to the communications and information technology industry and provides services associated with these products and their use. The Company s products are installed at corporations, public institutions, telecommunications companies, commercial businesses and personal residences. Cisco provides a broad line of products for transporting data, voice, and video within buildings, across campuses, and around the world.

The Company conducts business globally and is primarily managed on a geographic basis in the following theaters: United States and Canada; European Markets; Emerging Markets; Asia Pacific; and Japan. The Emerging Markets theater consists of Eastern Europe, Latin America, the Middle East and Africa, and Russia and the Commonwealth of Independent States (CIS).

On February 24, 2006, the Company completed the acquisition of Scientific-Atlanta, Inc. (Scientific-Atlanta), a provider of set-top boxes, end-to-end video distribution networks, and video system integration. With this acquisition, the Company has enhanced its video capabilities to help enable the convergence of data, voice and video technologies. The Company seeks to have further strategic business relationships with key service provider customers, and to reach a broad range of consumers with its enhanced product line following the acquisition.

2. Summary of Significant Accounting Policies

Fiscal Year

The Company s fiscal year is the 52 or 53 weeks ending on the last Saturday in July. Fiscal 2007 and fiscal 2006 are 52-week fiscal years.

Basis of Presentation

The accompanying financial data as of April 28, 2007 and for the three and nine months ended April 28, 2007 and April 29, 2006 has been prepared by the Company, without audit, pursuant to the rules and regulations of the Securities and Exchange Commission (SEC). Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States have been condensed or omitted pursuant to such rules and regulations. The July 29, 2006 Consolidated Balance Sheet was derived from audited financial statements, but does not include all disclosures required by accounting principles generally accepted in the United States. However, the Company believes that the disclosures are adequate to make the information presented not misleading. These Consolidated Financial Statements should be read in conjunction with the Consolidated Financial Statements and the notes thereto, included in the Company s Annual Report on Form 10-K for the fiscal year ended July 29, 2006.

In the opinion of management, all adjustments (which include normal recurring adjustments, except as disclosed herein) necessary to present a fair statement of financial position as of April 28, 2007, results of operations for the three and nine months ended April 28, 2007 and April 29, 2006, cash flows, and shareholders equity for the nine months ended April 28, 2007 and April 29, 2006, as applicable, have been made. The results of operations for the three and nine months ended April 28, 2007 are not necessarily indicative of the operating results for the full fiscal year or any future periods.

Computation of Net Income per Share

Basic net income per share is computed using the weighted-average number of common shares outstanding during the period. Diluted net income per share is computed using the weighted-average number of common shares and dilutive potential common shares outstanding during the period. Dilutive potential common shares primarily consist of employee stock options, restricted common stock and restricted stock units.

Statement of Financial Accounting Standards No. 128, Earnings per Share, requires that employee equity share options, nonvested shares, and similar equity instruments granted by the Company be treated as potential common shares outstanding in computing diluted earnings per share.

Diluted shares outstanding include the dilutive effect of in-the-money options which is calculated based on the average share price for each fiscal period using the treasury stock method. Under the treasury stock method, the amount the employee must pay for exercising stock options, the amount of compensation cost for future service that the Company has not yet recognized, and the amount of tax benefits that would be recorded in additional paid-in capital when the award becomes deductible are assumed to be used to repurchase shares.

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Recent Accounting Pronouncements

In July 2006, the Financial Accounting Standards Board (FASB) issued Financial Interpretation No. 48, Accounting for Uncertainty in Income Taxes-an interpretation of FASB Statement No. 109 (FIN 48), which is a change in accounting for income taxes. FIN 48 specifies how tax benefits for uncertain tax positions are to be recognized, measured, and derecognized in financial statements; requires certain disclosures of uncertain tax matters; specifies how reserves for uncertain tax positions should be classified on the balance sheet; and provides transition and interim-period guidance, among other provisions. FIN 48 is effective for fiscal years beginning after December 15, 2006 and as a result, is effective for the Company in the first quarter of fiscal 2008. The Company is currently evaluating the impact of FIN 48 on its Consolidated Financial Statements.

In September 2006, the SEC issued Staff Accounting Bulletin No. 108, Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements (SAB 108). SAB 108 provides interpretative guidance on the process of quantifying financial statement misstatements and is effective for fiscal years ending after November 15, 2006. The Company applied the provisions of SAB 108 beginning in the first quarter of fiscal 2007 and there was no impact to the Consolidated Financial Statements.

In September 2006, the FASB issued Statement of Financial Accounting Standards (SFAS) No. 157, Fair Value Measurements (SFAS 157). SFAS 157 defines fair value, establishes a framework and gives guidance regarding the methods used for measuring fair value, and expands disclosures about fair value measurements. SFAS 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. The Company is currently assessing the impact that SFAS 157 will have on its results of operations and financial position.

In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities Including an amendment of FASB Statement No. 115 (SFAS 159). SFAS 159 expands the use of fair value accounting but does not affect existing standards which require certain assets or liabilities to be carried at fair value. The objective of SFAS 159 is to improve financial reporting by providing companies with the opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions. Under SFAS 159, a company may choose, at specified election dates, to measure eligible items at fair value and report unrealized gains and losses on items for which the fair value option has been elected in earnings at each subsequent reporting date. SFAS 159 is effective as of the beginning of the fiscal year that begins after November 15, 2007. The Company is currently assessing the impact that SFAS 159 will have on its results of operations and financial position.

Reclassifications

Certain reclassifications have been made to prior period amounts in order to conform to the current period s presentation.

3. Business Combinations
Purchase Acquisitions

A summary of the purchase acquisitions and asset purchases for the nine months ended April 28, 2007 is as follows (in millions):

	Purchase Consideration	Liabilities Assumed	In-Process R&D Expense	Purchased Intangible Assets	Goodwill
Arroyo Video Solutions, Inc.	$ 86	$ 1	$ 3	$ 25	$ 57
Reactivity, Inc.	110	4	1	39	72
Other	211	17	3	77	135
Total	$ 407	$ 22	$ 7	$ 141	$ 264

The Company acquired Arroyo Video Solutions, Inc. to enable carriers to accelerate the creation and distribution of network-delivered entertainment, interactive media, and advertising services across the growing portfolio of televisions, personal computers, and mobile handsets.

The Company acquired Reactivity, Inc. to complement and extend the Company s application networking services portfolio, within advanced technologies.

Under the terms of the definitive agreements related to the acquisitions and asset purchases, the purchase consideration consisted of cash and stock options assumed. The purchase consideration for the Company s acquisitions and asset purchases is also allocated to tangible assets acquired. The Consolidated Financial Statements include the operating results of each business from the date of acquisition. Pro forma results of operations for the acquisitions completed during the nine months ended April 28, 2007 have not been presented because the effects of the acquisitions, individually or in the aggregate, were not material to the Company s financial results.

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Pro Forma Financial Information Relating to the Acquisition of Scientific-Atlanta, Inc.

The financial information in the table below summarizes the combined results of operations of Cisco and Scientific-Atlanta, on a pro forma basis, as though the companies had been combined at the beginning of each period presented. The pro forma financial information for the three months ended April 29, 2006 combines the historical results of operations of Cisco for that period, with the historical results of operations of Scientific-Atlanta for the month ended February 24, 2006. The pro forma financial information for the nine months ended April 29, 2006 combines the historical results of operations of Cisco for that period, with the historical results of operations of Scientific-Atlanta for the six months ended December 30, 2005 and the month ended February 24, 2006.

The pro forma financial information is presented for informational purposes only and is not indicative of the results of operations that would have been achieved if the acquisition of Scientific-Atlanta and issuance of $6.5 billion of debt (see Note 7) had taken place at the beginning of each period presented. The debt was issued to finance the acquisition of Scientific-Atlanta as well as for general corporate purposes. For the purposes of this pro forma financial information, the interest expense on the entire debt, including the effects of hedging, was included in the pro forma financial adjustments. The pro forma financial information for the three and nine months ended April 29, 2006 also includes incremental stock-based compensation expense due to the acceleration of Scientific-Atlanta employee stock options prior to the acquisition date, investment banking fees, and other acquisition-related costs, recorded in Scientific-Atlanta s historical results of operations during February 2006. In addition, the pro forma financial information for the three and nine months ended April 29, 2006 includes the purchase accounting adjustments on historical Scientific-Atlanta inventory, adjustments to depreciation on acquired property and equipment, a charge for in-process research and development, amortization charges from acquired intangible assets, adjustments to interest income, and related tax effects.

The following table summarizes the pro forma financial information (in millions, except per-share amounts):

	Three Months Ended April 29, 2006	Nine Months Ended April 29, 2006
Net sales	$ 7,485	$ 21,648
Net income	$ 1,299	$ 3,822
Net income per share basic	$ 0.21	$ 0.62
Net income per share diluted	$ 0.21	$ 0.61

Purchased Intangible Assets and In-Process Research and Development

The following table presents the amortization of purchased intangible assets and in-process research and development (in millions):

	Three Months Ended		Nine Months Ended	
	April 28, 2007	April 29, 2006	April 28, 2007	April 29, 2006
Amortization of purchased intangible assets	$ 133	$ 123	$ 406	$ 238
In-process research and development	$ 1	$ 88	$ 7	$ 90

The Company s methodology for allocating the purchase price for purchase acquisitions to in-process research and development (in-process R&D) is determined through established valuation techniques. In-process R&D is expensed upon acquisition because technological feasibility has not been established and no future alternative uses exist.

The following table presents details of the purchased intangible assets acquired during the nine months ended April 28, 2007 (in millions, except years):

	Technology		Customer Relationships		Other		Total
	Weighted	Amount	Weighted	Amount	Weighted	Amount	Amount

	Average Useful Life (in Years)		Average Useful Life (in Years)		Average Useful Life (in Years)		
Arroyo Video Solutions, Inc.	5.0	$ 14	7.0	$ 11		$	$ 25
Reactivity, Inc.	6.0	36	5.0	3			39
Other	4.7	69	4.5	7	2.4	1	77
Total		$ 119		$ 21		$ 1	$ 141

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The following tables present details of the Company s purchased intangible assets (in millions):

April 28, 2007	Gross	Accumulated Amortization	Net
Technology	$ 1,100	$ (424)	$ 676
Customer relationships	1,567	(357)	1,210
Other	141	(118)	23
Total	$ 2,808	$ (899)	$ 1,909

July 29, 2006	Gross	Accumulated Amortization	Net
Technology	$ 1,052	$ (302)	$ 750
Customer relationships	1,535	(175)	1,360
Other	164	(113)	51
Total	$ 2,751	$ (590)	$ 2,161

The estimated future amortization expense of purchased intangible assets as of April 28, 2007 is as follows (in millions):

Fiscal Year	Amount
2007 (remaining three months)	$ 134
2008	496
2009	410
2010	303
2011	230
Thereafter	336
Total	$ 1,909

Goodwill

The following table presents the changes in goodwill allocated to the Company s reportable segments during the nine months ended April 28, 2007 (in millions):

	Balance at July 29, 2006	Acquisitions	Other	Balance at April 28, 2007
United States and Canada	$ 6,778	$ 161	$ (20)	$ 6,919
European Markets	1,127	53	24	1,204
Emerging Markets	292	15	(2)	305
Asia Pacific	277	24		301
Japan	753	11		764
Total	$ 9,227	$ 264	$ 2	$ 9,493

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Compensation Expense Related to Acquisitions and Investments

The following table presents the compensation expense related to acquisitions and investments (in millions):

	Three Months Ended		Nine Months Ended	
	April 28, 2007	April 29, 2006	April 28, 2007	April 29, 2006
Share-based compensation expense	$ 8	$ 23	$ 27	$ 75
Cash compensation expense	8	9	37	27
Total	$ 16	$ 32	$ 64	$ 102

Share-Based Compensation Expense

Beginning in fiscal 2006, share-based compensation related to acquisitions and investments is measured under Statement of Financial Accounting Standards No. 123 (revised 2004), Share-Based Payment, (SFAS 123(R)) and includes deferred share-based compensation relating to acquisitions completed prior to fiscal 2006. As of April 28, 2007, the remaining balance of share-based compensation related to acquisitions and investments to be recognized over the vesting periods was approximately $85 million.

Cash Compensation Expense

In connection with the Company s purchase acquisitions, asset purchases, and acquisitions of variable interest entities, the Company has agreed to pay certain additional amounts in cash contingent upon achieving certain agreed-upon technology, development, product, or other milestones or continued employment of certain employees with the Company. In each case, any additional amounts paid will be recorded as compensation expense. As of April 28, 2007, the Company had remaining potential payments of up to $193 million pursuant to these agreements.

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4. Balance Sheet Details

The following tables provide details of selected balance sheet items (in millions):

	April 28, 2007	July 29, 2006
Inventories:		
Raw materials	$ 175	$ 131
Work in process	117	377
Finished goods:		
Distributor inventory and deferred cost of sales	474	423
Manufacturing finished goods	278	236
Total finished goods	752	659
Service-related spares	210	170
Demonstration systems	35	34
Total	$ 1,289	$ 1,371
Property and equipment, net:		
Land, buildings, and leasehold improvements	$ 3,852	$ 3,647
Computer equipment and related software	1,535	1,352
Production, engineering, and other equipment	4,195	3,678
Operating lease assets	160	153
Furniture and fixtures	375	363
	10,117	9,193
Less accumulated depreciation and amortization	(6,422)	(5,753)
Total	$ 3,695	$ 3,440
Other assets:		
Deferred tax assets	$ 1,147	$ 983
Investments in privately held companies	641	574
Income tax receivable	277	279
Lease receivables, net	526	464
Other	607	511
Total	$ 3,198	$ 2,811
Deferred revenue:		
Service	$ 4,392	$ 4,088
Product:		
Unrecognized revenue on product shipments and other deferred revenue	1,563	1,156
Cash receipts related to unrecognized revenue from two-tier distributors	384	405
Total product deferred revenue	1,947	1,561

Total	$ 6,339	$ 5,649
Reported as:		
Current	$ 4,854	$ 4,408
Noncurrent	1,485	1,241
Total	$ 6,339	$ 5,649

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5. Lease Receivables, Net

Lease receivables represent sales-type and direct-financing leases resulting from the sale of the Company s and complementary third-party products and services. These lease arrangements typically have terms from two to three years and are generally collateralized by a security interest in the underlying assets. The current portion of lease receivables, net, is recorded in prepaid expenses and other current assets, and the noncurrent portion is recorded in other assets in the Consolidated Balance Sheets. The net lease receivables are summarized as follows (in millions):

	April 28, 2007	July 29, 2006
Gross lease receivables	$ 1,109	$ 960
Unearned income and other allowances	(206)	(188)
Total	$ 903	$ 772
Reported as:		
Current	$ 377	$ 308
Noncurrent	526	464
Total	$ 903	$ 772

Contractual maturities of the gross lease receivables at April 28, 2007 were as follows (in millions):

Fiscal Year	Amount
2007 (remaining three months)	$ 150
2008	432
2009	275
2010	157
2011	72
Thereafter	23
Total	$ 1,109

Actual cash collections may differ from the contractual maturities due to early customer buyouts, refinancings, or defaults.

6. Investments

The following tables summarize the Company s investments (in millions):

April 28, 2007	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Fixed income securities:				
U.S. government notes and bonds	$ 5,947	$ 17	$ (12)	$ 5,952
Corporate notes, bonds, and asset-backed securities	8,390	9	(46)	8,353

Municipal notes and bonds	1,467		(1)	1,466
Total fixed income securities	15,804	26	(59)	15,771
Publicly traded equity securities	713	400	(5)	1,108
Total	$ 16,517	$ 426	$ (64)	$ 16,879

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July 29, 2006	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Fixed income securities:				
U.S. government notes and bonds	$ 5,179	$ 3	$ (47)	$ 5,135
Corporate notes, bonds, and asset-backed securities	7,950	2	(88)	7,864
Municipal notes and bonds	809		(3)	806
Total fixed income securities	13,938	5	(138)	13,805
Publicly traded equity securities	467	252	(7)	712
Total	$ 14,405	$ 257	$ (145)	$ 14,517

The following table summarizes the maturities of the Company s fixed income securities at April 28, 2007 (in millions):

	Amortized Cost	Fair Value
Less than 1 year	$ 3,699	$ 3,691
Due in 1 to 2 years	4,044	4,036
Due in 2 to 5 years	5,884	5,866
Due after 5 years	2,177	2,178
Total	$ 15,804	$ 15,771

Actual maturities may differ from the contractual maturities because borrowers may have the right to call or prepay certain obligations.

7. Long-Term Debt

In February 2006, the Company issued $500 million of senior floating interest rate notes due 2009 (the 2009 Notes), $3.0 billion of 5.25% senior notes due 2011 (the 2011 Notes), and $3.0 billion of 5.50% senior notes due 2016 (the 2016 Notes), for an aggregate principal amount of $6.5 billion. The following table summarizes the Company s long-term debt (in millions, except percentages):

	April 28, 2007		July 29, 2006	
	Amount	Effective Rate(1)	Amount	Effective Rate(1)
Senior notes:				
Floating-rate notes, due 2009	$ 500	5.44%	$ 500	5.27%
5.25% fixed-rate notes, due 2011	3,000	5.56%	3,000	5.39%
5.50% fixed-rate notes, due 2016	3,000	5.79%	3,000	5.62%
Total senior notes	6,500		6,500	
Other notes	5		5	
Unamortized discount	(17)		(18)	
Fair value adjustment	(10)		(155)	

Total	$ 6,478	$ 6,332

(1) The effective rates for the 2011 Notes and the 2016 Notes reflect the variable rate in effect as of the period end on the interest rate swaps designated as fair value hedges of those notes, including the amortization of the discount.

The 2011 Notes and the 2016 Notes are redeemable by the Company at any time, subject to a make-whole premium. To achieve its interest rate objectives, the Company entered into $6.0 billion notional amount of interest rate swaps. In effect, these swaps convert the fixed interest rates of the 2011 Notes and the 2016 Notes to floating interest rates based on the London Interbank Offered Rate (LIBOR). Gains and losses in the fair value of the interest rate swaps offset changes in the fair value of the underlying debt. The Company was in compliance with all debt covenants as of April 28, 2007.

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Interest is payable quarterly on the 2009 Notes and semi-annually on the 2011 Notes and 2016 Notes. Interest expense, net of the effect of hedging, included in interest income, net, in the Consolidated Statements of Operations and cash paid for interest are summarized as follows (in millions):

	Three Months Ended		Nine Months Ended	
	April 28, 2007	April 29, 2006	April 28, 2007	April 29, 2006
Interest expense	$ 94	$ 60	$ 283	$ 60
Cash paid for interest	$ 181	$	$ 354	$

8. Commitments and Contingencies

Operating Leases

The Company leases office space in several U.S. locations. Outside the United States, larger sites include Australia, Belgium, Canada, China, France, Germany, India, Italy, Japan, and the United Kingdom. Future annual minimum lease payments under all noncancelable operating leases with an initial term in excess of one year as of April 28, 2007 are as follows (in millions):

Fiscal Year	Amount
2007 (remaining three months)	$ 76
2008	239
2009	184
2010	155
2011	136
Thereafter	685
Total	$ 1,475

Purchase Commitments with Contract Manufacturers and Suppliers

The Company purchases components from a variety of suppliers and uses several contract manufacturers to provide manufacturing services for its products. During the normal course of business, in order to manage manufacturing lead times and help ensure adequate component supply, the Company enters into agreements with contract manufacturers and suppliers that either allow them to procure inventory based upon criteria as defined by the Company or that establish the parameters defining the Company s requirements. In certain instances, these agreements allow the Company the option to cancel, reschedule, and adjust the Company s requirements based on its business needs prior to firm orders being placed. Consequently, only a portion of the Company s reported purchase commitments arising from these agreements are firm, noncancelable, and unconditional commitments. As of April 28, 2007, the Company had total purchase commitments for inventory of $2.6 billion, compared with $2.0 billion as of July 29, 2006.

In addition to the above, the Company records a liability for firm, noncancelable, and unconditional purchase commitments for quantities in excess of its future demand forecasts consistent with the valuation of the Company s inventory. As of April 28, 2007, the liability for these purchase commitments was $161 million, compared with $148 million as of July 29, 2006, and was included in other accrued liabilities.

Nuova Systems, Inc.

In the first quarter of fiscal 2007, the Company made an investment in Nuova Systems, Inc. (Nuova Systems), which conducts research and development on data center-related products. This investment includes $50 million of funding and a license to certain of the Company s technology. As a result of this investment, the Company owns approximately 80% of Nuova Systems and has consolidated the results of Nuova Systems in the Company s Consolidated Financial Statements beginning in the first quarter of fiscal 2007. In April 2007, the agreements were amended to add additional product development activities to be undertaken by Nuova Systems. Upon the occurrence of certain events, the Company has committed up to $62 million of additional funding, which amount was increased by the April 2007 amendment from up to $42 million.

In connection with this investment, the Company and Nuova Systems have entered into a call option agreement that provides the Company with the right to purchase the remaining interests of approximately 20% in Nuova Systems. If the call option is exercised by the Company, the minority interest holders would be eligible to receive three milestone payments, revised from two milestone payments by the April 2007 amendment, based on agreed formulas. The amounts due under the milestone payments will be recognized by the Company when it is determined that the exercise of the call option is probable. These amounts will be recorded as compensation expense based on an estimate of the fair value of the amounts that could be earned by the minority interest holders pursuant to a vesting schedule. Subsequent changes to the fair value of the amounts probable of being earned and the continued

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vesting will result in adjustments to the recorded compensation expense. If the Company exercises the call option, the potential amount recorded as compensation expense would be up to a maximum of $678 million, which amount was increased by the April 2007 amendment from up to a maximum of $578 million due to additional employees required to perform the additional product development.

Other Commitments

The Company has entered into an agreement to invest approximately $800 million in venture funds managed by SOFTBANK Corp. and its affiliates (SOFTBANK) that are required to be funded on demand. The total commitment is to be invested in venture funds and as senior debt with entities as directed by SOFTBANK. The Company s commitment to fund the senior debt is contingent upon the achievement of certain agreed-upon milestones. As of April 28, 2007, the Company had invested $606 million in the venture funds pursuant to the commitment, compared with $523 million as of July 29, 2006. In addition, as of April 28, 2007 and July 29, 2006, the Company had invested $49 million in the senior debt pursuant to the commitment, all of which has been repaid.

The Company also has certain other funding commitments related to its privately held investments that are based on the achievement of certain agreed-upon milestones. The remaining funding commitments were approximately $60 million as of April 28, 2007, compared with approximately $34 million as of July 29, 2006.

Variable Interest Entities

In the ordinary course of business, the Company has investments in privately held companies and provides financing to certain customers through its wholly owned subsidiaries, which may be considered to be variable interest entities. The Company has evaluated its investments in privately held companies and customer financings and determined that there were no significant unconsolidated variable interest entities as of April 28, 2007.

Guarantees and Product Warranties

The following table summarizes the activity related to the product warranty liability during the nine months ended April 28, 2007 and April 29, 2006 (in millions):

	Nine Months Ended	
	April 28, 2007	**April 29, 2006**
Balance at beginning of period	$ 309	$ 259
Provision for warranties issued	370	283
Fair value of warranty liability acquired from Scientific-Atlanta		44
Payments	(341)	(287)
Balance at end of period	$ 338	$ 299

The Company accrues for warranty costs as part of its cost of sales based on associated material product costs, labor costs for technical support staff, and associated overhead. The products sold are generally covered by a warranty for periods ranging from 90 days to five years, and for some products the Company provides a limited lifetime warranty.

The Company s guarantees as of April 28, 2007 and July 29, 2006 that were subject to recognition and disclosure requirements were not material. In the normal course of business, the Company indemnifies other parties, including customers, lessors, and parties to other transactions with the Company, with respect to certain matters. The Company has agreed to hold the other parties harmless against losses arising from a breach of representations or covenants, or out of intellectual property infringement or other claims made against certain parties. These agreements may limit the time within which an indemnification claim can be made and the amount of the claim. In addition, the Company has entered into indemnification agreements with its officers and directors, and the Company s bylaws contain similar indemnification obligations to the Company s agents.

It is not possible to determine the maximum potential amount under these indemnification agreements due to the Company s limited history with prior indemnification claims and the unique facts and circumstances involved in each particular agreement. Historically, payments made by the Company under these agreements have not had a material effect on the Company s operating results, financial position, or cash flows.

Derivative Instruments

The Company primarily uses derivative instruments to manage exposures to foreign currency, interest rate, and equity security price

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risks. The Company s primary objective in holding derivatives is to reduce the volatility of earnings and cash flows associated with changes in foreign currency, interest rates, and equity security prices. The Company s derivatives expose it to credit risk to the extent that the counterparties may be unable to meet the terms of the agreement. The Company seeks to reduce such risks by limiting its counterparties to major financial institutions. In addition, the potential risk of loss with any one counterparty resulting from this type of credit risk is monitored. Management does not expect material losses as a result of defaults by counterparties.

Foreign Currency Derivatives

The Company s foreign exchange forward and option contracts are summarized as follows (in millions):

	April 28, 2007		July 29, 2006	
	Notional Amount	Fair Value	Notional Amount	Fair Value
Forward contracts:				
Purchased	$ 1,447	$ 3	$ 1,376	$ (2)
Sold	$ 535	$ (10)	$ 554	$ (3)
Option contracts:				
Purchased	$ 303	$ 19	$ 591	$ 20
Sold	$ 299	$ (1)	$ 573	$ (2)

The Company conducts business globally in numerous currencies. As such, it is exposed to adverse movements in foreign currency exchange rates. To limit the exposure related to foreign currency changes, the Company enters into foreign currency contracts. The Company does not enter into foreign exchange forward or option contracts for trading purposes.

The Company enters into foreign exchange forward contracts to reduce the short-term effects of foreign currency fluctuations on foreign currency receivables, investments, and payables. The gains and losses on the foreign exchange forward contracts offset the transaction gains and losses on foreign currency receivables, investments, and payables recognized in earnings. Gains and losses on the contracts are included in other income, net, in the Consolidated Statements of Operations and offset foreign exchange gains and losses from the revaluation of intercompany balances or other current assets, investments, or liabilities denominated in currencies other than the functional currency of the reporting entity. The Company s foreign exchange forward contracts related to current assets and liabilities generally range from one to three months in original maturity. Additionally, the Company has entered into foreign exchange forward contracts with maturities of up to two years related to long-term customer financings. The foreign exchange forward contracts related to investments generally have maturities of less than one year.

The Company periodically hedges certain foreign currency forecasted transactions related to certain operating expenses with currency options and forward contracts. These transactions are designated as cash flow hedges. The effective portion of the derivative s gain or loss is initially reported as a component of accumulated other comprehensive income and subsequently reclassified into earnings when the hedged exposure affects earnings. The ineffective portion, if any, of the gain or loss is reported in earnings immediately. These currency option contracts and forward contracts generally have maturities of less than 18 months.

Interest Rate Derivatives

The Company s interest rate derivatives are summarized as follows (in millions):

	April 28, 2007		July 29, 2006	
	Notional Amount	Fair Value	Notional Amount	Fair Value
Interest rate derivatives:				
Interest rate swaps- investments	$ 1,000	$ 26	$ 1,000	$ 45
Interest rate swaps- long-term debt	$ 6,000	$ (10)	$ 6,000	$ (155)

The Company s primary objective for holding fixed income securities is to achieve an appropriate investment return consistent with preserving principal and managing risk. To realize these objectives, the Company may utilize interest rate swaps or other derivatives designated as fair value or cash flow hedges. The Company has entered into $1.0 billion of interest rate swaps designated as fair value hedges of its investment portfolio. Under these interest rate swap contracts, the Company makes fixed-rate interest payments and receives interest payments based on LIBOR. The effect of these swaps is to convert fixed-rate returns to floating-rate returns based on LIBOR for a portion of the Company s fixed income portfolio. The gains and losses related to changes in the value of the interest rate swaps are included in other income, net, in the Consolidated Statements of Operations and offset the changes in fair value of the underlying hedged investment. The fair values of the interest rate swaps designated as hedges of the Company s investments were reflected in prepaid expenses and other current assets in the Consolidated Balance Sheets.

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In conjunction with its issuance of fixed-rate senior notes in February 2006, the Company entered into $6.0 billion of interest rate swaps designated as fair value hedges of the fixed-rate debt. Under these interest rate swap contracts, the Company receives fixed-rate interest payments and makes interest payments based on LIBOR. The effect of these swaps is to convert fixed-rate interest expense to floating-rate interest expense based on LIBOR. The gains and losses related to changes in the value of the interest rate swaps are included in other income, net, in the Consolidated Statements of Operations and offset the changes in fair value of the underlying debt. The fair values of the interest rate swaps designated as hedges of the Company s debt were reflected in other long-term liabilities in the Consolidated Balance Sheets.

Equity Derivatives

The Company s equity derivatives are summarized as follows (in millions):

	April 28, 2007		July 29, 2006	
	Notional Amount	Fair Value	Notional Amount	Fair Value
Equity derivatives:				
Forward sale and option agreements	$ 198	$ 10	$ 164	$ 93

The Company maintains a portfolio of publicly traded equity securities which are subject to price risk. The Company may hold equity securities for strategic purposes or to diversify the Company s overall investment portfolio. To manage its exposure to changes in the fair value of certain equity securities, the Company may, from time to time, enter into equity derivative contracts. As of April 28, 2007, the Company had entered into forward sale and option agreements on certain publicly traded equity securities designated as fair value hedges. The gains and losses due to changes in the value of the hedging instruments are included in other income, net, in the Consolidated Statements of Operations and offset the change in the fair value of the underlying hedged investment. The fair values of the equity derivatives were reflected in prepaid expenses and other current assets and other accrued liabilities in the Consolidated Balance Sheets.

Legal Proceedings

The Company and other defendants were subject to patent claims asserted by QPSX Developments 5 Pty Ltd (now known as Ipernica Ltd) against the Company and such other defendants on June 21, 2005 in the United States District Court for the Eastern District of Texas. QPSX alleged that various Cisco switches and routers infringed United States Patent No. 5,689,499 and sought damages and injunctive relief. On April 10, 2007, prior to trial, the Company and QPSX settled the dispute on terms that are not material to the Company, and the lawsuit was dismissed with prejudice on May 2, 2007.

The Company and other defendants were subject to claims asserted by Telcordia Technologies, Inc. on July 16, 2004 in the Federal District Court for the District of Delaware alleging that various Cisco routers, switches and optical products infringed United States Patent Nos. 4,893,306, 4,835,763 and Re 36,633. Telcordia sought damages and injunctive relief. The Court ruled that, as a matter of law, the Company does not infringe Patent No. 4,893,306. After conclusion of a trial, on May 10, 2007, a jury found that infringement had occurred and awarded damages in an amount that is not material to the Company. The Company intends to ask the Court to reverse the verdict as a matter of law, and if necessary, intends to appeal the decision. Telcordia also has the right to appeal the jury finding. The Company believes that the ultimate outcome of this matter and aggregate potential damages are not likely to be material.

In September 2005, Scientific-Atlanta, Inc. (which subsequently was acquired by the Company) and another plaintiff filed a declaratory judgment action against Forgent Networks in the United States District Court for the Eastern District of Texas after Forgent sued various Scientific-Atlanta customers. In the action, Scientific-Atlanta asserted that its products did not infringe Forgent s United States Patent No. 6,285,746 and that the patent was invalid. On October 20, 2005, Forgent responded to the complaint and alleged that various Scientific-Atlanta digital video recorders infringed the patent and sought damages and injunctive relief. Subsequent to that, another declaratory judgment plaintiff moved to intervene and the cases were combined. On April 25, 2007, prior to trial, Scientific-Atlanta and Forgent settled their dispute on terms that are not material to the Company and the lawsuits were dismissed with prejudice on April 30, 2007.

For information regarding legal proceedings terminated during prior quarters of fiscal 2007, see Legal Proceedings under Note 8 to the Consolidated Financial Statements in the Company s Quarterly Report on Form 10-Q for the quarter ended January 27, 2007.

In addition, the Company is subject to legal proceedings, claims, and litigation arising in the ordinary course of business, including intellectual property litigation. While the outcome of these matters is currently not determinable, the Company does not expect that the ultimate costs to resolve these matters will have a material adverse effect on its consolidated financial position, results of operations, or cash flows.

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9. Shareholders Equity

Stock Repurchase Program

In September 2001, the Company s Board of Directors authorized a stock repurchase program. As of April 28, 2007, the Company s Board of Directors had authorized an aggregate repurchase of up to $47 billion of common stock under this program and the remaining authorized repurchase amount was $5.3 billion with no termination date. The stock repurchase activity under the stock repurchase program during the first nine months of fiscal 2007 is summarized as follows (in millions, except per-share amounts):

Nine Months Ended April 28, 2007	Shares Repurchased	Weighted-Average Price per Share	Amount Repurchased
Cumulative balance at July 29, 2006	1,931	$ 18.36	$ 35,448
Repurchase of common stock	243	25.85	6,281
Cumulative balance at April 28, 2007	2,174	$ 19.20	$ 41,729

The purchase price for the shares of the Company s stock repurchased was reflected as a reduction to shareholders equity. In accordance with Accounting Principles Board Opinion No. 6, Status of Accounting Research Bulletins, the Company is required to allocate the purchase price of the repurchased shares as (i) a reduction to retained earnings until retained earnings are zero and then as an increase to accumulated deficit and (ii) a reduction of common stock and additional paid-in capital. Issuance of common stock and the tax benefit related to employee stock incentive plans are recorded as an increase to common stock and additional paid-in capital.

Comprehensive Income

The components of comprehensive income are as follows (in millions):

	Three Months Ended		Nine Months Ended	
	April 28, 2007	April 29, 2006	April 28, 2007	April 29, 2006
Net income	$ 1,874	$ 1,400	$ 5,403	$ 4,036
Other comprehensive income:				
Change in unrealized gains and losses on investments, net of tax	49	1	158	9
Other (1)	96	40	137	80
Comprehensive income before minority interest	2,019	1,441	5,698	4,125
Change in minority interest (2)	(1)	(4)	(3)	(1)
Total	$ 2,018	$ 1,437	$ 5,695	$ 4,124

(1) Includes changes in currency translation

(2) The Company consolidates its investment in a venture fund managed by SOFTBANK as it is the primary beneficiary as defined under FIN 46(R). As a result, SOFTBANK s interest in the change in the unrealized gains and losses on the investments in the venture fund is recorded as a component of accumulated other comprehensive income, and is reflected as a change in minority interest.

10. Employee Benefit Plans

Employee Stock Purchase Plan

The Company has an Employee Stock Purchase Plan, which includes its sub-plan, the International Employee Stock Purchase Plan (together, the Purchase Plan), under which 321.4 million shares of the Company s stock have been reserved for issuance. Eligible employees may purchase a limited number of shares of the Company s stock at a discount of up to 15% of the lesser of the market value on the subscription date or the purchase date, which is approximately six months after the subscription date. The Purchase Plan terminates on January 3, 2010. The Company issued 10 million and 11 million shares under the Purchase Plan during the nine months ended April 28, 2007 and April 29, 2006, respectively. As of April 28, 2007, 89 million shares were available for issuance under the Purchase Plan.

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Employee Stock Incentive Plans

Stock Incentive Plan Program Description

As of April 28, 2007, the Company had four stock incentive plans: the 2005 Stock Incentive Plan (the 2005 Plan), the 1996 Stock Incentive Plan (the 1996 Plan), the 1997 Supplemental Stock Incentive Plan (the Supplemental Plan), and the Cisco Systems, Inc. SA Acquisition Long-Term Incentive Plan (the Acquisition Plan). In addition, the Company has, in connection with the acquisitions of various companies, assumed the stock incentive plans of the acquired companies or issued replacement share-based awards. Share-based awards are designed to reward employees for their long-term contributions to the Company and provide incentives for them to remain with the Company. The number and frequency of share-based awards are based on competitive practices, operating results of the Company, and government regulations. Since the inception of the stock incentive plans, the Company has granted stock options to virtually all employees, and the majority has been granted to employees below the vice president level. The Company s stock incentive plans are summarized as follows:

2005 Plan

The maximum number of shares issuable over the term of the 2005 Plan is limited to 350 million shares. The 2005 Plan permits the granting of stock options, stock, stock units, and stock appreciation rights to employees (including employee directors and officers) and consultants of the Company and its subsidiaries and affiliates, and nonemployee directors of the Company. Stock options granted under the 2005 Plan have an exercise price of at least 100% of the fair market value of the underlying stock on the grant date and expire no later than nine years from the grant date. The stock options will generally become exercisable for 20% of the option shares one year from the date of grant and then ratably over the following 48 months. Stock grants and stock units will generally vest with respect to 20% of the shares covered by the grant on each of the first through fifth anniversaries of the date of the grant. The Compensation and Management Development Committee of the Board of Directors has the discretion to use a different vesting schedule. Stock appreciation rights may be awarded in combination with stock options or stock grants and such awards shall provide that the stock appreciation rights will not be exercisable unless the related stock options or stock grants are forfeited. Stock grants may be awarded in combination with nonstatutory stock options, and such awards may provide that the stock grants will be forfeited in the event that the related nonstatutory stock options are exercised. The 2005 Plan terminates at the 2007 Annual Meeting of Shareholders unless re-adopted or extended by the shareholders prior to or on such date.

1996 Plan

The 1996 Plan expired on December 31, 2006 and the Company may no longer make equity awards under the 1996 Plan. The maximum number of shares issuable over the term of the 1996 Plan was 2.5 billion shares. Stock options granted under the 1996 Plan have an exercise price of at least 100% of the fair market value of the underlying stock on the grant date and expire no later than nine years from the grant date. The stock options will generally become exercisable for 20% or 25% of the option shares one year from the date of grant and then ratably over the following 48 or 36 months, respectively. Certain other grants have utilized a 60-month ratable vesting schedule. In addition, the Board of Directors, or other committees administering the plan, have the discretion to use a different vesting schedule and have done so from time to time.

Supplemental Plan

In 1997, the Company adopted the Supplemental Plan, under which stock options can be granted or shares can be directly issued to eligible employees. Officers and members of the Company s Board of Directors are not eligible to participate in the Supplemental Plan. Nine million shares have been reserved for issuance under the Supplemental Plan. All stock option grants have an exercise price equal to the fair market value of the underlying stock on the grant date. The Company no longer makes stock option grants or direct share issuances under the Supplemental Plan.

Acquisition Plan

Effective upon completion of the Company s acquisition of Scientific-Atlanta, the Company adopted the Acquisition Plan. The Acquisition Plan constitutes an assumption, amendment, restatement and renaming of the 2003 Long-Term Incentive Plan of Scientific-Atlanta. The Acquisition Plan permits the grant of stock options, stock, stock units, and stock appreciation rights to certain employees of the Company and its subsidiaries and affiliates who had been employed by Scientific-Atlanta or its subsidiaries. An aggregate of 14.8 million shares of the Company s common stock has been reserved for issuance under the Acquisition Plan on a discretionary basis, subject to limitations set forth in the Acquisition Plan.

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Distribution and Dilutive Effect of Stock Options

Weighted-average basic and diluted shares outstanding for the nine months ended April 28, 2007 were 6.1 billion shares and 6.3 billion shares, respectively. For the nine months ended April 28, 2007, the dilutive effect of in-the-money employee stock options was approximately 201 million shares or 3.3% of the basic shares outstanding based on the Company s average share price of $25.00.

The following table illustrates grant dilution based on net options granted as a percentage of shares of common stock outstanding at period end (in millions, except percentages):

	Nine Months Ended	
	April 28, 2007	April 29, 2006
Shares of common stock outstanding	6,054	6,164
Granted and assumed	175	219
Canceled/forfeited/expired	(40)	(67)
Net stock options granted	135	152
Grant dilution	2.2%	2.5%

The Named Executive Officers represent the Company s Chief Executive Officer and the four other most highly paid executive officers whose salary and bonus for the years ended July 29, 2006 and July 30, 2005 were in excess of $100,000. The following table summarizes the options granted to the Named Executive Officers during the periods indicated (in millions, except percentages):

	Nine Months Ended	
	April 28, 2007	April 29, 2006
Stock options granted to the Named Executive Officers	2.9	2.9
Stock options granted to the Named Executive Officers as a percentage of net stock options granted	2.1%	1.9%
Stock options granted to the Named Executive Officers as a percentage of outstanding shares	0.05%	0.05%
Cumulative stock options held by Named Executive Officers as a percentage of total stock options outstanding	3.2%	3.3%

General Share-Based Award Information

A summary of share-based award activity is as follows (in millions, except per-share amounts):

		Stock Options Outstanding	
	Share-Based Awards	Number Outstanding	Weighted-Average

	Available for Grant		Exercise Price per Share
Balance at July 30, 2005	223	1,436	$ 25.02
Granted and assumed	(230)	230	18.21
Exercised		(136)	10.08
Canceled/forfeited/expired	79	(84)	29.53
Restricted stock and restricted stock units granted	(6)		
Additional shares reserved	398		
Balance at July 29, 2006	464	1,446	25.08
Granted and assumed	(175)	175	23.31
Exercised [1]		(229)	15.53
Canceled/forfeited/expired	15	(40)	31.45
Restricted stock and restricted stock units granted	(5)		
Additional shares reserved	3		
Balance at April 28, 2007	302	1,352	$ 26.28

(1) The total pretax intrinsic value of stock options exercised during the nine months ended April 28, 2007 was $2.2 billion.

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The following table summarizes significant ranges of outstanding and exercisable options as of April 28, 2007 (in millions, except years and per-share amounts):

	Stock Options Outstanding				Stock Options Exercisable		
Range of Exercise Prices	Number Outstanding	Weighted-Average Remaining Contractual Life (in Years)	Weighted-Average Exercise Price per Share	Aggregate Intrinsic Value	Number Exercisable	Weighted-Average Exercise Price per Share	Aggregate Intrinsic Value
$ 0.01 15.00	128	4.33	$ 11.21	$ 2,041	101	$ 11.21	$ 1,591
15.01 18.00	253	5.88	17.18	2,494	137	16.67	1,416
18.01 20.00	326	5.70	19.21	2,552	187	19.17	1,465
20.01 22.50	86	5.05	20.84	530	62	20.73	388
22.51 25.00	172	7.91	23.10	675	17	23.74	55
25.01 35.00	113	2.47	27.30	49	94	27.35	44
35.01 72.56	274	2.10	53.42		273	53.34	
Total	1,352	4.85	$ 26.28	$ 8,341	871	$ 29.71	$ 4,959

The aggregate intrinsic value in the preceding table represents the total pretax intrinsic value based on the Company s closing stock price of $27.03 as of April 27, 2007, which would have been received by the option holders had those option holders exercised their options as of that date. The total number of in-the-money stock options exercisable as of April 28, 2007 was 564 million. As of July 29, 2006, 969 million outstanding stock options were exercisable and the weighted-average exercise price was $28.53.

The following table presents the option exercises for the nine months ended April 28, 2007, and option values as of that date for the Named Executive Officers (in millions):

			Number of Securities Underlying Unexercised Options at April 28, 2007		Intrinsic Value of Unexercised in-the-Money Options at April 28, 2007	
	Number of Shares Acquired on Exercise	Value Realized	Exercisable	Unexercisable	Exercisable	Unexercisable
Named Executive Officers	9	$ 103	33	10	$ 139	$ 72

Valuation and Expense Information Under SFAS 123(R)

On July 31, 2005, the Company adopted SFAS 123(R), which requires the measurement and recognition of compensation expense for all share-based payment awards made to the Company s employees and directors including employee stock options, employee stock purchases related to the Employee Stock Purchase Plan (employee stock purchases), employee restricted stock and restricted stock units, based on estimated fair values. Employee share-based compensation expense under SFAS 123(R) was as follows (in millions):

	Three Months Ended		Nine Months Ended	
	April 28, 2007	April 29, 2006	April 28, 2007	April 29, 2006
Cost of sales product	$ 10	$ 11	$ 33	$ 41
Cost of sales service	25	28	79	90
Employee share-based compensation expense in cost of sales	35	39	112	131
Research and development	75	86	223	279
Sales and marketing	101	107	294	340
General and administrative	26	29	80	89
Employee share-based compensation expense in operating expenses	202	222	597	708
Total employee share-based compensation expense [1]	$ 237	$ 261	$ 709	$ 839

(1) Share-based compensation expense related to acquisitions and investments is disclosed in Note 3 and is not included in the table. As of April 28, 2007, total compensation cost related to nonvested share-based awards not yet recognized was $2.7 billion, including share-based compensation relating to acquisitions and investments, which is expected to be recognized over the next 3.7 years on a weighted-average basis.

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The income tax benefit for employee share-based compensation expense was $102 million and $265 million for the three and nine months ended April 28, 2007, respectively, and $73 million and $235 million for the three and nine months ended April 29, 2006, respectively. The income tax benefit has been determined using the applicable tax rates in jurisdictions to which this expense relates and for fiscal 2007 includes the tax effects resulting from the reinstatement of the U.S. federal research and development (R&D) tax credit in December 2006 (see Note 11). The tax benefit for fiscal 2006 includes the effect of U.S. tax regulations that require intercompany reimbursement of certain share-based compensation expenses.

Lattice-Binomial Model

Upon adoption of SFAS 123(R), the Company began estimating the value of employee stock options and employee stock purchases on the date of grant using a lattice-binomial model. Prior to the adoption of SFAS 123(R), the value of each employee stock option and employee stock purchase was estimated on the date of grant using the Black-Scholes model.

The Company s employee stock options have various restrictions including vesting provisions and restrictions on transfer and hedging, among others, and are often exercised prior to their contractual maturity. Lattice-binomial models are more capable of incorporating the features of the Company s employee stock options than closed-form models such as the Black-Scholes model. The use of a lattice-binomial model requires extensive actual employee exercise behavior data and a number of complex assumptions including expected volatility, risk-free interest rate, expected dividends, kurtosis, and skewness. The weighted-average assumptions, using the lattice-binomial model, the weighted-average expected life and estimated value of employee stock options are summarized as follows:

	Three Months Ended		Nine Months Ended	
	April 28, 2007	April 29, 2006	April 28, 2007	April 29, 2006
Weighted-average assumptions:				
Expected volatility	26.3%	22.4%	25.8%	23.6%
Risk-free interest rate	4.6%	4.7%	4.6%	4.2%
Expected dividend	0.0%	0.0%	0.0%	0.0%
Kurtosis	4.6	4.3	4.5	4.2
Skewness	(0.80)	(0.67)	(0.80)	(0.61)
Weighted-average expected life in years	6.7	6.7	6.7	6.6
Weighted-average estimated value	$ 8.21	$ 5.78	$ 7.01	$ 5.07

The determination of the fair value of share-based payment awards on the date of grant using an option-pricing model is affected by the Company s stock price as well as assumptions regarding a number of highly complex and subjective variables. The weighted-average assumptions were determined as follows:

The Company used the implied volatility for two-year traded options on the Company s stock as the expected volatility assumption required in the lattice-binomial model, consistent with SFAS 123(R) and Staff Accounting Bulletin No. 107 (SAB 107). The selection of the implied volatility approach was based upon the availability of actively traded options on the Company s stock and the Company s assessment that implied volatility is more representative of future stock price trends than historical volatility.

The risk-free interest rate assumption is based upon observed interest rates appropriate for the term of the Company s employee stock options.

The dividend yield assumption is based on the history and expectation of dividend payouts.

The estimated kurtosis and skewness are technical measures of the distribution of stock price returns, which affect expected employee exercise behaviors that are based on the Company s stock price return history as well as consideration of various academic analyses.

The expected life of employee stock options represents the weighted-average period the stock options are expected to remain outstanding and is a derived output of the lattice-binomial model. The expected life of employee stock options is impacted by all of the underlying assumptions and calibration of the Company s model. The lattice-binomial model assumes that employees exercise behavior is a function of the option s remaining vested life and the extent to which the option is in-the-money. The lattice-binomial model estimates the probability of exercise as a function of these two variables based on the entire history of exercises and cancellations on all past option grants made by the Company.

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Because share-based compensation expense recognized in the Consolidated Statements of Operations is based on awards ultimately expected to vest, it has been reduced for estimated forfeitures. SFAS 123(R) requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. Forfeitures were estimated based on historical experience and the Company estimated forfeitures to be 3% annually for the three and nine months ended April 28, 2007 and April 29, 2006.

Accuracy of Fair Value Estimates

The Company uses third-party analyses to assist in developing the assumptions used in, as well as calibrating, its lattice-binomial model. The Company is responsible for determining the assumptions used in estimating the fair value of its share-based payment awards.

The Company s determination of the fair value of share-based payment awards is affected by the assumptions regarding a number of highly complex and subjective variables. These variables include, but are not limited to, the Company s expected stock price volatility over the term of the awards, and actual and projected employee stock option exercise behaviors. Option-pricing models were developed for use in estimating the value of traded options that have no vesting or hedging restrictions and are fully transferable. Because the Company s employee stock options have certain characteristics that are significantly different from traded options, and because changes in the subjective assumptions can materially affect the estimated value, in management s opinion, the existing valuation models may not provide an accurate measure of the fair value of the Company s employee stock options. Although the fair value of employee stock options is determined in accordance with SFAS 123(R) and SAB 107 using an option-pricing model, that value may not be indicative of the fair value observed in a willing buyer/willing seller market transaction.

11. Income Taxes

The following table provides details of income taxes (in millions, except percentages):

	Three Months Ended		Nine Months Ended	
	April 28, 2007	**April 29, 2006**	**April 28, 2007**	**April 29, 2006**
Effective tax rate	22.5%	22.7%	22.0%	26.4 %
Cash paid for income taxes	$ 353	$ 287	$ 1,312	$ 1,261

In December 2006, the Tax Relief and Health Care Act of 2006 reinstated the U.S. federal R&D tax credit, retroactive to January 1, 2006. As a result, the tax provision rate for the nine months ended April 28, 2007 included a tax benefit relating to the reinstatement of the U.S. federal R&D tax credit, including $60 million related to fiscal 2006 R&D expenses. The effective tax rate for the three and nine months ended April 28, 2007 also reflects a benefit from an increase in foreign income taxed at other than U.S. rates.

The tax provision rates for the three and nine months ended April 29, 2006 included a benefit of approximately $124 million from the favorable settlement of a tax audit in a foreign jurisdiction.

The Company s income taxes currently payable have been reduced by the tax benefits from employee stock incentive plans. These benefits totaled $733 million and $418 million for the nine months ended April 28, 2007 and April 29, 2006, respectively, and were reflected as an increase to additional paid-in capital in the Consolidated Statements of Shareholders Equity. The Company includes only the direct tax effects of employee stock incentive plans in calculating this increase to additional paid-in capital.

The Company s federal income tax returns for fiscal years ended July 27, 2002 through July 31, 2004 are under examination and the Internal Revenue Service has proposed certain adjustments. The Company believes that adequate amounts have been reserved for any adjustments that may ultimately result from these examinations.

On October 22, 2004, the American Jobs Creation Act of 2004 (the Jobs Creation Act) was signed into law. The Jobs Creation Act created a temporary incentive for U.S. corporations to repatriate accumulated income earned abroad by providing an 85 percent dividends received deduction for certain dividends from controlled foreign corporations. In the first quarter of fiscal 2006, the Company distributed cash from its foreign subsidiaries and reported an extraordinary dividend (as defined in the Jobs Creation Act) of $1.2 billion and a related tax liability of approximately $63 million in its fiscal 2006 federal income tax return. This amount was previously provided for in the provision for income taxes and is included in income taxes payable. This distribution does not change the Company s intention to indefinitely reinvest undistributed earnings of certain of its foreign subsidiaries in operations outside the United States.

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12. Segment Information and Major Customers

The Company s operations involve the design, development, manufacturing, marketing, and technical support of networking and other products and services related to the communications and information technology industry. Cisco products include routers, switches, advanced technologies, and other products. These products, primarily integrated by Cisco IOS Software, link geographically dispersed local-area networks (LANs) and wide-area networks (WANs).

The Company conducts business globally and is primarily managed on a geographic basis. The Company s management makes financial decisions and allocates resources based on the information it receives from its internal management system. Sales are attributed to a geographic theater based on the ordering location of the customer. Gross margin for each theater includes the amortization of purchased intangible assets and the employee share-based compensation expense related to that theater. The Company does not allocate research and development, sales and marketing, or general and administrative expenses to its geographic theaters in this internal management system because management does not use the information to measure the performance of the operating segments.

Summarized financial information by theater based on the Company s internal management system, is as follows (in millions):

	Three Months Ended		Nine Months Ended	
	April 28, 2007	April 29, 2006	April 28, 2007	April 29, 2006
Net sales:				
United States and Canada [1]	$ 4,843	$ 4,138	$ 14,126	$ 11,258
European Markets	1,966	1,595	5,410	4,496
Emerging Markets	839	604	2,481	1,760
Asia Pacific	900	648	2,502	2,003
Japan	318	337	970	983
Total	$ 8,866	$ 7,322	$ 25,489	$ 20,500
Gross margin:				
United States and Canada	$ 3,047	$ 2,642	$ 8,870	$ 7,361
European Markets	1,269	1,037	3,530	3,028
Emerging Markets	530	395	1,610	1,209
Asia Pacific	578	413	1,585	1,308
Japan	223	239	673	696
Total	$ 5,647	$ 4,726	$ 16,268	$ 13,602

(1) Net sales in the United States were $4.6 billion and $3.9 billion for the three months ended April 28, 2007 and April 29, 2006, respectively. Net sales in the United States were $13.3 billion and $10.7 billion for the nine months ended April 28, 2007 and April 29, 2006, respectively.

The following table presents net sales for groups of similar products and services (in millions):

	Three Months Ended		Nine Months Ended	
	April 28, 2007	April 29, 2006	April 28, 2007	April 29, 2006
Net sales:				
Routers	$ 1,766	$ 1,519	$ 5,035	$ 4,356
Switches	3,089	2,691	9,132	7,999
Advanced technologies	2,072	1,529	5,862	3,825
Other	554	416	1,491	1,003
Product	7,481	6,155	21,520	17,183
Service	1,385	1,167	3,969	3,317
Total	$ 8,866	$ 7,322	$ 25,489	$ 20,500

The Company refers to some of its products and technologies as advanced technologies. As of April 28, 2007, the Company had identified the following advanced technologies for particular focus: application networking services, home networking, hosted small-business systems, security, storage area networking, unified communications, video systems, and wireless technology. The Company continues to identify additional advanced technologies for focus and investment in the future, and the Company s investments in some previously identified advanced technologies may be curtailed or eliminated depending on market developments. Beginning in the first quarter of fiscal 2007, sales of optical networking products, which were previously included in the advanced technologies product category, are included in the other product category, and prior period amounts have been reclassified in order to conform to the current period s presentation.

The majority of the Company s assets as of April 28, 2007 and July 29, 2006 were attributable to its U.S. operations. For the three and nine months ended April 28, 2007 and April 29, 2006, no single customer accounted for 10% or more of the Company s net sales.

Property and equipment information is based on the physical location of the assets. The following table presents property and equipment information for geographic areas (in millions):

	April 28, 2007	July 29, 2006
Property and equipment, net:		
United States	$ 3,294	$ 3,082
International	401	358
Total	$ 3,695	$ 3,440

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13. Net Income per Share

The following table presents the calculation of basic and diluted net income per share (in millions, except per-share amounts):

	Three Months Ended		Nine Months Ended	
	April 28, 2007	April 29, 2006	April 28, 2007	April 29, 2006
Net income	$ 1,874	$ 1,400	$ 5,403	$ 4,036
Weighted-average shares basic	6,034	6,160	6,052	6,184
Effect of dilutive potential common shares	210	129	203	116
Weighted-average shares diluted	6,244	6,289	6,255	6,300
Net income per share basic	$ 0.31	$ 0.23	$ 0.89	$ 0.65
Net income per share diluted	$ 0.30	$ 0.22	$ 0.86	$ 0.64
Antidilutive employee stock options	480	1,010	543	1,027

14. Pending Business Combinations

On January 4, 2007, the Company announced a definitive agreement to acquire privately held IronPort Systems, Inc. (IronPort), a provider of messaging security appliances focusing on enterprise spam and spyware protection. The announced estimated aggregate consideration for this acquisition is $830 million in cash, stock, and stock options assumed. The acquisition is expected to close in the fourth quarter of fiscal 2007 and will be accounted for under the purchase method of accounting.

On March 15, 2007, the Company announced a definitive agreement to acquire WebEx Communications, Inc. (WebEx). WebEx is a provider of on-demand collaboration applications. WebEx s network-based solution for delivering business-to-business collaboration extends the Company s unified communications portfolio, particularly within the small to medium-sized business (SMB) market. Under the terms of the agreement, Cisco commenced a cash tender offer to purchase all of the outstanding shares of WebEx for $57 per share and will assume outstanding share-based awards, for an aggregate purchase price of approximately $3.2 billion. The tender offer expired on May 21, 2007, and the acquisition is expected to close in late May 2007. The acquisition will be accounted for under the purchase method of accounting.

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

Forward-Looking Statements

This Quarterly Report on Form 10-Q, including this Management s Discussion and Analysis of Financial Condition and Results of Operations, contains forward-looking statements regarding future events and our future results that are subject to the safe harbors created under the Securities Act of 1933 (the Securities Act) and the Securities Exchange Act of 1934 (the Exchange Act). All statements other than statements of historical facts are statements that could be deemed forward-looking statements. These statements are based on current expectations, estimates, forecasts, and projections about the industries in which we operate and the beliefs and assumptions of our management. Words such as expects, anticipates, targets, goals, projects, intends, plans, believes, seeks, estimates, continues, may, variations of such words and are intended to identify such forward-looking statements. In addition, any statements that refer to projections of our future financial performance, our anticipated growth and trends in our businesses, and other characterizations of future events or circumstances are forward-looking statements. Readers are cautioned that these forward-looking statements are only predictions and are subject to risks, uncertainties, and assumptions that are difficult to predict, including those identified below, under Part II, Item 1A. Risk Factors and elsewhere herein. Therefore, actual results may differ materially and adversely from those expressed in any forward-looking statements. We undertake no obligation to revise or update any forward-looking statements for any reason.

Overview

Our results for the third quarter and first nine months of fiscal 2007 reflected increases in net sales, net income, and net income per diluted share from the corresponding periods of fiscal 2006, as we have continued to achieve a good balance in year-over-year revenue growth from our four largest geographic theaters, our customer markets, and our product families, which we believe is attributable in part to the successful implementation of our strategy. Net income increased by 34% during the third quarter and first nine months of fiscal 2007 compared to the corresponding periods of fiscal 2006, while net income per diluted share increased by 36% and 34% during the third quarter and first nine months of fiscal 2007, respectively, compared to the corresponding periods of fiscal 2006.

In February 2006, we completed the acquisition of Scientific-Atlanta, a provider of set-top boxes, end-to-end video distribution networks, and video integration systems. With this acquisition, we have enhanced our video capabilities and this enables the convergence of data, voice and video technologies. We believe that video applications have the potential to provide accelerating momentum resulting in growth of both bandwidth and set-top boxes, and we believe Scientific-Atlanta may enable us to have further strategic business relationships with key service provider customers and to reach a broad range of consumers with our enhanced product line. The results for the third quarter and first nine months of fiscal 2007 include the results of Scientific-Atlanta, compared with the results for fiscal 2006 which reflect Scientific-Atlanta s contribution subsequent to the February 24, 2006 acquisition date.

Revenue

Net sales increased by 21% and 24% during the third quarter and first nine months of fiscal 2007, respectively, compared to the corresponding periods of fiscal 2006. Revenue increased in our four largest geographic theaters in the third quarter and first nine months of fiscal 2007 compared to the corresponding periods of fiscal 2006, primarily in the service provider, commercial, and enterprise markets.

Sales of our advanced technologies, which represented the largest portion of the increase in net product sales during the third quarter and first nine months of fiscal 2007, increased by approximately 36% and 53%, respectively, over the corresponding periods of fiscal 2006. The increase in sales of advanced technologies during the third quarter and first nine months of fiscal 2007 was due to the additional contribution of Scientific-Atlanta, and also due to strength in sales of our unified communications, security, wireless, and storage products. For the third quarter and first nine months of fiscal 2007, we experienced strength in routing, led by our high-end routers, and switching, led by our fixed-configuration and modular switches.

Operating Margin

For the third quarter and first nine months of fiscal 2007, the decrease in our gross margin percentage compared to the corresponding periods of fiscal 2006 primarily related to the net sales from Scientific-Atlanta, whose business model has a lower gross margin percentage than the Cisco model. Operating expenses increased during the third quarter and first nine months of fiscal 2007 compared to the corresponding periods of fiscal 2006 primarily due to expenses related to increased investments in headcount, but decreased as a percentage of revenue.

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Other Financial Highlights

During the first nine months of fiscal 2007, we generated cash flows from operations of $7.4 billion. Our cash and cash equivalents and investments were $22.3 billion at the end of the third quarter of fiscal 2007, compared with $17.8 billion at the end of fiscal 2006. The increase in cash and cash equivalents and investments is in anticipation of the completion of our previously announced acquisitions of WebEx and IronPort. We used $6.3 billion of cash to repurchase 243 million shares of our common stock during the first nine months of fiscal 2007. Days sales outstanding in accounts receivable (DSO) at the end of the third quarter of fiscal 2007 improved to 33 days, compared to 38 days at the end of fiscal 2006. Our inventory balance was $1.3 billion at the end of the third quarter of fiscal 2007, compared to $1.4 billion at the end of fiscal 2006. Annualized inventory turns were 8.8 in the third quarter of fiscal 2007 as compared to 8.5 in the fourth quarter of fiscal 2006. Our purchase commitments were $2.6 billion at the end of the third quarter of fiscal 2007, compared to $2.0 billion at the end of fiscal 2006.

Focus Areas

We have continued to focus particular attention on the commercial market; additional sales coverage; growing and expanding our advanced technologies; evolving our support model; and expanding our presence in the Emerging Markets theater. In addition to these areas, we expect to continue to focus on next-generation service provider network build-outs, strengthening our product offerings in the consumer market, and providing more comprehensive solutions to our customers as they employ Internet solutions. The investments we have made and our architectural approach are based on the belief that Web 2.0, the technologies that enable user collaboration, and the increased use of the network as the platform for all forms of communications and information technology will create new market opportunities for us. We believe the industry is evolving to enable personal and business process collaboration enabled by Web 2.0, as part of the second major phase of the Internet.

We also have been focusing on expanding our service model. Compared to the corresponding periods in fiscal 2006, our net service revenue increased by approximately 19% and 20% during the third quarter and first nine months of fiscal 2007, respectively, with service gross margins of 61.4% and 62.4% during the respective periods. Our service and support strategy seeks to capitalize on increased globalization, and we believe this, along with our architectural approach, has the potential to further differentiate us from competitors.

Critical Accounting Estimates

The preparation of financial statements and related disclosures in conformity with accounting principles generally accepted in the United States requires us to make judgments, assumptions, and estimates that affect the amounts reported in the Consolidated Financial Statements and accompanying notes. Note 2 to the Consolidated Financial Statements in our Annual Report on Form 10-K for the fiscal year ended July 29, 2006 describes the significant accounting policies and methods used in the preparation of the Consolidated Financial Statements. The accounting policies described below are significantly affected by critical accounting estimates. Such accounting policies require significant judgments, assumptions, and estimates used in the preparation of the Consolidated Financial Statements, and actual results could differ materially from the amounts reported based on these policies.

Revenue Recognition

Our products are generally integrated with software that is essential to the functionality of the equipment. Additionally, we provide unspecified software upgrades and enhancements related to the equipment through our maintenance contracts for most of our products. Accordingly, we account for revenue in accordance with Statement of Position No. 97-2, Software Revenue Recognition, and all related interpretations. For sales of products where software is incidental to the equipment, we apply the provisions of Staff Accounting Bulletin No. 101, Revenue Recognition in Financial Statements and Staff Accounting Bulletin No. 104, Revenue Recognition, and all related interpretations. Revenue is recognized when persuasive evidence of an arrangement exists, delivery has occurred, the fee is fixed or determinable, and collectibility is reasonably assured. In instances where final acceptance of the product, system, or solution is specified by the customer, revenue is deferred until all acceptance criteria have been met.

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Contracts, Internet commerce agreements, and customer purchase orders are generally used to determine the existence of an arrangement. Shipping documents and customer acceptance, when applicable, are used to verify delivery. We assess whether the fee is fixed or determinable based on the payment terms associated with the transaction and whether the sales price is subject to refund or adjustment. We assess collectibility based primarily on the creditworthiness of the customer as determined by credit checks and analysis, as well as the customer s payment history. When a sale involves multiple elements, such as sales of products that include services, the entire fee from the arrangement is allocated to each respective element based on its relative fair value and recognized when revenue recognition criteria for each element are met. The amount of product and service revenue recognized is impacted by our judgment as to whether an arrangement includes multiple elements and, if so, whether vendor-specific objective evidence of fair value exists. Changes to the elements in an arrangement and our ability to establish vendor-specific objective evidence for those elements could affect the timing of the revenue recognition. Our total deferred revenue for products was $1.9 billion and $1.6 billion as of April 28, 2007 and July 29, 2006, respectively. Technical support services revenue is deferred and recognized ratably over the period during which the services are to be performed, which is typically from one to three years. Advanced services revenue is recognized upon delivery or completion of performance. Our total deferred revenue for services was $4.4 billion and $4.1 billion as of April 28, 2007 and July 29, 2006, respectively.

We make sales to distributors and retail partners and recognize revenue based on a sell-through method using information provided by them. Our distributors and retail partners participate in various cooperative marketing and other programs, and we maintain estimated accruals and allowances for these programs. If actual credits received by our distributors and retail partners for these programs were to deviate significantly from our estimates, which are based on historical experience, our revenue could be adversely affected.

Allowance for Doubtful Accounts and Sales Returns

Our accounts receivable balance, net of allowance for doubtful accounts, was $3.2 billion and $3.3 billion as of April 28, 2007 and July 29, 2006, respectively. The allowance for doubtful accounts was $172 million, or 5.0% of the gross accounts receivable balance, as of April 28, 2007, and $175 million, or 5.0% of the gross accounts receivable balance, as of July 29, 2006. The allowance is based on our assessment of the collectibility of customer accounts. We regularly review the allowance by considering factors such as historical experience, credit quality, age of the accounts receivable balances, and current economic conditions that may affect a customer s ability to pay.

Our provision for doubtful accounts was $6 million and $22 million for the first nine months of fiscal 2007 and 2006, respectively. If a major customer s creditworthiness deteriorates, or if actual defaults are higher than our historical experience, or if other circumstances arise, our estimates of the recoverability of amounts due to us could be overstated, and additional allowances could be required, which could have an adverse impact on our revenue.

A reserve for future sales returns is established based on historical trends in product return rates. The reserve for future sales returns as of April 28, 2007 and July 29, 2006 was $85 million and $80 million, respectively, and was recorded as a reduction of our accounts receivable. If the actual future returns were to deviate from the historical data on which the reserve had been established, our revenue could be adversely affected.

Inventory Valuation and Liability for Purchase Commitments with Contract Manufacturers and Suppliers

Our inventory balance was $1.3 billion and $1.4 billion as of April 28, 2007 and July 29, 2006, respectively. The valuation of inventory requires us to write down inventory based on excess and obsolete inventories determined primarily by future demand forecasts. Inventory write-downs are measured as the difference between the cost of the inventory and market based upon assumptions about future demand and are charged to the provision for inventory, which is a component of our cost of sales. At the point of the loss recognition, a new, lower cost basis for that inventory is established, and subsequent changes in facts and circumstances do not result in the restoration or increase in that newly established cost basis.

In addition, we record a liability for firm, noncancelable, and unconditional purchase commitments with contract manufacturers and suppliers for quantities in excess of our future demand forecasts consistent with the valuation of our inventory. As of April 28, 2007, the liability for these purchase commitments was $161 million, compared to $148 million as of July 29, 2006, and was included in other accrued liabilities. In the third quarter of fiscal 2006, we began the initial implementation of the lean manufacturing model. Lean manufacturing is an industry-standard model that seeks to drive efficiency and flexibility in manufacturing processes and in the broader supply chain. We expect to complete our implementation of the lean manufacturing model in early fiscal 2008.

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Our total provision for inventory was $173 million and $125 million for the first nine months of fiscal 2007 and 2006, respectively. The amount recorded to cost of sales for purchase commitments was $24 million and $47 million for the first nine months of fiscal 2007 and 2006, respectively. If there were to be a sudden and significant decrease in demand for our products, or if there were a higher incidence of inventory obsolescence because of rapidly changing technology and customer requirements, we could be required to increase our inventory write-downs and our liability for purchase commitments, and our gross margin could be adversely affected. Inventory and supply chain management remains an area of focus as we balance the need to maintain supply chain flexibility to ensure competitive lead times with the risk of inventory obsolescence.

Warranty Costs

The liability for product warranties, included in other accrued liabilities, was $338 million as of April 28, 2007, compared to $309 million as of July 29, 2006. See Note 8 to the Consolidated Financial Statements. Our products are generally covered by a warranty for periods ranging from 90 days to five years, and for some products we provide a limited lifetime warranty. We accrue for warranty costs as part of our cost of sales based on associated material costs, technical support labor costs, and associated overhead. Material cost is estimated based primarily upon historical trends in the volume of product returns within the warranty period and the cost to repair or replace the equipment. Technical support labor cost is estimated based primarily upon historical trends in the rate of customer cases and the cost to support the customer cases within the warranty period. Overhead cost is applied based on estimated time to support warranty activities.

The provision for product warranties issued during the first nine months of fiscal 2007 and 2006 was $370 million and $283 million, respectively. The increase in the provision for product warranties was due to higher warranty claims related to higher shipment volume of our products. If we experience an increase in warranty claims compared with our historical experience, or if the cost of servicing warranty claims is greater than the expectations on which the accrual has been based, our gross margin could be adversely affected.

Share-Based Compensation Expense

On July 31, 2005, we adopted SFAS 123(R) which requires the measurement and recognition of compensation expense for all share-based payment awards made to our employees and directors including employee stock options, employee stock purchases, and employee restricted stock and restricted stock units, based on estimated fair values. Share-based compensation expense recognized under SFAS 123(R) was as follows (in millions):

	Three Months Ended		Nine Months Ended	
	April 28, 2007	April 29, 2006	April 28, 2007	April 29, 2006
Employee share-based compensation expense	$ 237			