F5 NETWORKS INC
Form 10-Q
August 08, 2013

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

FORM 10-Q

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

For the quarterly period ended June 30, 2013

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 000-26041

F5 NETWORKS, INC.
(Exact name of registrant as specified in its charter)

WASHINGTON	91-1714307
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

401 Elliott Avenue West
Seattle, Washington 98119
(Address of principal executive offices and zip code)
(206) 272-5555
(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 þ No ¨

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes þ No ¨

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer	þ	Accelerated filer	¨
Non-accelerated filer	¨ (Do not check if a smaller reporting company)	Smaller reporting company	¨

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

The number of shares outstanding of the registrant's common stock as of August 2, 2013 was 78,303,641.

Table of Contents

F5 NETWORKS, INC.
QUARTERLY REPORT ON FORM 10-Q
For the Quarter Ended June 30, 2013
Table of Contents

Table of Contents

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements
F5 NETWORKS, INC.
CONSOLIDATED BALANCE SHEETS
(unaudited, in thousands)

	June 30, 2013	September 30, 2012
ASSETS		
Current assets		
Cash and cash equivalents	$198,280	$211,181
Short-term investments	353,045	320,970
Accounts receivable, net of allowances of $3,094 and $3,254	205,138	185,172
Inventories	18,260	17,410
Deferred tax assets	10,617	10,362
Other current assets	48,969	30,986
Total current assets	834,309	776,081
Property and equipment, net	63,720	59,604
Long-term investments	714,331	662,803
Deferred tax assets	33,085	35,478
Goodwill	447,799	348,239
Other assets, net	54,559	28,996
Total assets	$2,147,803	$1,911,201
LIABILITIES AND SHAREHOLDERS’ EQUITY		
Current liabilities		
Accounts payable	$28,691	$27,026
Accrued liabilities	89,780	86,409
Deferred revenue	411,477	352,594
Total current liabilities	529,948	466,029
Other long-term liabilities	21,391	21,078
Deferred revenue, long-term	108,278	94,694
Total long-term liabilities	129,669	115,772
Commitments and contingencies (Note 5)		
Shareholders’ equity		
Preferred stock, no par value; 10,000 shares authorized, no shares outstanding	—	—
Common stock, no par value; 200,000 shares authorized, 78,305 and 78,715 shares issued and outstanding	290,143	326,922
Accumulated other comprehensive loss	(9,347)	(3,829)
Retained earnings	1,207,390	1,006,307
Total shareholders’ equity	1,488,186	1,329,400
Total liabilities and shareholders’ equity	$2,147,803	$1,911,201

The accompanying notes are an integral part of these consolidated financial statements.

Table of Contents

F5 NETWORKS, INC.
CONSOLIDATED INCOME STATEMENTS
(unaudited, in thousands, except per share data)

	Three months ended June 30,		Nine months ended June 30,	
	2013	2012	2013	2012
Net revenues				
Products	$196,746	$207,118	$586,565	$608,837
Services	173,556	145,516	499,420	405,851
Total	370,302	352,634	1,085,985	1,014,688
Cost of net revenues				
Products	32,350	34,482	93,915	101,350
Services	32,567	25,805	92,189	72,137
Total	64,917	60,287	186,104	173,487
Gross profit	305,385	292,347	899,881	841,201
Operating expenses				
Sales and marketing	121,906	112,064	363,205	329,297
Research and development	54,075	46,985	155,150	129,675
General and administrative	25,327	23,298	75,889	67,760
Total	201,308	182,347	594,244	526,732
Income from operations	104,077	110,000	305,637	314,469
Other income, net	2,874	1,713	6,542	5,002
Income before income taxes	106,951	111,713	312,179	319,471
Provision for income taxes	38,773	39,377	111,096	112,002
Net income	$68,178	$72,336	$201,083	$207,469
Net income per share — basic	$0.87	$0.91	$2.56	$2.62
Weighted average shares — basic	78,516	79,135	78,636	79,188
Net income per share — diluted	$0.86	$0.91	$2.54	$2.60
Weighted average shares — diluted	78,864	79,655	79,207	79,834

The accompanying notes are an integral part of these consolidated financial statements.

Table of Contents

F5 NETWORKS, INC.
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(unaudited, in thousands)

	Three months ended June 30,		Nine months ended June 30,	
	2013	2012	2013	2012
Net income	$68,178	$72,336	$201,083	$207,469
Other comprehensive income:				
Foreign currency translation adjustment	(1,728)	(287)	(3,220)	(460)
Unrealized (loss) gain on securities, net of tax	(1,710)	516	(2,297)	1,049
Total other comprehensive (loss) income	(3,438)	229	(5,517)	589
Comprehensive income	$64,740	$72,565	$195,566	$208,058

The accompanying notes are an integral part of these consolidated financial statements.

Table of Contents

F5 NETWORKS, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS
(unaudited, in thousands)

	Nine months ended June 30, 2013	2012
Operating activities		
Net income	$201,083	$207,469
Adjustments to reconcile net income to net cash provided by operating activities:		
Realized (gain) loss on disposition of assets and investments	(190)	552
Stock-based compensation	82,181	69,005
Provisions for doubtful accounts and sales returns	584	1,061
Depreciation and amortization	29,705	24,987
Deferred income taxes	(3,601)	(1,057)
Changes in operating assets and liabilities, net of amounts acquired:		
Accounts receivable	(20,550)	(28,229)
Inventories	(850)	111
Other current assets	(18,069)	(13,852)
Other assets	1,517	(244)
Accounts payable and accrued liabilities	7,420	(3,089)
Deferred revenue	72,468	90,168
Net cash provided by operating activities	351,698	346,882
Investing activities		
Purchases of investments	(744,557)	(780,493)
Maturities of investments	509,381	584,085
Sales of investments	138,171	76,444
Increase in restricted cash	(713)	(30)
Acquisition of intangible assets	—	(250)
Acquisition of businesses, net of cash acquired	(124,918)	(128,335)
Purchases of property and equipment	(21,434)	(18,544)
Net cash used in investing activities	(244,070)	(267,123)
Financing activities		
Excess tax benefit from stock-based compensation	3,656	9,426
Proceeds from the exercise of stock options and purchases of stock under employee stock purchase plan	29,405	24,942
Repurchase of common stock	(150,000)	(134,776)
Net cash used in financing activities	(116,939)	(100,408)
Net decrease in cash and cash equivalents	(9,311)	(20,649)
Effect of exchange rate changes on cash and cash equivalents	(3,590)	(528)
Cash and cash equivalents, beginning of period	211,181	216,784
Cash and cash equivalents, end of period	$198,280	$195,607

The accompanying notes are an integral part of these consolidated financial statements.

F5 NETWORKS, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (unaudited)
1. Summary of Significant Accounting Policies
Description of Business
F5 Networks, Inc. (the "Company") provides products and services to help companies manage their Internet Protocol (IP) traffic and file storage infrastructure efficiently and securely. The Company's application delivery networking products improve the performance, availability and security of servers and other network resources. Internet traffic between network-based applications and clients passes through these devices where the content is inspected to ensure that it is safe and modified as necessary to ensure that it is delivered securely and in a way that optimizes the performance of both the network and the applications. The Company's principal products are application delivery controllers that include the BIG-IP family of appliances and a line of scalable VIPRION systems. The Company's recently acquired line of Diameter signaling and routing products enable full connectivity, enhanced scalability, and comprehensive control of signaling traffic in service providers' evolving packet core networks. The Company's storage virtualization products simplify and reduce the cost of managing files and file storage devices, and ensure fast, secure, easy access to files for users and applications. In February 2013, the Company acquired LineRate Systems, Inc., a developer of software defined network services technology. The Company also offers a broad range of services that include consulting, training, maintenance and other technical support services.
Basis of Presentation
The year-end condensed consolidated balance sheet data was derived from audited financial statements, but does not include all disclosures required by accounting principles generally accepted in the United States of America. In the opinion of management, the unaudited consolidated financial statements reflect all adjustments, consisting only of normal recurring adjustments, necessary for their fair statement in conformity with accounting principles generally accepted in the United States of America. Certain information and footnote disclosures normally included in annual financial statements have been condensed or omitted in accordance with the rules and regulations of the Securities and Exchange Commission. The information included in this Form 10-Q should be read in conjunction with Management's Discussion and Analysis of Financial Condition and Results of Operations and financial statements and notes thereto included in the Company's Annual Report on Form 10-K for the fiscal year ended September 30, 2012.
Certain prior year amounts, specifically relating to cash flows in connection with the disposition of investments, have been reclassified from sales of investments to maturities of investments to conform to the current year presentation in the Consolidated Statement of Cash Flows. There was no change to the net cash used in investing activities as a result of this reclassification. This reclassification did not affect total revenue, operating income or net income.
Revenue Recognition
The Company sells products through distributors, resellers, and directly to end users. Revenue is recognized provided that all of the following criteria have been met:

- Persuasive evidence of an arrangement exists. Evidence of an arrangement generally consists of a purchase order issued pursuant to the terms and conditions of a distributor, reseller or end user agreement.
- Delivery has occurred. The Company uses shipping or related documents, or written evidence of customer acceptance, when applicable, to verify delivery or completion of any performance terms.
- The sales price is fixed or determinable. The Company assesses whether the sales price is fixed or determinable based on payment terms associated with the transaction and whether the sales price is subject to refund or adjustment.
- Collectability is reasonably assured. The Company assesses collectability primarily based on the creditworthiness of the customer as determined by credit checks and related analysis, as well as the Customer's payment history.

Revenue from the sale of products is generally recognized when the product has been shipped and the customer is obligated to pay for the product. When rights of return are present and the Company cannot estimate returns, revenue is recognized when such rights of return lapse. In certain regions where the Company does not have the ability to reasonably estimate returns, the Company defers revenue on sales to its distributors until information is received from the channel partner indicating that the product has been sold to the end-user customer. Payment terms to domestic customers are generally net 30 days to net 45 days. Payment terms to international customers range from net 30 days to net 120 days based on normal and customary trade practices in the individual markets. The Company offers extended payment terms to certain customers, in which case, revenue is recognized when payments are due.

7

Table of Contents

Revenues for post-contract customer support (PCS) are recognized on a straight-line basis over the service contract term. PCS includes a limited period of telephone support, updates, repair or replacement of any failed product or component that fails during the term of the agreement, bug fixes and rights to upgrades, when and if available. Consulting services are customarily billed at fixed hourly rates, plus out-of-pocket expenses, and revenues are recognized when the consulting has been completed. Training revenue is recognized when the training has been completed.

Arrangement consideration is first allocated between software (consisting of nonessential and stand-alone software) and non-software deliverables. The majority of the Company's products are hardware appliances which contain software essential to the overall functionality of the products. Hardware appliances are generally sold with PCS and on occasion, with consulting and/or training services. Arrangement consideration in such multiple element transactions is allocated to each element based on a fair value hierarchy, where the selling price for an element is based on vendor specific objective evidence (VSOE), if available, third-party evidence (TPE), if available and VSOE is not available; or the best estimate of selling price (BESP), if neither VSOE or TPE is available.

For software deliverables, the Company allocates revenue between multiple elements based on software revenue recognition guidance. Software revenue recognition guidance requires revenue earned on software arrangements involving multiple elements to be allocated to each element based on the relative fair values of those elements. The fair value of an element must be based on VSOE. Where fair value of delivered elements is not available, revenue is recognized on the "residual method" based on the fair value of undelivered elements. If evidence of fair value of one or more undelivered elements does not exist, all revenue is deferred and recognized at the earlier of the delivery of those elements or the establishment of fair value of the remaining undelivered elements.

The Company establishes VSOE for its products, PCS, consulting and training services based on the sales price charged for each element when sold separately. The sales price is discounted from the applicable list price based on various factors including the type of customer, volume of sales, geographic region and program level. The Company's list prices are generally not fair value as discounts may be given based on the factors enumerated above. The Company uses historical sales transactions to determine whether VSOE can be established for each of the elements. In most instances, VSOE of fair value is the sales price of actual standalone (unbundled) transactions within the past 12 month period, when a substantial majority of transactions (more than 80%) are priced within a narrow range, which the Company has determined to be plus or minus 15% of the median sales price.

The Company believes that the VSOE of fair value of training and consulting services is represented by the billable rate per hour, based on the rates charged to customers when they purchase standalone training or consulting services. The price of consulting services is not based on the type of customer, volume of sales, geographic region or program level.

The Company is typically not able to determine VSOE or TPE for its non-software products. TPE is determined based on competitor prices for similar elements when sold separately. Generally, the Company's go-to-market strategy differs from that of other competitive products or services in its markets and the Company's offerings contain a significant level of differentiation such that the comparable pricing of products with similar functionality cannot be obtained. Furthermore, the Company is unable to reliably determine the selling prices on a stand-alone basis of similar products offered by its competitors.

When the Company is unable to establish selling price using VSOE or TPE, the Company uses BESP in its allocation of arrangement consideration. The objective of BESP is to determine the price at which the Company would transact a sale if the product or service were sold on a stand-alone basis. The Company has been able to establish BESP through the list price, less a discount deemed appropriate to maintain a reasonable gross margin. Management regularly reviews the gross margin information. Non-software product BESP is determined through the Company's review of historical sales transactions within the past 12 month period. Additional factors considered in determining an appropriate BESP include, but are not limited to, cost of products, pricing practices, geographies, customer classes, and distribution channels.

The Company regularly validates the VSOE of fair value and BESP for elements in its multiple element arrangements.

The Company accounts for taxes collected from customers and remitted to governmental authorities on a net basis and excluded from revenues.

Goodwill and Acquired Intangible Assets

Goodwill represents the excess purchase price over the estimated fair value of net assets acquired as of the acquisition date. The Company tests goodwill for impairment on an annual basis and between annual tests when impairment indicators are identified, and goodwill is written down when impaired. Goodwill was recorded in connection with the acquisition of LineRate Systems, Inc. in February 2013, Traffix Systems in fiscal year 2012, Acopia Networks, Inc. in fiscal year 2007, Swan Labs, Inc. in fiscal year 2006, MagniFire Websystems, Inc. in fiscal year 2004 and uRoam, Inc. in fiscal year 2003. For its annual goodwill impairment test, the Company operates under one reporting unit and the fair value of its reporting unit is determined

Table of Contents

by the Company’s enterprise value. The Company performs its annual goodwill impairment test during the second fiscal quarter.

As part of the annual goodwill impairment test, the Company first performs a qualitative assessment to determine whether further impairment testing is necessary. If, as a result of its qualitative assessment, it is more-likely-than-not (i.e. greater than 50% chance) that the fair value of the Company’s reporting unit is less than its carrying amount, the quantitative impairment test will be required. Otherwise, no further testing will be required.

Examples of events and circumstances that might indicate that a reporting unit’s fair value is less than its carrying amount include macro-economic conditions such as deterioration in the entity’s operating environment or industry or market considerations; entity-specific events such as increasing costs, declining financial performance, or loss of key personnel; or other events such as an expectation that a reporting unit will be sold or a sustained decrease in the stock price on either an absolute basis or relative to peers.

If it is determined, as a result of the qualitative assessment, that it is more-likely-than-not that the fair value of the Company’s reporting unit is less than its carrying amount, the provisions of authoritative guidance require that the Company perform a two-step impairment test on goodwill. The first step of the test identifies whether potential impairment may have occurred, while the second step of the test measures the amount of the impairment, if any. Impairment is recognized when the carrying amount of goodwill exceeds its fair value. In March 2013, the Company completed a qualitative assessment of potential impairment indicators and concluded that it was more-likely-than-not that the fair value of its reporting unit exceeded its carrying amount.

Acquired in-process research and development (IPR&D) are intangible assets initially recognized at fair value and classified as indefinite-lived assets until the successful completion or abandonment of the associated research and development efforts. During the development period, these assets will not be amortized as charges to earnings; instead these assets will be tested for impairment on an annual basis or more frequently if impairment indicators are identified. IPR&D was recorded in connection with the acquisition of LineRate Systems, Inc. in February 2013.

Stock-Based Compensation

The Company accounts for stock-based compensation using the straight-line attribution method for recognizing compensation expense. The Company recognized $27.9 million and $23.5 million of stock-based compensation expense for the three months ended June 30, 2013 and 2012, respectively, and $82.2 million and $69.0 million for the nine months ended June 30, 2013 and 2012, respectively. As of June 30, 2013, there was $100.8 million of total unrecognized stock-based compensation cost, the majority of which will be recognized over the next two years. Going forward, stock-based compensation expenses may increase as the Company issues additional equity-based awards to continue to attract and retain key employees.

The Company issues incentive awards to its employees through stock-based compensation consisting of restricted stock units (RSUs). The value of RSUs is determined using the fair value method, which in this case, is based on the number of shares granted and the quoted price of the Company’s common stock on the date of grant.

The Company recognizes compensation expense for only the portion of restricted stock units that are expected to vest. Therefore, the Company applies estimated forfeiture rates that are derived from historical employee termination behavior. Based on historical differences with forfeitures of stock-based awards granted to the Company’s executive officers and Board of Directors versus grants awarded to all other employees, the Company has developed separate forfeiture expectations for these two groups. The Company’s estimated forfeiture rate in the third quarter of fiscal year 2013 is 5.8% for grants awarded to the Company’s executive officers and Board of Directors, and 7.9% for grants awarded to all other employees. If the actual number of forfeitures differs from those estimated by management, additional adjustments to compensation expense may be required in future periods.

In November 2012, the Company granted 290,415 RSUs to certain current executive officers as part of the annual equity awards program. Fifty percent of the aggregate number of RSUs vest in equal quarterly increments over four years, until such portion of the grant is fully vested on November 1, 2016. One-eighth of the RSU grant, or a portion thereof, is subject to the Company achieving specified quarterly revenue and EBITDA goals during fiscal year 2013. In each case, 50% of the quarterly performance stock grant is based on achieving at least 80% of the quarterly revenue goal and the other 50% is based on achieving at least 80% of the quarterly EBITDA goal. The quarterly performance stock grant is paid linearly above 80% of the targeted goals. At least 100% of both goals must be attained in order for the quarterly performance stock grant to be awarded over 100%. Each goal is evaluated individually and subject to the 80% achievement threshold and 100% over-achievement threshold. The remaining 37.5% of this annual equity awards RSU grant shall be subject to quarterly performance based vesting

9

for fiscal years 2014, 2015 and 2016 (12.5% in each period). The Compensation Committee of the Board of Directors will set applicable performance targets and vesting formulas for each of these periods.

In November 2011, as part of the annual review of executive compensation by the Compensation Committee of the Board of Directors and a change in the grant date for the Company's annual equity awards program for the executive officers from August 1 to November 1, the Company granted 82,968 RSUs to certain current executive officers. Fifty percent of the aggregate number of RSUs vest in equal quarterly increments over three years, until such portion of the grant is fully vested on November 1, 2014. One-sixth of the RSU grant, or a portion thereof, was subject to the Company achieving specified quarterly revenue and EBITDA goals during fiscal year 2012. The remaining 33.33% of this annual equity awards RSU grant shall be subject to quarterly performance based vesting for fiscal years 2013 and 2014 (16.66% in each period). The Compensation Committee of the Board of Directors will set applicable performance targets and vesting formulas for each of these periods.

In August 2011, the Company granted 170,390 RSUs to certain current executive officers as part of the annual equity awards program. Fifty percent of the aggregate number of RSUs granted as part of the annual equity awards program vest in equal quarterly increments over three years, until such portion of the grant is fully vested on August 1, 2014. One-sixth of the annual equity awards RSU grant, or a portion thereof, was subject to the Company achieving specified quarterly revenue and EBITDA goals during the period beginning in the fourth quarter of fiscal year 2011 through the third quarter of fiscal year 2012. The remaining 33.33% of this annual equity awards RSU grant shall be subject to performance based vesting for each of the four quarter periods beginning with the fourth quarters of fiscal years 2012 and 2013 (16.66% in each period). The Compensation Committee of the Board of Directors will set applicable performance targets and vesting formulas for each of these periods.

In August 2010, the Company granted 181,334 and 83,000 RSUs to certain current executive officers as part of the annual equity and retention awards programs, respectively. Fifty percent of the aggregate number of RSUs granted as part of the annual equity awards program vest in equal quarterly increments over three years, until such portion of the grant is fully vested on August 1, 2013.

The Company recognizes compensation costs for awards with performance conditions when it concludes it is probable that the performance condition will be achieved. The Company reassesses the probability of vesting at each balance sheet date and adjusts compensation costs based on the probability assessment.

Common Stock Repurchase

On April 24, 2013, the Company announced that its Board of Directors authorized an additional $200 million for its common stock share repurchase program. This new authorization is incremental to the existing $600 million program, initially approved in October 2010 and expanded in August 2011 and October 2011. Acquisitions for the share repurchase programs will be made from time to time in private transactions or open market purchases as permitted by securities laws and other legal requirements. The programs can be terminated at any time. As of August 2, 2013, the Company had repurchased and retired 10,919,493 shares at an average price of $70.68 per share and the Company had $227.8 million remaining to purchase shares as part of its repurchase programs.

Earnings Per Share

Basic net income per share is computed by dividing net income by the weighted average number of common shares outstanding during the period. Diluted net income per share is computed by dividing net income by the weighted average number of common and dilutive common stock equivalent shares outstanding during the period. The Company's nonvested restricted stock awards and restricted stock units do not have nonforfeitable rights to dividends or dividend equivalents and are not considered participating securities that should be included in the computation of earnings per share under the two-class method.

Table of Contents

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

	Three months ended June 30,		Nine months ended June 30,	
	2013	2012	2013	2012
Numerator				
Net income	$68,178	$72,336	$201,083	$207,469
Denominator				
Weighted average shares outstanding — basic	78,516	79,135	78,636	79,188
Dilutive effect of common shares from stock options and restricted stock units	348	520	571	646
Weighted average shares outstanding — diluted	78,864	79,655	79,207	79,834
Basic net income per share	$0.87	$0.91	$2.56	$2.62
Diluted net income per share	$0.86	$0.91	$2.54	$2.60

An immaterial amount of common shares potentially issuable from stock options for the three and nine months ended June 30, 2013 and 2012, are excluded from the calculation of diluted earnings per share because the exercise price was greater than the average market price of common stock for the respective period.

Comprehensive Income

Comprehensive income includes certain changes in equity that are excluded from net income. Specifically, unrealized gains or losses on securities and foreign currency translation adjustments are included in accumulated other comprehensive loss.

Recent Accounting Pronouncements

In February 2013, the FASB issued ASU 2013-2, Comprehensive Income (Topic 220): Reporting of Amounts Reclassified out of Accumulated Other Comprehensive Income (ASU 2013-2), to improve the reporting of reclassifications out of accumulated other comprehensive income. ASU 2013-2 requires presentation, either on the face of the financial statements or in the notes, of amounts reclassified out of accumulated other comprehensive income by component and by net income line item. ASU 2013-2 is effective prospectively for fiscal years, and interim periods within those years, beginning after December 15, 2012. The Company will adopt ASU 2013-2 in the first quarter of fiscal 2014 and does not expect the adoption of this standard to have an impact on its consolidated financial statements.

2. Fair Value Measurements

In accordance with the authoritative guidance on fair value measurements and disclosure under GAAP, the Company determines fair value using a fair value hierarchy that distinguishes between market participant assumptions developed based on market data obtained from sources independent of the reporting entity, and the reporting entity's own assumptions about market participant assumptions developed based on the best information available in the circumstances and expands disclosure about fair value measurements.

Fair value is the price that would be received to sell an asset or paid to transfer a liability in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants at the measurement date, essentially the exit price.

The levels of fair value hierarchy are:

Level 1: Quoted prices in active markets for identical assets and liabilities at the measurement date that the Company has the ability to access.

Level 2: Observable inputs other than quoted prices included in Level 1, such as quoted prices for similar assets and liabilities in active markets; quoted prices for identical or similar assets and liabilities in markets that are not active; or other inputs that are observable or can be corroborated by observable market data.

Level 3: Unobservable inputs for which there is little or no market data available. These inputs reflect management's assumptions of what market participants would use in pricing the asset or liability.

11

Table of Contents

Level 1 investments are valued based on quoted market prices in active markets and include the Company's cash equivalent investments. Level 2 investments, which include investments that are valued based on quoted prices in markets that are not active, broker or dealer quotations, actual trade data, benchmark yields or alternative pricing sources with reasonable levels of price transparency, include the Company's certificates of deposit, corporate bonds and notes, municipal bonds and notes, U.S. government securities and U.S. government agency securities. Fair values for the Company's level 2 investments are based on similar assets without applying significant judgments. In addition, all of the Company's level 2 investments have a sufficient level of trading volume to demonstrate that the fair values used are appropriate for these investments.

A financial instrument's level within the fair value hierarchy is based upon the lowest level of any input that is significant to the fair value measurement. However, the determination of what constitutes "observable" requires significant judgment by the Company. The Company considers observable data to be market data which is readily available, regularly distributed or updated, reliable and verifiable, not proprietary, and provided by independent sources that are actively involved in the relevant market.

The Company's financial assets measured at fair value on a recurring basis subject to the disclosure requirements at June 30, 2013, were as follows (in thousands):

	Fair Value Measurements at Reporting Date Using			
	Quoted Prices in Active Markets for Identical Securities (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Fair Value at June 30, 2013
Cash equivalents	$26,263	$ —	$ —	$26,263
Short-term investments				
Available-for-sale securities — corporate bonds and notes	—	155,174	—	155,174
Available-for-sale securities — municipal bonds and notes	—	63,861	—	63,861
Available-for-sale securities — U.S. government securities	—	4,998	—	4,998
Available-for-sale securities — U.S. government agency securities	—	129,012	—	129,012
Long-term investments				
Available-for-sale securities — corporate bonds and notes	—	230,509	—	230,509
Available-for-sale securities — municipal bonds and notes	—	29,050	—	29,050
Available-for-sale securities — U.S. government securities	—	12,358	—	12,358
Available-for-sale securities — U.S. government agency securities	—	438,366	—	438,366
Available-for-sale securities — auction rate securities	—	—	4,048	4,048
Total	$26,263	$ 1,063,328	$ 4,048	$1,093,639

Table of Contents

The Company’s financial assets measured at fair value on a recurring basis subject to the disclosure requirements at September 30, 2012, were as follows (in thousands):

	Fair Value Measurements at Reporting Date Using			
	Quoted Prices in Active Markets for Identical Securities (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Fair Value at September 30, 2012
Cash equivalents	$35,658	$ —	$ —	$ 35,658
Short-term investments				
Available-for-sale securities — certificates of deposit	—	3,533	—	3,533
Available-for-sale securities — corporate bonds and notes	—	193,990	—	193,990
Available-for-sale securities — municipal bonds and notes	—	63,422		63,422
Available-for-sale securities — U.S. government agency securities	—	60,025	—	60,025
Long-term investments				
Available-for-sale securities — corporate bonds and notes	—	229,441	—	229,441
Available-for-sale securities — municipal bonds and notes	—	30,307	—	30,307
Available-for-sale securities — U.S. government securities	—	4,995	—	4,995
Available-for-sale securities — U.S. government agency securities	—	393,310	—	393,310
Available-for-sale securities — auction rate securities	—	—	4,750	4,750
Total	$35,658	$ 979,023	$ 4,750	$ 1,019,431

Due to the auction failures of the Company’s auction rate securities (ARS) that began in the second quarter of fiscal year 2008, there are still no quoted prices in active markets for similar assets as of June 30, 2013. Therefore, the Company has classified its ARS as level 3 financial assets. The following table provides a reconciliation between the beginning and ending balances of items measured at fair value on a recurring basis in the table above that used significant unobservable inputs (Level 3) (in thousands):

	Three months ended June 30,		Nine months ended June 30,	
	2013	2012	2013	2012
Balance, beginning of period	$4,048	$13,193	$4,750	$13,010
Total gains (losses) realized or unrealized:				
Included in other comprehensive income	—	914	(102)	1,097
Settlements	—	(5,000)	(600)	(5,000)
Balance, end of period	$4,048	$9,107	$4,048	$9,107
Unrealized gains (losses) attributable to assets still held as of end of period	—	914	(102)	1,097

Financial assets are considered Level 3 when their fair values are determined using pricing models, discounted cash flow methodologies or similar techniques and at least one significant model assumption or input is unobservable or there is limited market activity such that the determination of fair value requires significant judgment or estimation. Level 3 investment securities primarily include certain ARS for which there was a decrease in the observation of market pricing. At June 30, 2013, the values of these securities were estimated primarily using discounted cash flow analysis that incorporated transaction details such as contractual terms, maturity, timing and amount of future cash flows, as well as assumptions about liquidity and credit valuation adjustments of marketplace participants at June 30, 2013. Significant fluctuations in any of these inputs in isolation would result in changes in the fair value of the Company's ARS.

The Company uses the fair value hierarchy for financial assets and liabilities. The Company's non-financial assets and liabilities, which include goodwill, intangible assets, and long-lived assets, are not required to be carried at fair value on a recurring basis. These non-financial assets and liabilities are measured at fair value on a non-recurring basis when there is an indicator of impairment, and they are recorded at fair value only when impairment is recognized. The Company reviews goodwill and intangible assets for impairment annually, during the second quarter of each fiscal year, or as circumstances indicate the possibility of impairment. The Company monitors the carrying value of long-lived assets for impairment whenever

Table of Contents

events or changes in circumstances indicate its carrying amount may not be recoverable. During the three months ended June 30, 2013, the Company did not recognize any impairment charges related to goodwill, intangible assets, or long-lived assets.

3. Short-Term and Long-Term Investments

Short-term investments consist of the following (in thousands):

June 30, 2013	Cost or Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Corporate bonds and notes	$154,949	$274	$(49)	$155,174
Municipal bonds and notes	63,795	71	(5)	63,861
U.S. government securities	4,997	1	—	4,998
U.S. government agency securities	129,008	29	(25)	129,012
	$352,749	$375	$(79)	$353,045

September 30, 2012	Cost or Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Certificates of deposit	$3,528	$5	$—	$3,533
Corporate bonds and notes	193,548	482	(40)	193,990
Municipal bonds and notes	63,371	61	(10)	63,422
U.S. government agency securities	60,010	15	—	60,025
	$320,457	$563	$(50)	$320,970

Long-term investments consist of the following (in thousands):

June 30, 2013	Cost or Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Corporate bonds and notes	$231,182	$231	$(904)	$230,509
Municipal bonds and notes	29,049	33	(32)	29,050
Auction rate securities	4,400	—	(352)	4,048
U.S. government securities	12,348	10	—	12,358
U.S. government agency securities	439,537	102	(1,273)	438,366
	$716,516	$376	$(2,561)	$714,331

September 30, 2012	Cost or Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Corporate bonds and notes	$228,438	$1,063	$(60)	$229,441
Municipal bonds and notes	30,177	138	(8)	30,307
Auction rate securities	5,000	—	(250)	4,750
U.S. government securities	4,983	12	—	4,995
U.S. government agency securities	392,959	389	(38	