

F5 NETWORKS INC  
Form 10-Q/A  
December 13, 2006

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**UNITED STATES SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549  
FORM 10-Q/A**

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

**For the quarterly period ended March 31, 2006**

**OR**

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

**For the transition period from \_\_\_\_\_ to \_\_\_\_\_**

**Commission File Number 000-26041**

**F5 NETWORKS, INC.**

(Exact name of registrant as specified in its charter)

**WASHINGTON**

(State or other jurisdiction of  
incorporation or organization)

**91-1714307**

(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  No

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

Large accelerated filer  Accelerated filer  Non-accelerated filer

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

The number of shares outstanding of the registrant's common stock as of May 5, 2006 was 40,547,825.

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**EXPLANATION OF AMENDMENT**

We are amending our Quarterly Report on Form 10-Q for the quarter ended March 31, 2006 filed on May 9, 2006 (the Original Report ) to restate our condensed consolidated financial statements for the quarters ended March 31, 2006 and 2005 and the related disclosures.

The restatement (the Restatement ) of the Original Report reflected in this Quarterly Report on Form 10-Q/A for the quarter ended March 31, 2006 this Amendment includes adjustments arising from the determinations of a Special Committee of our Board of Directors, consisting of independent members of our Board of Directors, which was formed by our Board of Directors to conduct an internal investigation into our past stock option practices.

For more information on these matters, please refer to Item 2, Management s Discussion and Analysis of Financial Condition and Results of Operations Restatement of Consolidated Financial Statements, Special Committee and Company Findings, Internal Controls, Remedial Measures and Related Proceedings, Note 2, Restatement of Previously Issued Financial Statements, of the Notes to the Consolidated Financial Statements, and Item 4, Controls and Procedures.

As a result of the findings of the Special Committee as well as our own internal review, we concluded that we needed to amend our Annual Report on Form 10-K/A No. 1 for the year ended September 30, 2005, originally filed on December 15, 2005 and amended by our Annual Report on Form 10-K/A No. 2, which was filed on December 12, 2006 to restate our consolidated financial statements for the years ended September 30, 2005, 2004 and 2003 and the related disclosures as well as Management s Report on Internal Control Over Financial Reporting as of September 30, 2005.

We have not amended and we do not intend to amend any of our other previously filed annual reports on Form 10-K or quarterly reports on Form 10-Q for the periods affected by the Restatement or adjustments other than (i) this Amendment, (ii) the amended Quarterly Report on Form 10-Q/A for the quarter ended December 31, 2005 and (iii) the amended Annual Report on Form 10-K/A No. 2 for the year ended September 30, 2005. For this reason, the condensed consolidated financial statements and related financial information contained in such previously filed reports should no longer be relied upon. Except for the sections of this Amendment entitled Restatement of Consolidated Financial Statements, Special Committee and Company Findings, Internal Controls, Remedial Measures and Related Proceedings and Risk Factors that May Affect Future Results (included in Item 2, Management s Discussion and Analysis of Financial Condition and Results of Operations ), Note 2 and 6 of the Notes to the Consolidated Financial Statements, and Item 4, Controls and Procedures, all of the information in this Amendment is as of March 31, 2006 and does not reflect events occurring after the Original Report, other than the restatement, or modify or update disclosures (including, except for the updated Exhibits 31.1, 31.2 and 32.1 described below, the exhibits to the Original Report) affected by subsequent events.

For the convenience of the reader, this Amendment sets forth the Original Report in its entirety, as amended by, and to reflect, the Restatement. The following items have been amended principally as a result of, and to reflect, the Restatement, and no other information in the Original Report is amended hereby as a result of the Restatement:

- Part I Item 1 Unaudited Financial Statements;
- Part I Item 2 Management s Discussion and Analysis of Financial Condition and Results of Operations and Risk Factors;
- Part I Item 4 Controls and Procedures;
- Part II-Item 1 Legal Proceedings
- Part II Item 6 Exhibits

This Amendment should be read in conjunction with our amended Annual Report on Form 10-K/A No.2 for the year ended September 30, 2005, as well as any Current Reports filed on Form 8-K subsequent to the date of the Original Report. In addition, in accordance with applicable SEC rules, this Amendment includes updated certifications from our Chief Executive Officer (CEO) and Chief Accounting Officer (CAO) as Exhibits 31.1, 31.2 and 32.1

**F5 NETWORKS, INC.**  
**QUARTERLY REPORT ON FORM 10-Q**  
**For the Quarter Ended March 31, 2006**  
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**F5 NETWORKS, INC.**  
**CONSOLIDATED BALANCE SHEETS**  
(unaudited, in thousands)

	<b>March 31, 2006 (as restated)(1)</b>	<b>September 30, 2005 (as restated)(1)</b>
<b>ASSETS</b>		
Current assets		
Cash and cash equivalents	\$ 23,003	\$ 51,867
Short-term investments	321,003	184,314
Accounts receivable, net of allowances of \$2,309 and \$2,969	51,953	41,703
Inventories	3,024	2,699
Deferred tax assets	4,182	4,175
Other current assets	12,266	9,906
Total current assets	415,431	294,664
Restricted cash	3,870	3,871
Property and equipment, net	23,669	16,158
Long-term investments	76,009	128,834
Deferred tax assets	19,682	36,212
Goodwill	81,652	49,677
Other assets, net	16,674	8,323
Total assets	\$ 636,987	\$ 537,739
<b>LIABILITIES AND SHAREHOLDERS EQUITY</b>		
Current liabilities		
Accounts payable	\$ 14,605	\$ 7,668
Accrued liabilities	27,325	23,931
Deferred revenue	44,256	36,009
Total current liabilities	86,186	67,608
Other long-term liabilities	7,580	6,650
Deferred revenue, long-term	3,650	3,314
Total long-term liabilities	11,230	9,964
Commitments and contingencies		
Shareholders' equity		
Preferred stock, no par value; 10,000 shares authorized, no shares outstanding	480,267	431,897

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Common stock, no par value; 100,000 shares authorized, 40,388 and 38,593 shares issued and outstanding		
Accumulated other comprehensive loss	(1,684)	(1,430)
Retained earnings	60,988	29,700
Total shareholders' equity	539,571	460,167
Total liabilities and shareholders' equity	\$ 636,987	\$ 537,739

(1) See Note 2,  
Restatement of  
Previously  
Issued Financial  
Statements, of  
the Notes to  
Consolidated  
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Statements

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

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

	Three months ended March 31,		Six months ended March 31,	
	2006	2005 (as restated)(1)	2006	2005 (as restated)(1)
Net revenues				
Products	\$ 72,775	\$ 53,332	\$ 141,366	\$ 99,729
Services	21,341	14,398	40,837	28,010
Total	94,116	67,730	182,203	127,739
Cost of net revenues				
Products	15,441	11,822	30,034	22,352
Services	5,846	3,915	10,820	7,310
Total	21,287	15,737	40,854	29,662
Gross profit	72,829	51,993	141,349	98,077
Operating expenses				
Sales and marketing	31,162	20,988	60,027	41,072
Research and development	12,276	7,834	22,754	14,866
General and administrative	7,148	6,341	14,545	11,832
Total	50,586	35,163	97,326	67,770
Income from operations	22,243	16,830	44,023	30,307
Other income, net	3,877	1,641	6,847	3,028
Income before income taxes	26,120	18,471	50,870	33,335
Provision for income taxes	10,053	7,507	19,582	14,033
Net income	\$ 16,067	\$ 10,964	\$ 31,288	\$ 19,302
Net income per share basic	\$ 0.40	\$ 0.30	\$ 0.79	\$ 0.53
Weighted average shares basic	40,120	36,905	39,636	36,234
Net income per share diluted	\$ 0.39	\$ 0.28	\$ 0.76	\$ 0.50
Weighted average shares diluted	41,627	38,939	41,278	38,419

(1) See Note 2,  
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**F5 NETWORKS, INC.**  
**CONSOLIDATED STATEMENT OF SHAREHOLDERS EQUITY**  
(unaudited, in thousands)

	Six Months Ended March 31, 2006				
	Common Stock		Accumulated Other	Retained	Total
	Shares	Amount	Comprehensive Loss	Earnings	Shareholders Equity
<b>Balance, September 30, 2005</b>	38,593	\$ 412,419	\$ (1,430)	\$ 53,221	\$ 464,210
Cumulative effect of restatement (Note 2)		19,478		(23,521)	(4,043)
<b>Balance, September 30, 2005 (as restated)(1)</b>	38,593	431,897	(1,430)	29,700	460,167
Exercise of employee stock options	1,570	35,298			35,298
Issuance of stock under employee stock purchase plan	62	2,229			2,229
Issuance of restricted stock	163				
Stock based compensation		10,843			10,843
Net income				31,288	
Foreign currency translation adjustment			(20)		
Unrealized loss on securities			(234)		
Comprehensive income					31,034
<b>Balance, March 31, 2006 (as restated)(1)</b>	40,388	\$ 480,267	\$ (1,684)	\$ 60,988	\$ 539,571

(1) See Note 2,  
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**F5 NETWORKS, INC.**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**  
(unaudited, in thousands)

	<b>Six months ended</b>	
	<b>March 31,</b>	
	<b>2006</b>	<b>2005</b>
		<b>(as</b>
		<b>restated)(1)</b>
<b>Operating activities</b>		
Net income	\$ 31,288	\$ 19,302
Adjustments to reconcile net income to net cash provided by operating activities:		
Loss on disposition of assets	37	38
Stock based compensation	10,843	690
Provisions for doubtful accounts and sales returns	(397)	547
Depreciation and amortization	5,017	3,261
Deferred income taxes	18,973	(12,264)
Tax benefit from employee stock option plans		24,240
Changes in operating assets and liabilities, net of amounts acquired:		
Accounts receivable	(9,560)	(12,703)
Inventories	(258)	(398)
Other current assets	(1,736)	(1,218)
Other assets	(1,392)	(120)
Accounts payable and accrued liabilities	8,923	5,279
Deferred revenue	8,353	4,414
Net cash provided by operating activities	70,091	31,068
<b>Investing activities</b>		
Purchases of investments	(240,444)	(198,264)
Sales of investments	156,222	122,726
Investment of restricted cash	2	29
Acquisition of business, net of cash acquired	(42,778)	(395)
Purchases of property and equipment	(9,047)	(3,491)
Net cash used in investing activities	(136,045)	(79,395)
<b>Financing activities</b>		
Proceeds from the exercise of stock options and purchases of stock under employee stock purchase plan	37,077	45,125
Net cash provided by financing activities	37,077	45,125
Net decrease in cash and cash equivalents	(28,877)	(3,202)
Effect of exchange rate changes on cash and cash equivalents	13	93
Cash and cash equivalents, beginning of period	51,867	24,901
Cash and cash equivalents, end of period	\$ 23,003	\$ 21,792

- (1) See Note 2,  
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**Table of Contents****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 efficiently and securely manage their Internet Protocol (IP) traffic. The Company's products improve the performance, availability and security of applications running on Internet-based networks. Internet traffic between servers running applications and clients using these applications passes through the Company's products 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 also offers a broad range of services such as consulting, training, installation, maintenance, and other technical support services.

**Acquisition**

On October 4, 2005, the Company acquired all of the capital stock of Swan Labs, Inc. (Swan Labs), a privately held Delaware corporation headquartered in San Jose, California for \$43.0 million in cash. The Company also incurred \$3.2 million of direct transaction costs for a total purchase price of approximately \$46.2 million. Swan Labs provides WAN (Wide Area Network) optimization and application acceleration products and services. The addition of Swan Labs is intended to allow the Company to quickly enter the WAN optimization market, broaden the Company's customer base, and augment the Company's existing product line. Refer to Note 5, Business Combinations, for additional information related to the acquisition.

**Basis of Presentation**

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, 2005.

**Revenue Recognition**

The Company's products are integrated with software that is essential to the functionality of the equipment. Accordingly, the Company recognizes revenue in accordance with the guidance provided under Statement of Position (SOP) No. 97-2, Software Revenue Recognition, and SOP No. 98-9 Modification of SOP No. 97-2, Software Revenue Recognition, with Respect to Certain Transactions, Statement of Financial Accounting Standards (SFAS) No. 48, Revenue Recognition When Right of Return Exists, and SEC Staff Accounting Bulletin (SAB) No. 104, Revenue Recognition.

The Company sells products through distributors, resellers, and directly to end users. The Company recognizes product revenue upon shipment, net of estimated returns, provided that collection is determined to be probable and no significant obligations remain. In certain regions where the Company does not have the ability to reasonably estimate returns, the Company defers revenue on sales to our distributors until it has received information from the channel partner indicating that the distributor has sold the product to its customer. Payment terms to domestic customers are generally net 45 days. Payment terms to international customers range from net 30 to 90 days based on normal and customary trade practices in the individual markets. The Company has offered extended payment terms ranging from three to six months to certain customers, in which case, revenue is recognized when payments are received.

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Whenever a software license, hardware, installation and post-contract customer support ( PCS ), elements are sold together, a portion of the sales price is allocated to each element based on their respective fair values as determined when the individual elements are sold separately. Revenues from the license of software are recognized when the software has been shipped and the customer is obligated to pay for the software. When rights of return are present and the Company cannot estimate returns, it recognizes revenue when such rights of return lapse. Revenues for PCS are recognized on a straight-line basis over the service contract term. PCS includes rights to upgrades, when and if available, a limited period of telephone support, updates, and bug fixes. Installation revenue is recognized when the product has been installed at the customer's site. Consulting services are customarily billed at fixed 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.

**Goodwill**

Goodwill represents the excess purchase price over the estimated fair value of net assets acquired as of the acquisition date. The Company has adopted the requirements of SFAS No. 142, *Goodwill and Other Intangible Assets* (SFAS No. 142). SFAS No. 142 requires goodwill to be tested for impairment on an annual basis and between annual tests in certain circumstances, and written down when impaired. Goodwill of \$24.2 million was recorded in connection with the acquisition of uRoam, Inc. in fiscal year 2003, goodwill of \$25.5 million was recorded in connection with the acquisition of MagniFire Websystems Inc. in fiscal year 2004 and goodwill of \$32.0 million was recorded in connection with the acquisition of Swan Labs, Inc in first fiscal quarter 2006. The Company completes its annual impairment test in the second quarter of each fiscal year and when events or conditions indicate that impairment may have occurred. There was no impairment of goodwill during the three months ended March 31, 2006 and 2005, respectively.

**Stock-Based Compensation**

On July 1, 2005, the Company adopted the fair value recognition provisions of Financial Accounting Standards Board ( FASB ) Statement No. 123(R), *Share-Based Payment*, ( FAS 123R ). Prior to July 1, 2005, the Company accounted for share-based payments under the recognition and measurement provisions of APB Opinion No. 25, *Accounting for Stock Issued to Employees* ( APB 25 ), and related Interpretations, as permitted by FASB Statement No. 123, *Accounting for Stock-Based Compensation* ( FAS 123 ). In accordance with APB 25 no compensation cost was required to be recognized for options granted that had an exercise price equal to the market value of the underlying common stock on the date of grant.

The Company adopted FAS 123R using the modified-prospective-transition method. Accordingly, compensation cost recognized for the three month and six month periods ended March 31, 2006 include: a) compensation cost for all share-based payments granted prior to, but not yet vested as of July 1, 2005, based on the grant-date fair value estimated in accordance with the original provisions of FAS 123, and b) compensation cost for all share-based payments granted subsequent to July 1, 2005, based on the grant-date fair value estimated in accordance with the provisions of FAS 123R. The results for the prior periods have not been restated.

Effective July 1, 2005, the Company adopted the straight-line attribution method for recognizing compensation expense. Previously under the disclosure-only provisions of FAS 123, the Company used the accelerated method of expense recognition pursuant to FASB Interpretation No. 28, *Accounting for Stock Appreciation Rights and Other Variable Stock Option or Award Plans* ( FIN 28 ). For all unvested options outstanding as of July 1, 2005, the previously measured but unrecognized compensation expense, based on the fair value at the original grant date, will be recognized on an accelerated basis over the remaining vesting period. For share-based payments granted subsequent to July 1, 2005, compensation expense, based on the fair value on the date of grant, will be recognized on a straight-line basis over the vesting period.

The fair value of restricted stock units is based on the price of a share of our common stock on the date of grant. In determining the fair value of stock options, the Company uses the Black-Scholes option pricing model which is affected by its stock price as well as assumptions regarding a number of highly complex and subjective variables. These variables include, but are not limited to the risk free interest rate; the Company's expected stock price volatility over the term of the option and actual and projected employee stock option exercise behaviors.

The risk-free rate is based on the U.S. Treasury yield curve in effect at the time of grant. The Company does not anticipate declaring dividends in the foreseeable future. Expected volatility is based on the annualized daily historical volatility of our stock price commensurate with the expected life of the option. For the period ended March 31, 2006, the expected term of the option is based on the vesting terms of the option and a contractual life of ten years using the simplified method calculation as defined by Staff Accounting Bulletin 107. For the period ended March 31, 2005, the expected term of the option is based on an evaluation of the historical employee stock option exercise behavior, the vesting terms of the respective option and a contractual life of ten years. The Company's stock price volatility and option lives involve management's best estimates at that time, both of which impact the fair

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value of the option calculated under the Black- Scholes methodology and, ultimately, the expense that will be recognized over the life of the option. FAS 123R also requires that the Company recognize compensation expense for only the portion of options or stock units that are expected to vest. Therefore, the Company applies an estimated forfeiture rate that is derived from historical employee termination behavior. The estimated forfeiture rate in the second quarter of fiscal year 2006 is 5%. If the actual number of forfeitures differs from those estimated by management, additional adjustments to compensation expense may be required in future periods.

The following table shows the pro forma effect on the Company's net income and net income per share for the three months and six months ended March 31, 2005, had compensation expense been determined based upon the fair value at the grant date for awards consistent with the methodology prescribed by FAS 123. Stock-based compensation for the three months and six months ended March 31, 2006 has been included in statements of income. The pro forma effect may not be representative of expense in future periods since the estimated fair value of stock options on the date of grant is amortized to expense over the vesting period, and additional options may be granted or options may be cancelled in future years (in thousands, except per share data):

	<b>Three months ended March 31, 2005 (as restated)(1)</b>	<b>Six months ended March 31, 2005 (as restated)(1)</b>
Net income, as reported	\$ 10,964	\$ 19,302
Add : Stock-based employee compensation expense under APB No. 25 included in reported net income, net of tax effect	168	690
Deduct : Total stock-based employee compensation expense determined under the fair value methods, net of tax effect	(2,460)	(5,298)
Pro forma net income	\$ 8,672	\$ 14,694
Net income per share:		
As reported basic	\$ 0.30	\$ 0.53
Pro forma basic	\$ 0.23	\$ 0.41
As reported diluted	\$ 0.28	\$ 0.50
Pro forma diluted	\$ 0.22	\$ 0.38

(1) See Note 2,  
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**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.

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

	Three months ended March 31,		Six months ended March 31,	
	2006	2005 (as restated)(1)	2006	2005 (as restated)(1)
<b>Numerator</b>				
Net income	\$ 16,067	\$ 10,964	\$ 31,288	\$ 19,302
<b>Denominator</b>				
Weighted average shares outstanding basic	40,120	36,905	39,636	36,234
Dilutive effect of common shares from stock options and restricted stock units	1,507	2,034	1,642	2,185
Weighted average shares outstanding diluted	41,627	38,939	41,278	38,419
Basic net income per share	\$ 0.40	\$ 0.30	\$ 0.79	\$ 0.53
Diluted net income per share	\$ 0.39	\$ 0.28	\$ 0.76	\$ 0.50

(1) See Note 2, Restatement of Previously Issued Financial Statements, of the Notes to Consolidated Financial Statements

Approximately 117,000 and 319,000 of common shares potentially issuable from stock options for the three months ended March 31, 2006 and 2005, respectively, are excluded from the calculation of diluted earnings per share because the exercise price was greater than the average market price of the common stock for the respective period. Approximately 246,000 and 422,000 of common shares potentially issuable from stock options for the six months ended March 31, 2006 and 2005, respectively, are excluded from the calculation of diluted earnings per share because the exercise price was greater than the average market price of the common stock for the respective period.



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On May 16, 2006, the Center for Financial Research and Analysis ( CFRA ) issued a report entitled Options Backdating, Which Companies Are At Risk? (the CFRA Report ) in which CFRA reviewed the option prices of 100 public companies and, based upon an analysis of the exercise prices of option grants with reference to the companies stock prices, concluded that 17% of the subject companies were, in CFRA s view, at risk for having backdated option grants during the period 1997 to 2002. The Company was among the 17 companies so identified.

On May 18, 2006, the Company was contacted by the Securities and Exchange Commission ( SEC ) as part of an informal inquiry entitled *In the Matter of F5 Networks, Inc.*, (SEC File No. MHO-10462). On May 19, 2006, the Company received a grand jury subpoena issued by the U.S. District Court for the Eastern District of New York requesting documents related to the granting of stock options from 1995 through the present in connection with an inquiry into the Company s stock option practices by the United States Attorney s Office for the Eastern District of New York (the Department of Justice ). The Company voluntarily produced documents in response to these requests and is continuing to cooperate fully with the SEC regarding these inquiries.

On May 22, 2006, the Company s Board of Directors (the Board of Directors ) formed a special committee of outside directors with broad authority to conduct a review of the Company s stock option practices, including a review of the Company s underlying stock option documentation and procedures (the Special Committee ). At that time, the Special Committee was composed of three members of the Board of Directors, one of which was also on the Audit Committee, Karl Guelich, Rich Malone and Gary Ames. In July 2006, the Special Committee was reconstituted to consist of two independent members of the Board of Directors, Gary Ames and Deborah Bevier (who joined the Company s Board of Directors on July 14, 2006). The Special Committee retained the law firm of Wilson Sonsini Goodrich & Rosati P.C. ( Wilson Sonsini ) as its independent outside legal counsel. Wilson Sonsini engaged Deloitte Financial Advisory Services LLP as independent accounting experts to aid in its investigation.

In the course of responding to the SEC and the Department of Justice s inquiries, the Company determined that there were potential problems with the accounting treatment of certain stock option grants. On July 20, 2006, the Company announced that the Audit Committee of the Board of Directors (the Audit Committee ) had determined, after consultation with management, that the Company s financial statements and all earnings releases and similar communications relating to fiscal periods beginning on or after October 1, 2000, the first day of its fiscal year 2001, should no longer be relied upon.

In October 2006, the Special Committee determined that the recorded grant dates for certain stock options granted during fiscal years 1999 through 2004 should not be relied upon as the measurement date for accounting purposes and that the accounting treatment used for the vesting of certain stock options was incorrect. Because the prices at the originally stated grant dates were lower than the prices on the actual measurement dates, the Company determined it should have recognized material amounts of stock-based compensation expense which were not accounted for in the Company s previously issued financial statements. Therefore, the Audit Committee after consultation with management concluded that the Company s previously filed unaudited interim and audited financial statement for the years ended September 30, 2005, 2004, 2003, 2002, 2001, 2000 and 1999 as well as the unaudited interim financial statements for the first and second quarters ended December 31, 2005 and March 31, 2006, should no longer be relied upon because these financial statements contained material misstatements and would need to be restated.

***Special Committee and Company Findings***

On November 8, 2006, the Company announced that the Special Committee had completed its review of the Company s stock option practices and reported its final findings to the Board of Directors.

The Special Committee concluded that there were options grants where the Company (i) used improper measurement dates in connection with certain annual stock option grants to employees because the number of shares certain individual employees were entitled to receive was not determined until after the original grant date, (ii) granted options to certain new employees and board members prior to their start dates, (iii) did not have sufficient documentation to support certain measurement dates and did not obtain the required approvals for stock options issued to certain individuals, (iv) did not properly account for stock option grants issued to a consultant who later became an employee, and (v) did not properly account for stock options of certain individuals that were modified after the grant date. Based on its investigations, the Special Committee concluded that it continued to have confidence in the ability

of the Company's current senior management to serve in their positions with integrity at the Company. The Special Committee was unable to reach any conclusions regarding the intent of former officers, directors and employees. Based on the Special Committee's findings, the Company has adopted and is implementing a number of remedial measures designed to improve its policies, controls, processes and procedures relating to the granting and modification of stock-based compensation and will provide additional training for personnel responsible for administration of the Company's equity compensation plans.

As a result of the Special Committee's investigation, as well as the Company's internal review of its stock option practices and historical financial statements, the Company has determined the following:

*Improper Measurement Dates for Annual Stock Option Grants.* In connection with the Company's annual stock option grants to certain employees in 2000, 2001, 2003 and 2004, the number of shares that certain individual employees were entitled to receive was not determined until after the original grant date, and therefore the measurement date for such options was subsequent to the original grant date. In addition, in connection with the Company's annual stock option grant to employees in 2000, the exercise price was not set in accordance with APB Opinion No. 25, *Accounting for Stock Issued to Employees*

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( APB 25 ) and related interpretations. As a result, the Company has restated its historical financial statements to increase stock-based compensation expense by approximately \$14.3 million recognized over the applicable vesting periods.

*Improper Measurement Dates for Other Stock Option.* Certain options to new employees and board members were granted on dates other than their respective start date with us. As a result, the Company has restated its historical financial statements to increase stock-based compensation expense by approximately \$1.3 million recognized over the applicable vesting periods.

*Incomplete Documentation or Approval for Stock Option Grants.* In 2000 and 2001 the Company did not have sufficient documentation to support certain measurement dates and did not obtain the required approvals for stock options issued to certain individuals. As a result, the Company has restated its historical financial statements to increase stock-based compensation expense by approximately \$4.6 million recognized over the applicable vesting periods.

*Stock Options Grants to Non-employees.* In 2000, the Company did not properly account for stock option grants issued to a consultant who later became an employee. The Company erroneously accounted for the grant in accordance with APB No. 25 rather than FASB Statement No. 123, *Accounting for Stock-Based Compensation* ( FAS 123 ) and related interpretations. As a result, the Company has restated its historical financial statements to increase stock-based compensation expense by approximately \$3.0 million.

*Modifications to Stock Option Grants.* From 1999 through 2002, the Company did not properly account for stock options for certain individuals that were modified after the grant date. Some of these modifications were not identified in the Company's financial reporting processes and were therefore not properly reflected in its financial statements. As a result, the Company has restated its historical financial statements to increase stock-based compensation expense by approximately \$843,000 recognized as of the date of the respective modifications.

As a result of the above, the Company has recorded additional non-cash stock-based compensation expense of approximately \$24.1 million on stock option grants made from 1999 through 2004. In addition, the Company recorded approximately \$1.7 million of additional compensation expense in 2005 related to its obligation under pre-existing commitments to reimburse employees for penalties incurred resulting from receipt of in-the-money option grants. Tax impacts of these additional expenses include; a reclassification of windfall tax benefits of \$4.8 million which were previously recognized in paid-in-capital and now are required to be recognized as a tax benefit and additional tax expenses resulting from non-deductible employee compensation of \$2.5 million, which together result in a net benefit of \$2.3 million.

As a result of these findings the Company's restated consolidated financial statements reflect a decrease in net income of approximately \$23.5 million for the periods 1999 through 2005. These charges had no impact on the Company's reported net sales or cash and cash equivalents.

The cumulative effect of the restatement adjustments on the Company's consolidated balance sheet at September 30, 2005 resulted in a decrease in retained earnings of \$23.5 million partially offset an increase in additional paid-in capital of \$19.5 million, which results in a net decrease in total shareholders' equity of \$4.0 million. All of the restatements of financial statements, financial data and related disclosures described in these Consolidated Financial Statements are collectively referred to elsewhere in these Consolidated Financial Statements as the restatement.

For explanatory purposes, the Company has classified the stock-based compensation and other adjustments that were affected by the restatement into the aforementioned categories as presented below. The classified amounts involve certain subjective judgments by management to the extent particular stock option related accounting errors may fall within more than one category to avoid double counting the adjustment amounts between categories (e.g., a stock option that is subject to date changes and/or combined with expenses resulting from consulting, transition or

advisory roles). As such, the table below should be considered a reasonable representation of the magnitude of expenses in each category.

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<b>Adjustments to Stock Based Compensation by Category</b>	<b>Years Ended September 30,</b> <b>(in thousands)</b>			<b>Cumulative effect 1999-2002</b>
	<b>2005</b>	<b>2004</b>	<b>2003</b>	
Improper measurement dates for annual stock option grants	\$ 464	\$ 719	\$ 1,407	\$ 11,717
Modifications to stock option grants	335	356	152	
Incomplete documentation or approval for stock option grants				4,625
Improper measurement dates for other stock option grants	34	107	272	904
Stock option grants to non-employees				2,988
Total adjustment to income before income taxes	833	1,182	1,831	20,234
Payroll related liabilities	1,700			
Total adjustments to net income	2,533	1,182	1,831	20,234
Income tax impact of restatement adjustments	2,298	(4,557)		
Total adjustments to net income	\$ 4,831	\$ (3,375)	\$ 1,831	\$ 20,234

The following tables set forth the effects of the restatement on certain line items within the Company's consolidated statements of operations for the three and six months ended March 31, 2005, and the consolidated balance sheets as of March 31, 2006 and September 30, 2005 (in thousands):

	<b>Three months ended March 31, 2005</b>	<b>Six months ended March 31, 2005</b>
<b>Consolidated Statement of Operations:</b>		
Cost of revenues product		
As previously reported	\$ 11,820	\$ 22,348
As restated	\$ 11,822	\$ 22,352
Cost of revenues services		
As previously reported	\$ 3,908	\$ 7,294
As restated	\$ 3,915	\$ 7,310
Gross Profit		
As previously reported	\$ 52,002	\$ 98,097
As restated	\$ 51,993	\$ 98,077
Sales and marketing		
As previously reported	\$ 20,885	\$ 40,525
As restated	\$ 20,988	\$ 41,072
Research and development		
As previously reported	\$ 7,789	\$ 14,763
As restated	\$ 7,834	\$ 14,866
General and administrative		
As previously reported	\$ 5,854	\$ 10,860
As restated	\$ 6,341	\$ 11,832
Income from operations		
As previously reported	\$ 17,474	\$ 31,949

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As restated	\$ 16,830	\$ 30,307
Income before income taxes		
As previously reported	\$ 19,115	\$ 34,977
As restated	\$ 18,471	\$ 33,335
Provision for income taxes		
As previously reported	\$ 7,003	\$ 12,872
As restated	\$ 7,507	\$ 14,033
Net income		
As previously reported	\$ 12,112	\$ 22,105
As restated	\$ 10,964	\$ 19,302
Basic net income per share		
As previously reported	\$ 0.33	\$ 0.61
As restated	\$ 0.30	\$ 0.53
Diluted net income per share		
As previously reported	\$ 0.31	\$ 0.58
As restated	\$ 0.28	\$ 0.50

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	<b>As of March 31, 2006</b>	<b>As of September 30, 2005</b>
<b>Consolidated Balance Sheet:</b>		
Deferred tax asset		
As previously reported	\$ 3,942	\$ 3,935
As restated	\$ 4,182	\$ 4,175
Accrued liabilities		
As previously reported	\$ 23,042	\$ 19,648
As restated	\$ 27,325	\$ 23,931
Common stock		
As previously reported	\$ 460,789	\$ 412,419
As restated	\$ 480,267	\$ 431,897
Retained earnings		
As previously reported	\$ 84,509	\$ 53,221
As restated	\$ 60,988	\$ 29,700
Shareholders equity		
As previously reported	\$ 543,614	\$ 464,210
As restated	\$ 539,571	\$ 460,167

These adjustments, along with the stock-based items referenced above, did not affect the Company's previously reported cash and cash equivalents and investments balances in prior periods. In addition, these adjustments had no impact on reported net cash flows from operating activities.

The following table sets forth the impact of the restatement on the pro forma effect on the Company's net income and net income per share for the quarter ended March 31, 2005, had compensation expense been determined based upon the fair value at the grant date for awards consistent with the methodology prescribed by SFAS 123 (in thousands, except per share data):

	<b>Three months ended March 31, 2005</b>	<b>Six months ended March 31, 2005</b>
Pro forma net income		
As previously reported	\$ 9,721	\$ 16,968
As restated	\$ 8,672	\$ 14,694
Pro forma net income per share basic		
As previously reported	\$ 0.26	\$ 0.47
As restated	\$ 0.23	\$ 0.41
Pro forma net income per share diluted		
As previously reported	\$ 0.25	\$ 0.44
As restated	\$ 0.22	\$ 0.38

### **3. Commitments and Contingencies**

#### **Guarantees and Product Warranties**

In the normal course of business to facilitate sales of the Company's products, the Company indemnifies other parties, including customers, resellers, lessors, and parties to other transactions with them, with respect to certain matters. The Company has agreed to hold the other party 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 the Company's 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 limited history of prior indemnification claims and the unique facts and circumstances involved in each particular agreement.

The Company generally offers warranties of one year for hardware with the option of purchasing additional warranty coverage in increments of one year. The Company accrues for warranty costs as part of its cost of sales based on associated material product costs and technical support labor costs. The following table summarizes the activity related to product warranties during the three months ended March 31, 2006 and 2005 (in thousands):

	<b>Three months ended</b>		<b>Six months ended</b>	
	<b>March 31,</b>		<b>March 31,</b>	
	<b>2006</b>	<b>2005</b>	<b>2006</b>	<b>2005</b>
Balance, beginning of period	\$ 1,575	\$ 1,062	\$ 1,565	\$ 1,062
Provision for warranties issued	320	272	700	538
Payments	(313)	(271)	(683)	(537)
Balance, end of period	\$ 1,582	\$ 1,063	\$ 1,582	\$ 1,063

### **Purchase Commitments**

The Company currently has arrangements with contract manufacturers and other suppliers for the manufacture of the Company's products. The arrangement with the primary contract manufacturer allows them to procure component inventory on the Company's behalf based on a rolling production forecast provided by the Company. The Company is obligated to the purchase of component inventory that the contract manufacturer procures in accordance with the forecast, unless they give notice of order cancellation in advance of applicable lead times. As of March 31, 2006, the Company was committed to purchase approximately \$16.3 million of such inventory during the next quarter.

### **Legal Proceedings**

*Internal Revenue Service Audit.* We received a notice from the Internal Revenue Service (the IRS) indicating the IRS would be auditing our tax returns for the 2002, 2003, and 2004. We have produced documents and other information to the IRS and are currently in discussions with the IRS to resolve all issues arising from this audit. We do not believe this audit and any settlement with the IRS will have a material adverse impact on our consolidated financial position or results of operations.



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*Derivative Suits.* On May 24, 2006, a shareholder action captioned Adams v. Amdahl et al. was filed against certain of our current and former officers and directors in the King County Superior Court in Washington. The complaint generally alleges that the defendants breached their fiduciary duties to us in connection with the granting of certain stock options. Five additional shareholder derivative complaints, based on substantially the same allegations, were subsequently filed in the Washington federal and state courts. Although litigation is subject to inherent uncertainties, we do not believe the results of these pending actions will, individually or in the aggregate, have a material adverse impact on our consolidated financial position or results of operations.

*Nasdaq Delisting.* On July 20, 2006 we announced that it would be unlikely that the Special Committee's review would be completed in time for us to file our Form 10-Q for the quarter ended June 30, 2006, by the SEC's deadline of August 14, 2006. In August 2006, we failed to timely file our Form 10-Q for the period ended June 30, 2006 as a result of the ongoing Special Committee investigation. On August 14, 2006, we received a written Staff Determination Notice from The Nasdaq Stock Market (Nasdaq) stating that we are not in compliance with Nasdaq's Marketplace Rule 4310(c)(14) because we have not timely filed our Quarterly Report on Form 10-Q for the quarter ended June 30, 2006, and that, therefore, our securities are subject to delisting. On August 18, 2006, we appealed Nasdaq's Staff's delisting determination to the Nasdaq Listings Qualification Panel (Panel) and requested an oral hearing before the Panel. On August 23, 2006, Nasdaq's Staff stayed the delisting action pending a final written decision on our appeal by the Panel. A hearing before the Panel occurred on September 22, 2006. On November 28, 2006, the Company's received notice that the Panel had granted our request for continued listing on the Nasdaq Global Market, subject to certain conditions the Company expects to satisfy within the time period requested by the Panel.

As of March 31, 2006, the Company was not aware of any other pending legal proceedings, other than that mention above that, individually or in the aggregate, would have a material adverse effect on the Company's business, operating results, or financial condition. The Company may in the future be party to litigation arising in the ordinary course of business, including claims that allegedly infringe upon third-party trademarks or other intellectual property rights. Such claims, even if not meritorious, could result in the expenditure of significant financial and managerial resources.

**4. Geographic Sales and Significant Customers**

Operating segments are defined as components of an enterprise for which separate financial information is available and evaluated regularly by the chief operating decision-maker, or decision-making group, in deciding how to allocate resources and in assessing performance. The Company is organized as, and operates in, one reportable segment: the development, marketing and selling of a comprehensive suite of application networking solutions that helps customers efficiently and securely manage application traffic on their Internet-based networks. The Company manages its business based on four geographic regions: the Americas (primarily the United States); Europe, the Middle East, and Africa (EMEA); Japan; and Asia Pacific. The Company's chief operating decision-making group reviews financial information presented on a consolidated basis accompanied by information about revenues by geographic region. The Company's foreign offices conduct sales, marketing and support activities. The Company's management evaluates performance based primarily on revenues in the geographic locations in which it operates. Revenues are attributed by geographic location based on the location of the customer. The Company's assets are primarily located in the United States and not allocated to any specific region. Therefore, geographic information is presented only for net product revenue.

The following presents revenues by geographic region (in thousands):

	<b>Three months ended</b>		<b>Six months ended</b>	
	<b>March 31,</b>		<b>March 31,</b>	
	<b>2006</b>	<b>2005</b>	<b>2006</b>	<b>2005</b>
Americas	\$ 52,549	\$ 37,479	\$ 104,754	\$ 72,676
EMEA	16,787	10,702	31,903	21,736
Japan	14,602	12,283	25,915	20,882
Asia Pacific	10,178	7,266	19,631	12,445

\$ 94,116      \$ 67,730      \$ 182,203      \$ 127,739

Net revenues from international customers are primarily denominated in U.S. dollars and totaled \$41.6 million and \$30.3 million for the three months ended March 31, 2006 and 2005, respectively, and \$77.4 and \$55.1 million for the six months ended March 31, 2006 and 2005, respectively. Two domestic distributors accounted for 24.3% and 24.4% of total net revenue for the three and six month periods ended March 31, 2006, respectively. One domestic distributor accounted for 17.8% and 16.9% of total net revenue for the three and six month periods ended March 31, 2005, respectively. One domestic distributor accounted for 10.7% and 24.8% of accounts receivable as of March 31, 2006 and 2005, respectively.

**Table of Contents****5. Business Combinations**

On October 4, 2005, the Company acquired all of the capital stock of Swan Labs, a privately held Delaware corporation headquartered in San Jose, California for \$43.0 million in cash. The Company also incurred \$3.2 million of direct transaction costs for a total purchase price of approximately \$46.2 million. As a result of the merger, the Company acquired all the assets of Swan Labs, all property, equipment and other assets that Swan Labs used in its business and assumed all the liabilities of Swan Labs. Swan Labs provides WAN (Wide Area Network) optimization and application acceleration products and services. The addition of Swan Labs is intended to allow us to quickly enter the WAN optimization market, broaden the Company's customer base, and augment the Company's existing product line. The results of operations of Swan Labs have been included in the Company's consolidated financial statements from the date of acquisition.

The Company accounted for the acquisition under the purchase method of accounting in accordance with Statement of Financial Accounting Standards No. 141, Business Combinations. The total purchase price is allocated to the tangible and intangible assets acquired and the liabilities assumed based on their estimated fair values. The excess of the purchase price over those fair values is recorded as goodwill. The fair value assigned to the tangible and intangible assets acquired and liabilities assumed are based on estimates and assumptions provided by management, and other information compiled by management, including independent valuations, prepared by valuation specialists that utilize established valuation techniques appropriate for the technology industry. In accordance with Statement of Financial Accounting Standards No. 142, Goodwill and Other Intangible Assets, goodwill is not amortized but instead is tested for impairment at least annually.

The purchase price allocation is as follows (in thousands):

**Assets acquired**

Cash	\$ 3,448
Fair value of tangible assets	1,497
Deferred tax assets, net	2,341
Developed technology and customer relationships	8,589
Goodwill	31,975
 Total assets acquired	 \$ 47,850

**Liabilities assumed**

Accrued liabilities	\$ (1,405)
Deferred revenue	(229)
 Total liabilities assumed	 (1,634)
 Net assets acquired	 \$ 46,216

Of the total estimated purchase price, \$8.0 million and \$0.6 million was allocated to developed technology and customer relationships, respectively. To determine the value of the developed technology, a combination of cost and market approaches were used. The cost approach required an estimation of the costs required to reproduce the developed technology. The market approach measures the fair value of the technology through an analysis of recent comparable transactions. To determine the value of customer relationships, the income approach was used. The income approach estimates the fair value based on the earnings and cash flow capacity of an asset. The \$8.6 million allocated to developed technology and customer relationships will be amortized on a straight-line basis over an estimated useful life of five years.

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

The statements contained below that are not purely historical are forward-looking statements within the meaning of Section 21E of the Securities Exchange Act of 1934 and Section 27A of the Securities Act of 1933. These statements include, but are not limited to, statements about our plans, objectives, expectations, strategies, intentions or other characterizations of future events or circumstances and are generally identified by the words expects, anticipates, intends, plans, believes, seeks, estimates, and similar expressions. Because these forward-looking statements are subject to a number of risks and uncertainties, our actual results could differ materially from those expressed or implied by these forward-looking statements. Factors that could cause or contribute to such differences include, but are not limited to, those discussed under the heading Risk Factors that May Affect Future Results below and in other documents we file from time to time with the Securities and Exchange Commission. All forward-looking statements set forth below are based on information available to us on the date hereof. Our business and the associated risks may have changed since the date this report was filed with the SEC. We assume no obligation to update any such forward-looking statements. Further, except for the forward-looking statements included in Item 4, Controls and Procedures and under the heading Restatement of Consolidated Financial Statements, Special Committee and Company Findings, Internal Controls, Remedial Measures and Related Proceedings and Risk Factors that May Affect Future Results under this Item 2, all forward-looking statements contained in this Amendment, unless they are specifically otherwise stated to be made as of a different date, are made as of May 9, 2006, the original filing date of our Quarterly Report on Form 10-Q for the quarter ended March 31, 2005. In addition, except for the sections of this Amendment entitled Restatement of Consolidated Financial Statements, Special Committee and Company Findings, Internal Controls, Remedial Measures and Related Proceedings and Risk Factors that May Affect Future Results (included in this Item 2), Item 4, Controls and Procedures, and Note 2 and Note 6 of the Notes to Condensed Consolidated Financial Statements, this Amendment does not reflect events occurring after the filing of our Quarterly Report on Form 10-Q filed on May 9, 2006, other than the Restatement, and we undertake no obligation to update the forward-looking statements in this Amendment.

The discussion and analysis set forth below in this Item 2 has been amended to reflect the restatement as described above in the Explanation of Amendment to this Amendment and in Note 2, Restatement of Previously Issued Financial Statements, to the Notes to Consolidated Financial Statements. For this reason, the data set forth in this section may not be comparable to discussions and data in our previously filed Quarterly Reports.

**Restatement of Consolidated Financial Statements, Special Committee and Company Findings, Internal Controls, Remedial Measures and Related Proceedings*****Restatement of Consolidated Financial Statements***

On May 16, 2006, the Center for Financial Research and Analysis (CFRA) issued a report entitled Options Backdating, Which Companies Are At Risk? (the CFRA Report) in which CFRA reviewed the option prices of 100 public companies and, based upon an analysis of the exercise prices of option grants with reference to the companies stock prices, concluded that 17% of the subject

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companies were, in CFRA's view, at risk for having backdated option grants during the period 1997 to 2002. We were among the 17 companies so identified.

On May 18, 2006, we were contacted by the Securities and Exchange Commission (SEC) as part of an informal inquiry entitled *In the Matter of F5 Networks, Inc.* (SEC File No. MHO-10462). On May 19, 2006, we received a grand jury subpoena issued by the U.S. District Court for the Eastern District of New York requesting documents related to the granting of stock options from 1995 through the present in connection with an inquiry into our stock option practices by the United States Attorney's Office for the Eastern District of New York (the Department of Justice). We produced documents in response to these requests and are continuing to cooperate fully with the SEC regarding these inquiries.

On May 22, 2006, our Board of Directors formed a special committee of outside directors with broad authority to conduct a review of our stock option practices, including a review of our underlying stock option documentation and procedures (the Special Committee). The Special Committee was originally composed of three members of our Board of Directors, one of which was also on the Audit Committee, Karl Guelich, Rich Malone and Gary Ames. In July 2006, the Special Committee was reconstituted to consist of two independent members of our Board of Directors, Gary Ames and Deborah Bevier (who joined our Board of Directors on July 14, 2006). The Special Committee retained the law firm of Wilson Sonsini Goodrich & Rosati P.C. (Wilson Sonsini) as its independent outside legal counsel. Wilson Sonsini engaged Deloitte Financial Advisory Services LLP as independent accounting experts to aid in its investigation.

In the course of responding to the SEC and the Department of Justice's inquiries, we determined that there were potential problems with the accounting treatment of certain stock option grants. On July 20, 2006, we announced that the Audit Committee of our Board of Directors (the Audit Committee) had determined, after consultation with management, that our financial statements and all earnings releases and similar communications relating to fiscal periods beginning on or after October 1, 2000, the first day of our fiscal year 2001, should be restated.

In October 2006, the Special Committee determined that the recorded grant dates for certain stock options granted during fiscal years 1999 through 2004 should not be relied upon as the measurement date for accounting purposes and that the accounting treatment used for the vesting of certain stock options was incorrect. Because the prices at the originally stated grant dates were lower than the prices on the actual dates of determination, we determined we should have recognized material amounts of stock-based compensation expense which were not accounted for in our previously issued financial statements. Therefore, the Audit Committee after consultation with management, concluded that our previously filed unaudited interim and audited financial statement for the years ended September 30, 2005, 2004, 2003, 2002, 2001, 2000 and 1999, as well as the unaudited interim financial statements for the quarters ended December 31, 2005 and March 31, 2006, should be restated relied upon because these financial statements contained material misstatements and would need to be restated.

***Special Committee and Company Findings***

On November 8, 2006, we announced that the Special Committee had completed its review of our stock option practices and reported its final findings to our Board of Directors.

The Special Committee concluded that there were options where the Company (i) used improper measurement dates in connection with certain annual stock option grants to employees because the number of shares certain individual employees were entitled to receive was not determined until after the original grant date, (ii) granted options to certain new employees and board members prior to their start dates, (iii) did not have sufficient documentation to support certain measurement dates and did not obtain the necessary approvals for stock options issued to certain individuals, (iv) did not properly account for stock option grants issued to a consultant who later became an employee, and (v) did not properly account for stock options of certain individuals that were modified after the grant date. Based on its investigation, the Special Committee concluded that it continued to have confidence in the ability of the Company's current senior management to serve in their positions with integrity at the Company. The Special Committee was unable to reach any conclusions regarding the intent of former officers, directors and employees. Based on the Special Committee's findings, the Company has adopted and is implementing a number of remedial measures designed to improve its policies, controls, processes and procedures relating to the granting and modification of stock-based compensation and will provide additional training for personnel responsible for administration of the

Company's equity compensation plans.

As a result of the Special Committee's investigation, as well as our internal review of our stock option practices and historical financial statements, we have determined the following:

*Improper Measurement Dates for Annual Stock Option Grants.* In connection with our annual stock option grants to some employees in 2000, 2001, 2003 and 2004, the number of shares that certain individual employees were entitled to receive was not determined until after the original grant date, and therefore the measurement date for such options was subsequent to the original grant date. In addition, in connection with our annual stock option grant to employees in 2000, the exercise price was not set in accordance with APB Opinion No. 25, *Accounting for Stock Issued to Employees* ( APB 25 ) and related interpretations. As a result, we have restated our historical financial statements to increase stock-based compensation expense by approximately \$14.3 million recognized over the applicable vesting periods.

*Improper Measurement Dates for Other Stock Option Grants.* Certain options to new employees and board members were granted on dates other than their respective start date with us. As a result, we have restated our historical financial statements to increase stock-based compensation expense by approximately \$1.3 million recognized over the applicable vesting periods.

*Incomplete Documentation or Approval for Stock Option Grants.* In 2000 and 2001, we did not have sufficient documentation to support certain measurement dates and did not obtain the required approvals for stock options issued to certain individuals. As a result, we have restated

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our historical financial statements to increase stock-based compensation expense by approximately \$4.6 million recognized over the applicable vesting periods.

*Stock Options Grants to Non-employees.* In 2000, we did not properly account for stock option grants issued to a consultant who later became an employee. We accounted for the grants in accordance with APB No. 25 rather than FASB Statement No. 123, *Accounting for Stock-Based Compensation* ( FAS 123 ) and related interpretations. As a result, we have restated our historical financial statements to increase stock-based compensation expense by approximately \$3.0 million.

*Modifications to Stock Option Grants.* From 1999 through 2002, we did not properly account for stock options for certain individuals that were modified after the grant date. Some of these modifications were not identified in our financial reporting processes and were therefore not properly reflected in our financial statements. As a result, we have restated our historical financial statements to increase stock-based compensation expense by approximately \$843,000 recognized as of the date of the respective modifications.

As a result of the above, we have recorded additional non-cash stock-based compensation expense of approximately \$24.1 million on stock option grants made from 1999 through 2004. In addition, the Company recorded approximately \$1.7 million of additional compensation expense in 2005 related to its obligation under pre-existing commitments to reimburse employees for penalties incurred resulting from receipt of in-the-money option grants. As a result of the previously mentioned Restatement, additional tax related expenses include; a reclassification of windfall tax benefits of \$4.8 million which were previously recognized in paid-in-capital and now are required to be recognized as a tax benefit and additional tax expenses resulting from non-deductible employee compensation of \$2.5 million which resulted in a net benefit of \$2.3 million.

As a result of these findings our restated consolidated financial statements reflect a decrease in net income of approximately \$23.5 million for the periods 1999 through 2005. These charges had no impact on our reported net sales or cash and cash equivalents.

The cumulative effect of the restatement adjustments on our consolidated balance sheet at September 30, 2005 resulted in a decrease in retained earnings of \$23.5 million partially offset by an increase in additional paid-in capital of \$19.5 million, which results in a net decrease in total shareholders' equity of \$4.0 million.

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### ***Internal Controls***

Based on the definition of material weakness in the Public Company Accounting Oversight Board's Auditing Standard No. 2, An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements, the restatement of financial statements in prior filings with the SEC is a strong indicator of the existence of a material weakness in the design or operation of internal control over financial reporting. Based on this definition, management has concluded the issues identified above resulted in a material weakness in our internal control over financial reporting for stock-based compensation as of September 30, 2005 and has disclosed this to the Audit Committee and to our independent registered public accountants. A further discussion of this material weakness, as well as management's remedial measures regarding this material weakness, is set forth in Item 4, Controls and Procedures.

### ***Remedial Measures***

In connection with the conclusion of its review, the Special Committee recommended that our Board of Directors, and its compensation and audit committees, consider and adopt certain additional remedial measures related to the issues raised in the Special Committee's investigation, including:

A best practices review and evaluation of our equity compensation controls, processes and procedures;

A best practices review and evaluation of our controls, process and procedures for documentation of corporate actions, including drafting and finalizing minutes, unanimous written consents and other similar corporate documentation;

The adoption of a policy requiring that all equity compensation awards to the board members, officers and employees be granted and priced according to a predetermined schedule; and

The implementation of a cross-functional training program for certain key employees concerning (i) our equity compensation programs and related improvements to equity compensation controls, processes and procedures; (ii) the accounting implications of our equity compensation programs; and (iii) the legal implications our equity compensation programs.

In addition, at the recommendation of the Special Committee, we have identified and hired an interim general counsel to replace our previous general counsel, who has tendered her resignation.

Management along with our Board of Directors has implemented, or is in the process of implementing, such remedial measures.

### ***Related Proceedings***

*Internal Revenue Service Audit.* We received a notice from the Internal Revenue Service (the IRS) indicating the IRS would be auditing our tax returns for the 2002, 2003, and 2004. We have produced documents and other information to the IRS and are currently in discussions with the IRS to resolve all issues arising from this audit. We do not believe this audit and any settlement with the IRS will have a material adverse impact on our consolidated financial position or results of operations.

*Derivative Suits.* On May 24, 2006, a shareholder action captioned Adams v. Amdahl et al. was filed against certain of our current and former officers and directors in the King County Superior Court in Washington. The complaint generally alleges that the defendants breached their fiduciary duties to us in connection with the granting of certain stock options. Five additional shareholder derivative complaints, based on substantially the same allegations, were subsequently filed in the Washington federal and state courts. Although litigation is subject to inherent uncertainties, we do not believe the results of these pending actions will, individually or in the aggregate, have a material adverse impact on our consolidated financial position or results of operations.

*Nasdaq Delisting.* On July 20, 2006 we announced that it would be unlikely that the Special Committee's review would be completed in time for us to file our Form 10-Q for the quarter ended June 30, 2006, by the SEC's deadline of August 14, 2006. In August 2006, we failed to timely file our Form 10-Q for the period ended June 30, 2006 as a result of the ongoing Special Committee investigation. On August 14, 2006, we received a written Staff Determination Notice from Nasdaq stating that we are not in compliance with Nasdaq's Marketplace Rule 4310(c)(14) because we



have not timely filed our Quarterly Report on Form 10-Q for the quarter ended June 30, 2006, and that, therefore, our securities are subject to delisting. On August 18, 2006, we appealed Nasdaq's Staff's delisting determination to the Panel and requested an oral hearing before the Panel. On August 23, 2006, Nasdaq's Staff stayed the delisting action pending a final written decision on our appeal by the Panel. A hearing before the Panel occurred on September 22, 2006. On November 28, 2006, we received notice that the Panel had granted our request for continued listing on the Nasdaq Stock Market, subject to certain conditions we expect to satisfy within the time period requested by the Panel.

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There is no assurance that we will not be subject to inquiries related to our stock option grant practices by other federal, state or foreign regulatory agencies.

*Cost of Related Proceedings and Restated Financial Statements.* We have incurred substantial expenses for legal, accounting, tax and other professional services in connection with the Special Committee investigation, our internal review of our historical stock option practices and financial statements, the preparation of the restated financial statements, the SEC and Department of Justice investigation and inquiries from other government agencies, and the related derivative litigation. We estimate these expenses were approximately \$7.0 million in aggregate through the quarter ended September 30, 2006.

**Overview**

We are a global provider of software and hardware products and services that help companies efficiently and securely manage their Internet traffic. Our products enhance the delivery, optimization and security of application traffic on Internet-based networks. We market and sell our products primarily through indirect sales channels in the Americas (primarily the United States); Europe, the Middle East, and Africa (EMEA); Japan; and the Asia Pacific region. Enterprise customers (Fortune 1000 or Business Week Global 1000 companies) in financial services, transportation, government and telecommunications industries continue to make up the largest percentage of our customer base.

Our management monitors and analyzes a number of key performance indicators in order to manage our business and evaluate our financial and operating performance. Those indicators include:

*Revenues.* The majority of our revenues are derived from sales of our Application Security, Application Optimization, and Application Availability platforms. We also derive revenues from the sales of services including annual maintenance contracts, installation, training and consulting services. We carefully monitor the sales mix of our revenues within each reporting period. We believe customer acceptance rates of our new products and feature enhancements are key indicators of future trends. We also consider overall revenue concentration by customer and by geographic region as additional indicators of current and future trends.

*Cost of revenues and gross margins.* We strive to control our cost of revenues and thereby maintain our gross margins. Significant items impacting cost of revenues are hardware costs paid to our contract manufacturers, third-party software license fees, amortization of developed technology, and personnel and overhead expenses. Our margins have remained relatively stable over the past two years; however factors such as sales price, product mix, inventory obsolescence, returns, component price increases, and warranty costs could significantly impact our gross margins from quarter to quarter and represent the significant indicators we monitor on a regular basis.

*Operating expenses.* Operating expenses are substantially driven by personnel and related overhead expenses. Existing headcount and future hiring plans are the predominant factors in analyzing and forecasting future operating expense trends. Other significant operating expenses that we monitor include marketing and promotions, travel, professional fees, computer costs related to the development of new products, facilities and depreciation expenses.

*Liquidity and cash flows.* Our financial condition remains strong with significant cash and investments and no long term debt. The increase in cash and investments for the first six months of fiscal year 2006 was primarily due to net income from operations, with operating activities providing cash of \$70.1 million. Going forward, we believe the primary driver of cash flows will be net income from operations. Capital expenditures for the first six months of fiscal year 2006 were comprised primarily of tenant improvements and information technology infrastructure and equipment to support the growth of our core business activities. We will continue to evaluate possible acquisitions of or investments in businesses, products, or technologies that we believe are strategic, which may require the use of cash.

*Balance sheet.* We view cash, short-term and long-term investments, deferred revenue, accounts receivable balances and day's sales outstanding as important indicators of our financial health. Deferred revenues continued to increase due to the growth in the amount of annual maintenance contracts purchased on new products and maintenance renewal contracts related to our existing product installation base. Our day's sales outstanding for the second quarter of fiscal year 2006 was 50. We expect to maintain this metric going forward.

**Table of Contents****Critical Accounting Policies and Estimates**

Our consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities. We base our estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances. Actual results may differ from these estimates under different assumptions or conditions.

We believe the following critical accounting policies affect the more significant estimates and judgments used in the preparation of our financial statements. These critical accounting policies are consistent with those disclosed in our Annual Report on Form 10-K.

*Revenue Recognition.* We recognize revenue in accordance with the guidance provided under Statement of Position ( SOP ) No. 97-2, Software Revenue Recognition, and SOP No. 98-9 Modification of SOP No. 97-2, Software Revenue Recognition, with Respect to Certain Transactions, Statement of Financial Accounting Standards ( SFAS ) No. 48, Revenue Recognition When Right of Return Exists, and SEC Staff Accounting Bulletin ( SAB ) No. 101, Revenue Recognition in Financial Statements, and SAB No. 104, Revenue Recognition.

We sell products through distributors, resellers, and directly to end users. We recognize product revenue upon shipment, net of estimated returns, provided that collection is determined to be probable and no significant obligations remain. In certain regions where we do not have the ability to reasonably estimate returns, revenue is recognized upon sale to the end user. In this situation, we receive a sales report from the channel partner to determine when the sales transaction to the end user has occurred. Payment terms to domestic customers are generally net 30 to net 45 days. Payment terms to international customers range from net 30 to net 90 days based on normal and customary trade practices in the individual markets. We have offered extended payment terms to certain customers, in which case, revenue is recognized when payments are received.

Whenever a software license, hardware, installation and post-contract customer support (PCS) elements are combined into a package with a single bundled price, a portion of the sales price is allocated to each element of the bundled package based on their respective fair values as determined when the individual elements are sold separately. Revenues from the license of software are recognized when the software has been shipped and the customer is obligated to pay for the software. When rights of return are present and we cannot estimate returns, we recognize revenue when such rights of return lapse. Revenues for PCS are recognized on a straight-line basis over the service contract term. PCS includes rights to upgrades, when and if available, a limited period of telephone support, updates, and bug fixes. Installation revenue is recognized when the product has been installed at the customer's site. Consulting services are customarily billed at fixed 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.

*Reserve for Doubtful Accounts.* Estimates are used in determining our allowance for doubtful accounts and are based upon an assessment of selected accounts and as a percentage of our remaining accounts receivable by aging category. In determining these percentages, we evaluate historical write-offs, current trends in the credit quality of our customer base, as well as changes in the credit policies. We perform ongoing credit evaluations of our customers financial condition and do not require any collateral. If there is deterioration of a major customer's credit worthiness or actual defaults are higher than our historical experience, our allowance for doubtful accounts may not be sufficient.

*Reserve for Product Returns.* In some instances, product revenue from distributors is subject to agreements allowing rights of return. Product returns are estimated based on historical experience and are recorded at the time revenues are recognized. Accordingly, we reduce recognized revenue for estimated future returns at the time revenue is recorded. When rights of return are present and we cannot estimate returns, revenue is recognized when such rights lapse. The estimates for returns are adjusted periodically based upon changes in historical rates of returns and other related factors. It is possible that these estimates will change in the future or that the actual amounts could vary from our estimates.

*Reserve for Warranties.* A warranty reserve is established based on our historical experience and an estimate of the amounts necessary to settle future and existing claims on products sold as of the balance sheet date. While we believe that our warranty reserve is adequate and that the judgment applied is appropriate, such amounts estimated to be due

and payable could differ materially from what will actually transpire in the future.

*Accounting for Income Taxes.* We utilize the liability method of accounting for income taxes as set forth by SFAS No. 109, Accounting for Income Taxes, or SFAS 109. Accordingly, we are required to estimate our income taxes in each of the jurisdictions in which we operate as part of the process of preparing our consolidated financial statements. This process involves estimating our actual current tax exposure, together with assessing temporary differences resulting from the different treatment of items for tax and

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accounting purposes in each geographic region. These differences result in deferred tax assets and liabilities. Due to the evolving nature and complexity of tax rules combined with the large number of jurisdictions in which we operate, it is possible that our estimates of our tax liability could change in the future, which may result in additional tax liabilities and adversely affect our results of operations, financial condition and cash flows.

*Stock-based Compensation.* We adopted the fair value recognition provisions of Financial Accounting Standards Board ( FASB ) Statement No. 123(R), *Share-Based Payment*, ( FAS 123R ) on July 1, 2005. We recognized \$5.2 million and \$10.1 million of expense related to stock-based compensation charges included in operating expenses for the three months and six months ended March 31, 2006, respectively. Prior to July 1, 2005, we accounted for share-based payments under the recognition and measurement provisions of APB Opinion No. 25, *Accounting for Stock Issued to Employees* ( APB 25 ), and related Interpretations, as permitted by FASB Statement No. 123, *Accounting for Stock-Based Compensation* ( FAS 123 ). In accordance with APB 25 no compensation cost was required to be recognized for options granted that had an exercise price equal to the market value of the underlying common stock on the date of grant.

We adopted FAS 123R using the modified-prospective-transition application method. Under that transition method, compensation cost recognized includes: a) compensation cost for all share-based payments granted prior to, but not yet vested as of July 1, 2005, based on the grant-date fair value estimated in accordance with the original provisions of FAS 123, and b) compensation cost for all share-based payments granted subsequent to July 1, 2005, based on the grant-date fair value estimated in accordance with the provisions of FAS 123R. The results for the prior periods have not been restated.

Effective July 1, 2005 we adopted the straight-line attribution method for recognizing compensation expense. Previously under the disclosure-only provisions of FAS 123, we used the accelerated method of expense recognition pursuant to FASB Interpretation No. 28, *Accounting for Stock Appreciation Rights and Other Variable Stock Option or Award Plans* ( FIN 28 ). For all unvested options outstanding as of July 1, 2005, the previously measured but unrecognized compensation expense, based on the fair value at the original grant date, will be recognized on an accelerated basis over the remaining vesting period. For share-based payments granted subsequent to July 1, 2005, compensation expense, based on the fair value on the date of grant, will be recognized on a straight-line basis over the vesting period. As of March 31, 2006, there was \$28.1 million of total unrecognized compensation cost, the majority of which will be recognized ratably over the next two years. Going forward, stock compensation expenses may increase as we issue additional equity-based awards to continue to attract and retain key employees.

In addition, we recently modified the method in which we issue incentive awards to our employees through stock-based compensation. In prior years, stock-based compensation consisted only of stock options. Beginning in the fourth quarter of fiscal year 2005, we began to grant restricted stock unit awards instead of stock options. The value of restricted stock units is determined by the number of shares granted and the quoted price of our common stock on the date of grant. Alternatively, in determining the fair value of stock options, we use the Black-Scholes option pricing model that employs the following key assumptions: expected volatility is based on the annualized daily historical volatility of our stock price, over the expected life of the option and; expected term of the option is based on historical employee stock option exercise behavior, the vesting terms of the respective option and a contractual life of ten years. Our stock price volatility and option lives involve management's best estimates at that time, both of which impact the fair value of the option calculated under the Black-Scholes methodology and, ultimately, the expense that will be recognized over the life of the option.

FAS 123R also requires that we recognize compensation expense for only the portion of options or stock units that are expected to vest. Therefore, we apply estimated forfeiture rates that are derived from historical employee termination behavior. Our estimated forfeiture rate in the second quarter of fiscal year 2006 is 5%. If the actual number of forfeitures differs from those estimated by management, additional adjustments to compensation expense may be required in future periods.

*Goodwill Impairments.* Goodwill represents the excess purchase price over the estimated fair value of net assets acquired as of the acquisition date. We have adopted the requirements of SFAS No. 142, *Goodwill and Other Intangible Assets* ( SFAS No. 142 ). SFAS No. 142 requires goodwill to be tested for impairment on an annual basis and between annual tests in certain circumstances, and written down when impaired. Goodwill of \$24.2 million was

recorded in connection with the acquisition of uRoam, Inc. in fiscal year 2003, goodwill of \$25.5 million was recorded in connection with the acquisition of MagniFire Websystems Inc. in fiscal year 2004 and goodwill of \$32.0 million was recorded in connection with the acquisition of Swan Labs in fiscal year 2006. We complete our annual impairment test in the second quarter of each fiscal year and when events or conditions indicate that an impairment may have occurred. There was no impairment of goodwill during the six months ended March 31, 2006 and 2005, respectively.

**Results of Operations**

The following discussion and analysis should be read in conjunction with our consolidated financial statements, related notes and risk factors included elsewhere in this Quarterly Report on Form 10-Q/A.

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	<b>Three months ended March 31,</b>		<b>Six months ended March 31,</b>	
	<b>2006</b>	<b>2005</b>	<b>2006</b>	<b>2005</b>
	<b>(in thousands, except percentages)</b>			
<b>Net Revenues</b>				
Products	\$ 72,775	\$ 53,332	\$ 141,366	\$ 99,729
Services	21,341	14,398	40,837	28,010
Total	\$ 94,116	\$ 67,730	\$ 182,203	\$ 127,739
<b>Percentage of net revenues</b>				
Products	77.3%	78.7%	77.6%	78.1%
Services	22.7	21.3	22.4	21.9
Total	100.0%	100.0%	100.0%	100.0%

*Net revenues.* Total net revenues increased 39.0% and 42.6% for the three and six months ended March 31, 2006, respectively, up from the comparable periods in the prior year. The improvement was due to increased demand for our application delivery networking products and higher services revenues resulting from our increased installed base of products. During the three and six months ended March 31, 2006, each of our primary geographic regions reported higher revenues compared to the prior period. International revenues were 44.2% and 42.5% of total net revenues for the three and six months ended March 31, 2006, respectively, compared to 44.7% and 43.1% for the three and six months ended March 31, 2005, respectively. We expect international sales will continue to represent a significant portion of net revenues, although we cannot provide assurance that international revenues as a percentage of net revenues will remain at current levels.

Net product revenues increased 36.5% and 41.8% for the three and six months ended March 31, 2006, respectively up from the comparable periods in the prior year. The increase in the six months ended March 31, 2006, was primarily due to absolute growth in the volume of product sales of our Application Traffic Management (ATM), product line as well as incremental revenues derived from sales of our FirePass and TrafficShield product lines. Sales of our ATM family of application delivery networking products represented 89.5% and 89.4% of product revenues for the three months ended March 31, 2006 and 2005, respectively, and 90.5% and 89.9% of product revenue for the six months ended March 31, 2006 and 2005, respectively.

Net service revenues increased 48.2% and 45.8% for the three month and six months ended March 31, 2006, respectively, up from the comparable periods in the prior year. The increase in services revenue was primarily due to increases in the purchase or renewal of maintenance contracts as our installed base of products increased.

Ingram Micro Inc. and GE Access, two of our domestic distributors, accounted for 12.6% and 11.7% of our total net revenue for the three months ended March 31, 2006, respectively, and 13.7% and 10.7% of our total net revenue for the six months ended March 31, 2006, respectively. Ingram Micro Inc., accounted for 17.8% and 16.9% of our total net revenues for the three and six month periods ended March 31, 2005, respectively. GE Access accounted for 10.7% of our accounts receivable as of March 31, 2006.

	<b>Three months ended March 31,</b>		<b>Six months ended March 31,</b>	
	<b>2006</b>	<b>2005</b>	<b>2006</b>	<b>2005</b>
	<b>(in thousands, except percentages)</b>			
		(as restated)		(as restated)
		(1)		(1)

**Cost of net revenues and gross profit**

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Products	\$ 15,441	\$ 11,822	\$ 30,034	\$ 22,352
Services	5,846	3,915	10,820	7,310
Total	21,287	15,737	40,854	29,662
Gross profit	\$ 72,829	\$ 51,993	\$ 141,349	\$ 98,077
<b>Cost of net revenues and gross profit (as a percentage of related net revenue)</b>				
Products	21.2%	22.2%	21.2%	22.4%
Services	27.4	27.2	26.5	26.1
Total	22.6	23.2	22.4	23.2
Gross profit	77.4%	76.8%	77.6%	76.8%

(1) See Note 2, Restatement of Previously Issued Financial Statements, of the Notes to Consolidated Financial Statements.

*Cost of Net Product Revenues.* Cost of net product revenues consist of finished products purchased from our contract manufacturers, manufacturing overhead, freight, warranty, provisions for excess and obsolete inventory, and amortization expenses in connection with developed technology from acquisitions. Our product margins remained stable for all periods presented at 77% to 78%. In absolute dollars, cost of net product revenues increased to \$15.4 million and \$30.0 million for the three and six months ended March 31, 2006, respectively, up from \$11.8 million and \$22.4 million for the three and six months ended March 31, 2005, respectively. The increases were primarily due to the higher volume of units shipped.



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*Cost of Net Service Revenues.* Cost of net service revenues consist of the salaries and related benefits of our professional services staff, travel, facilities, and depreciation expenses. For the three months and six months ended March 31, 2006, cost of net services revenues as a percentage of net service revenues remained relatively stable as compared to the periods in the prior year at 27.4% and 26.5%, respectively, and increased in absolute dollars primarily as a result of recent growth in professional services headcount. Professional services headcount at the end of March 2006 increased to 176 from 123 at the end of March 2005. Going forward, we expect to continue to increase our cost of service revenues to support our expanded product lines and growing customer base.

We expect to maintain our gross margins in the near term; however, gross margins could be adversely affected by increased material cost, component shortages, excess and obsolete inventory charges and heightened sales price competition.

	<b>Three months ended March 31,</b>		<b>Six months ended March 31,</b>	
	<b>2006</b>	<b>2005</b>	<b>2006</b>	<b>2005</b>
	<b>(in thousands, except percentages)</b>			
	<b>(as restated)(1)</b>		<b>(as restated)(1)</b>	
<b>Operating expenses</b>				
Sales and marketing	\$ 31,162	\$ 20,988	\$ 60,027	\$ 41,072
Research and development	12,276	7,834	22,754	14,866
General and administrative	7,148	6,341	14,545	11,832
 Total	 \$ 50,586	 \$ 35,163	 \$ 97,326	 \$ 67,770
 <b>Operating expenses (as a percentage of net revenue)</b>				
Sales and marketing	33.1%	31.0%	32.9%	32.2%
Research and development	13.0	11.6	12.5	11.6
General and administrative	7.6	9.4	8.0	9.3
 Total	 53.7%	 51.9%	 53.4%	 53.1%

(1) See Note 2  
Restatement of  
Previously  
Issued Financial  
Statements, of  
the Notes to  
Consolidated  
Financial  
Statements

*Sales and marketing.* Sales and marketing expenses consist of salaries, commissions and related benefits of our sales and marketing staff, the costs of our marketing programs, including public relations, advertising and trade shows, facilities and depreciation expenses. In absolute dollars, sales and marketing expenses increased 48.5% and 46.2% for the three and six months ended months ended March 31, 2006, respectively, from the comparable periods in the prior year. The increase in sales and marketing expense was primarily due to increased sales and marketing commissions and personnel costs of \$4.9 million and \$10.1 million for the three and six months ended March 31, 2006, respectively. The increased commissions and personnel costs were driven by growth in sales and marketing

employee headcount and increased revenue for the respective periods. Sales and marketing headcount at the end of March 2006 increased to 398 from 293 at the end of March 2005. In addition, sales and marketing expense includes stock-based compensation expense of \$2.2 million and \$4.3 million for the three and six months ended March 31, 2006, respectively, due to the adoption of FAS 123R in the fourth quarter of fiscal year 2005. We expect to continue to increase sales and marketing expenses in absolute dollars in order to grow revenues and increase our market share.

*Research and development.* Research and development expenses consist of the salaries and related benefits for our product development personnel, prototype materials and expenses related to the development of new and improved products, facilities and depreciation expenses. In absolute dollars, research and development expenses increased 56.7% and 53.1% for the three and six months ended months ended March 31, 2006, respectively, from the comparable periods in the prior year. The increase in research and development expenses was primarily due to higher research and development salary and benefit expenses of \$2.2 million and \$3.7 million for the three and six months ended March 31, 2006, respectively. Research and development headcount at the end of March 2006 increased to 278 from 205 at the end of March 2005. The growth in research and development employee headcount was primarily related to enhancement of our current products and our ability to develop new, technologically advanced products that meet the changing needs of our customers. In addition, research and development expense includes stock-based compensation expense of \$1.5 million and \$3.0 million for the three and six months ended March 31, 2006, respectively, due to the adoption of FAS 123R in the fourth quarter of fiscal year 2005. We expect to continue to increase research and development expenses as our future success is dependent on the continued development of our products.

*General and administrative.* General and administrative expenses consist of the salaries, benefits and related costs of our executive, finance, information technology, human resource and legal personnel, third-party professional service fees, bad debt charges, facilities, and depreciation expenses. In absolute dollars, general and administrative expenses increased 12.7% and 22.9% for the three and six months ended months ended March 31, 2006, respectively, from the comparable period in the prior year. The

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increase in general and administrative expenses was primarily due to stock-based compensation expense of \$1.5 million and \$2.9 million for the three and six months ended March 31, 2006, respectively, due to the adoption of FAS 123R in the fourth quarter of fiscal year 2005. In addition, general and administrative salary and benefit expenses increased \$0.9 million and \$1.4 million for the three and six months ended March 31, 2006, respectively. General and administrative headcount at the end of March 2006 increased to 121 from 89 at the end of March 2005. These increases in general and administrative expenses were partially offset by a decrease in bad debt expense. General and administrative expense is expected to remain at these increased levels as we continue to build our infrastructure to support the worldwide growth of our business.

	<b>Three months ended</b>		<b>Six months ended</b>	
	<b>March 31,</b>		<b>March 31,</b>	
	<b>2006</b>	<b>2005</b>	<b>2006</b>	<b>2005</b>
	<b>(in thousands, except percentages)</b>			
		<b>(as</b>		<b>(as</b>
		<b>restated)(1)</b>		<b>restated)(1)</b>
<b>Other Income and Income Taxes</b>				
Income from operations	\$ 22,243	\$ 16,830	\$ 44,023	\$ 30,307
Other income, net	3,877	1,641	6,847	3,028
Income before income taxes	26,120	18,471	50,870	33,335
Provision for income taxes	10,053	7,507	19,582	14,033
Net income	\$ 16,067	\$ 10,964	\$ 31,288	\$ 19,302
<b>Other income and income taxes (as percentage of net revenue)</b>				
Income from operations	23.6%	24.8%	24.2%	23.7%
Other income, net	4.1	2.4	3.8	2.4
Income before income taxes	27.8	27.3	27.9	26.1
Provision for income taxes	10.7	11.1	10.7	11.0
Net income	17.1%	16.2%	17.2%	15.1%

(1) See Note 2, Restatement of Previously Issued Financial Statements, of the Note to Consolidated Financial Statements

*Other income, net.* Other income, net, consists of interest income and foreign currency transaction gains and losses. For the three months ended March 31, 2006, other income, net, increased 136.3% compared with the prior period. For the six months ended March 31, 2006, other income, net, increased 126.1% compared with the prior period. The significant increase was due to a combination of higher yields and increased investment balances. The increased investment balances are the result of cash provided from operating and financing activities.

*Provision for Income taxes.* We recorded a 38.5% provision for income taxes during the current period. As of March 31, 2006 we do not have a valuation allowance on any of our deferred tax assets in any of the jurisdictions in which we operate because we believe that the assets are more likely than not to be realized. In making this determination we have considered projected future taxable income and ongoing prudent and feasible tax planning strategies in assessing the appropriateness of a valuation allowance. Our net deferred tax assets at March 31, 2006 and March 31, 2005 were \$23.9 million and \$43.9 million, respectively. Our world wide effective tax rate may fluctuate based on a number of factors including variations in projected taxable income in our geographic locations, changes in the valuation of our net deferred tax assets, resolution of potential exposures or establishment of potential exposures, introduction of new accounting standards or changes in tax laws or interpretations thereof in any of our geographic locations. Significant judgment is required in evaluating our tax positions and determining our provision for income taxes. During the ordinary course of business, there are many transactions and calculations for which the ultimate tax determination is uncertain. We establish reserves for tax-related uncertainties based on judgment of whether, and the extent to which, additional taxes and interest may be due. These reserves are established when, despite our belief that our tax return positions are fully supportable, we believe that certain positions may be challenged and may not be sustained on review by tax authorities. We adjust these reserves in light of changing facts and circumstances, such as the closing of a tax audit or changes in tax laws or interpretations thereof. The provision for income taxes includes the impact of reserve provisions and changes to reserves that are considered appropriate. The ultimate resolution of these potential exposures may be greater or less than the liabilities recorded which could result in an adjustment to our future tax expense and a fluctuation in our effective tax rate.

#### **Liquidity and Capital Resources**

Cash and cash equivalents, short-term investments and long-term investments were \$420.0 million as of March 31, 2006 compared to \$365.0 million as of September 30, 2005, representing an increase of \$55.0 million. The increase was primarily due to cash provided by operating activities of \$70.1 million for the six months ended March 31, 2006 compared to \$31.1 million for the same period in the prior year. The increase in cash flow from operations for the first six months of fiscal year 2006 resulted from increased net income combined with changes in operating assets and liabilities, as adjusted for various non-cash items including stock based compensation, depreciation and amortization charges.

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Cash used in investing activities was \$136.0 million for the six months ended March 31, 2006 compared to \$79.4 million for the same period in the prior year. The significant amount of cash used in investing activities for the first six months of fiscal year 2006 was primarily due to the purchase of investments partially offset by the sale of investments and \$42.8 million of cash payments, net of cash acquired, to shareholders of Swan Labs, which was acquired in October 2005.

Cash provided by financing activities for the six months ended March 31, 2006 was \$37.1 million compared to \$45.1 million for the same period in the prior year. Our financing activities for the six months ended March 31, 2006 and 2005 consisted of cash received from the exercise of employee stock options and purchases under our employee stock purchase plan. Based on our current operating and capital expenditure forecasts, we believe that our existing cash and investment balances together with cash generated from operations should be sufficient to meet our operating requirements for the foreseeable future.

As of March 31, 2006, our principal commitments consisted of obligations outstanding under operating leases. We lease our facilities under operating leases that expire at various dates through 2012. There have been no material changes in our principal lease commitments compared to those discussed in our Annual Report on Form 10-K for the year ended September 30, 2005. In connection with the lease agreement for our corporate headquarters we established a restricted escrow account collateralized by a certificate of deposit that has been included on our balance sheet as a component of restricted cash. The total amount required in escrow reduces at various dates as set forth by the lease agreement. The amount required in escrow at March 31, 2006 was \$3.6 million as set forth by the lease agreement.

We outsource the manufacturing of our pre-configured hardware platforms to contract manufacturers who assemble each product to our specifications. Our agreement with our largest contract manufacturer allows them to procure component inventory on our behalf based upon a rolling production forecast. We are contractually obligated to purchase the component inventory in accordance with the forecast, unless we give notice of order cancellation in advance of applicable lead times. As of March 31, 2006, we were committed to purchase approximately \$16.3 million of such inventory during the next quarter. Committed purchases includes additional component inventory due to the anticipated Restriction of Hazardous Substances Directive (RoHS) requirements in the European Union which become effective July 1, 2006.

**Risk Factors that May Affect Future Results**

This Quarterly Report on Form 10-Q contains forward-looking statements that involve risks and uncertainties. Our business, operating results, financial performance, and share price may be materially adversely affected by a number of factors, including but not limited to the following risk factors, any one of which could cause actual results to vary materially from anticipated results or from those expressed in any forward-looking statements made by us in this Quarterly Report on Form 10-Q or in other reports, press releases or other statements issued from time to time. Additional factors that may cause such a difference are set forth elsewhere in this Quarterly Report on Form 10-Q.

**Our success depends on our timely development of new products and features, market acceptance of new product offerings and proper management of the timing of the life cycle of our products**

We expect the application delivery networking market to be characterized by rapid technological change, frequent new product introductions, changes in customer requirements and evolving industry standards. Our continued success depends on our ability to identify and develop new products and new features for our existing products to meet the demands of these changes, and for those products and features to be accepted by our existing and target customers. If we are unable to identify, develop and deploy new products and new product features on a timely basis, our business and results of operations may be harmed.

In September 2004, we announced the release of our next-generation BIG-IP product featuring the Traffic Management Operating System, or TMOS. This major new version of BIG-IP represented the culmination of over two years of research and development efforts. TMOS is specifically designed to facilitate the development and integration of application delivery functions as modules that can be added to BIG-IP's core functionality to keep pace with rapidly evolving customer needs. We currently offer software modules as add-ons for this product and our continued success depends significantly on our ability to integrate new modules and functionality onto this platform and the acceptance of the new hardware and software platforms associated with this release by our existing and target customers.

The current life cycle of our products is typically 12 to 24 months. The introduction of new products or product enhancements may shorten the life cycle of our existing products, or replace sales of some of our current products, thereby offsetting the benefit of even a successful product introduction, and may cause customers to defer purchasing our existing products in anticipation of the new

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products. This could harm our operating results by decreasing sales, increasing our inventory levels of older products and exposing us to greater risk of product obsolescence. We have also experienced, and may in the future experience, delays in developing and releasing new products and product enhancements. This has led to, and may in the future lead to, delayed sales, increased expenses and lower quarterly revenue than anticipated. Also, in the development of our products, we have experienced delays in the prototyping of our products, which in turn has led to delays in product introductions. In addition, complexity and difficulties in managing product transitions at the end-of-life stage of a product can create excess inventory of components associated with the outgoing product that can lead to increased expenses. Any or all of the above problems could materially harm our business and operating results.

**Our success depends on sales and continued innovation of our BIG-IP product lines**

For the fiscal year ended September 30, 2005, we derived 89.1% of our product revenues from sales of our BIG-IP family of application delivery networking product lines. We expect to derive a significant portion of our net revenues from sales of our BIG-IP products in the future. Implementation of our strategy depends upon BIG-IP being able to solve critical network availability and performance problems of our customers. If BIG-IP is unable to solve these problems for our customers or if we are unable to sustain the high levels of innovation in BIG-IP's product feature set needed to maintain leadership in what will continue to be a competitive market environment, our business and results of operations will be harmed.

**We may not be able to compete effectively in the emerging application delivery networking market**

The markets we serve are new, rapidly evolving and highly competitive, and we expect competition to persist and intensify in the future. Our principal competitors in the application delivery networking market include Cisco Systems, Inc., Nortel Networks Corporation, Foundry Networks, Inc., Citrix Systems, Inc., Radware Ltd. and Juniper Networks, Inc. We expect to continue to face additional competition as new participants enter our market. In addition, larger companies with significant resources, brand recognition and sales channels may form alliances with or acquire competing application delivery networking solutions and emerge as significant competitors. Potential competitors may bundle their products or incorporate an Internet traffic management or security component into existing products in a manner that discourages users from purchasing our products.

**Table of Contents****Our quarterly and annual operating results are volatile and may cause our stock price to fluctuate**

Our quarterly and annual operating results have varied significantly in the past and will vary significantly in the future, which makes it difficult for us to predict our future operating results. In particular, we anticipate that the size of customer orders may increase as we continue to focus on larger business accounts. A delay in the recognition of revenue, even from just one account, may have a significant negative impact on our results of operations for a given period. In the past, a majority of our sales have been realized near the end of a quarter. Accordingly, a delay in an anticipated sale past the end of a particular quarter may negatively impact our results of operations for that quarter, or in some cases, that year. Additionally, we have exposure to the credit risks of some of our customers and sub-tenants. Although we have programs in place that are designed to monitor and mitigate the associated risk, there can be no assurance that such programs will be effective in reducing our credit risks adequately. We monitor individual payment capability in granting credit arrangements, seek to limit the total credit to amounts we believe our customers can pay, and maintain reserves we believe are adequate to cover exposure for potential losses. If there is a deterioration of a sub-tenant's or major customer's creditworthiness or actual defaults are higher than expected future resulting losses, if incurred, could harm our business and have a material adverse effect on our operating results.

Further, our operating results may be below the expectations of securities analysts and investors in future quarters or years. Our failure to meet these expectations will likely harm the market price of our common stock.

**The average selling price of our products may decrease and our costs may increase, which may negatively impact gross profits**

It is possible that the average selling prices of our products will decrease in the future in response to competitive pricing pressures, increased sales discounts, new product introductions by us or our competitors or other factors. Therefore, in order to maintain our gross profits, we must develop and introduce new products and product enhancements on a timely basis and continually reduce our product costs. Our failure to do so will cause our net revenue and gross profits to decline, which will harm our business and results of operations. In addition, we may experience substantial period-to-period fluctuations in future operating results due to the erosion of our average selling prices.

**It is difficult to predict our future operating results because we have an unpredictable sales cycle**

Our products have a lengthy sales cycle, which is difficult to predict. Historically, our sales cycle has ranged from approximately two to three months and has tended to lengthen as we have increasingly focused our sales efforts on the enterprise market. Also, as our distribution strategy has evolved into more of a channel model, utilizing value-added resellers, distributors and systems integrators, the level of variability in the length of sales cycle across transactions has increased and made it more difficult to predict the timing of many of our sales transactions. Sales of our products require us to educate potential customers in their use and benefits. Sales of our products are subject to delays from the lengthy internal budgeting, approval and competitive evaluation processes that large corporations and governmental entities may require. For example, customers frequently begin by evaluating our products on a limited basis and devote time and resources to testing our products before they decide whether or not to purchase. Customers may also defer orders as a result of anticipated releases of new products or enhancements by our competitors or us. As a result, our products have an unpredictable sales cycle that contributes to the uncertainty of our future operating results.

**Our business may be harmed if our contract manufacturers are not able to provide us with adequate supplies of our products or if a single source of hardware assembly is lost or impaired**

We rely on third party contract manufacturers to assemble our products. We outsource the manufacturing of our hardware platforms to contract manufacturers who assemble these hardware platforms to our specifications. We have experienced minor delays in shipments from contract manufacturers in the past. However, if we experience major delays in the future or other problems, such as inferior quality and insufficient quantity of product, any one or a combination of these factors may harm our business and results of operations. The inability of our contract manufacturers to provide us with adequate supplies of our products or the loss of our contract manufacturer may cause a delay in our ability to fulfill orders while we obtain a replacement manufacturer and may harm our business and results of operations. In particular, because we subcontract substantially all of our manufacturing to a single contract manufacturer, with whom we do not have a long-term contract, any termination, loss or impairment in our arrangement with this single source of hardware assembly, or any impairment of their facilities or operations, would



harm our business, financial condition and results of operation.

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If the demand for our products grows, we will need to increase our raw material and component purchases, contract manufacturing capacity and internal test and quality control functions. Any disruptions in product flow may limit our revenue, may harm our competitive position and may result in additional costs or cancellation of orders by our customers.

### **Our business could suffer if there are any interruptions or delays in the supply of hardware components from our third-party sources**

We currently purchase several hardware components used in the assembly of our products from a number of single or limited sources. Lead times for these components vary significantly. The unavailability of suitable components, any interruption or delay in the supply of any of these hardware components, or the inability to procure a similar component from alternate sources at acceptable prices within a reasonable time, may delay assembly and sales of our products and, hence, our revenues, and may harm our business and results of operations.

### **We may not adequately protect our intellectual property and our products may infringe on the intellectual property rights of third parties**

We rely on a combination of patent, copyright, trademark and trade secret laws and restrictions on disclosure of confidential and proprietary information to protect our intellectual property rights. Despite our efforts to protect our proprietary rights, unauthorized parties may attempt to copy or otherwise obtain and use our products or technology. Monitoring unauthorized use of our products is difficult, and we cannot be certain that the steps we have taken will prevent misappropriation of our technology, particularly in foreign countries where the laws may not protect our proprietary rights as fully as in the United States.

Our industry is characterized by the existence of a large number of patents and frequent claims and related litigation regarding patent and other intellectual property rights. In the ordinary course of our business, we are involved in disputes and licensing discussions with others regarding their claimed proprietary rights and cannot assure you that we will always successfully defend ourselves against such claims. If we are found to infringe the proprietary rights of others, or if we otherwise settle such claims, we could be compelled to pay damages or royalties and either obtain a license to those intellectual property rights or alter our products so that they no longer infringe upon such proprietary rights. Any license could be very expensive to obtain or may not be available at all. Similarly, changing our products or processes to avoid infringing the rights of others may be costly or impractical. In addition, we have initiated, and may in the future initiate, claims or litigation against third parties for infringement of our proprietary rights, to determine the scope and validity of our proprietary rights or those of our competitors. Any of these claims, whether claims that we are infringing the proprietary rights of others, or vice versa, with or without merit, may be time-consuming, result in costly litigation and diversion of technical and management personnel or require us to cease using infringing technology, develop non-infringing technology or enter into royalty or licensing agreements. Further, our license agreements typically require us to indemnify our customers, distributors and resellers for infringement actions related to our technology, which could cause us to become involved in infringement claims made against our customers, distributors or resellers. Any of the above-described circumstances relating to intellectual property rights disputes could result in our business and results of operations being harmed.

Many of our products include intellectual property licensed from third parties. In the future, it may be necessary to renew licenses for third party intellectual property or obtain new licenses for other technology. These third party licenses may not be available to us on acceptable terms, if at all. The inability to obtain certain licenses, or litigation regarding the interpretation or enforcement of license rights and related intellectual property issues, could have a material adverse effect on our business, operating results and financial condition. Furthermore, we license some third party intellectual property on a non-exclusive basis and this may limit our ability to protect our intellectual property rights in our products.

### **We may not be able to sustain or develop new distribution relationships and a reduction or delay in sales to a significant distribution partner could hurt our business**

Our sales strategy requires that we establish and maintain multiple distribution channels in the United States and internationally through leading industry resellers, systems integrators, Internet service providers and other channel partners. We have a limited number of agreements with companies in these channels, and we may not be able to increase our number of distribution relationships or maintain our existing relationships. If we are unable to establish or

maintain our indirect sales channels, our business and results of operations will be harmed. In addition, one domestic distributor of our products accounted for 18.6% and 19.1% of our total net revenue for the fiscal years 2005 and 2004, respectively. A substantial reduction or delay in sales of our products to this or any other key distribution partner could harm our business, operating results and financial condition.

**Table of Contents****Undetected software errors may harm our business and results of operations**

Software products frequently contain undetected errors when first introduced or as new versions are released. We have experienced these errors in the past in connection with new products and product upgrades. We expect that these errors will be found from time to time in new or enhanced products after commencement of commercial shipments. These problems may cause us to incur significant warranty and repair costs, divert the attention of our engineering personnel from our product development efforts and cause significant customer relations problems. We may also be subject to liability claims for damages related to product errors. While we carry insurance policies covering this type of liability, these policies may not provide sufficient protection should a claim be asserted. A material product liability claim may harm our business and results of operations.

Our products must successfully operate with products from other vendors. As a result, when problems occur in a network, it may be difficult to identify the source of the problem. The occurrence of software errors, whether caused by our products or another vendor's products, may result in the delay or loss of market acceptance of our products. The occurrence of any of these problems may harm our business and results of operations.

**Our operating results are exposed to risks associated with international commerce**

As our international sales increase, our operating results become more exposed to international operating risks. These risks include risks related to potential recessions in economies outside the United States, foreign currency exchange rates, managing foreign sales offices, regulatory, political, or economic conditions in specific countries, military conflict or terrorist activities, changes in laws and tariffs, inadequate protection of intellectual property rights in foreign countries, foreign regulatory requirements, and natural disasters. All of these factors could have a material adverse effect on our business. We intend to continue expanding into international markets. International sales represented 40.5% and 39.4% of our net revenues for the fiscal years ended September 30, 2005 and 2004, respectively. In particular, in fiscal year 2005, we derived 13.7% of our total revenue from the Japanese market. This revenue is dependent on a number of factors outside our control, including the viability and success of our resellers and the strength of the Japanese economy.

**Changes in governmental regulations could negatively affect our revenues**

Our products are subject to various regulations promulgated by the United States and various foreign governments including, but not limited to, environmental regulations and regulations implementing export license requirements and restrictions on the import or export of some technologies, especially encryption technology. Changes in governmental regulation and our inability or failure to obtain required approvals, permits or registrations could harm our international and domestic sales and adversely affect our revenues, business and operations.

**Acquisitions, including our recent acquisition of Swan Labs, present many risks and we may not realize the financial and strategic goals that are contemplated at the time of the transaction**

With respect to our acquisitions, as well as any other future acquisitions we may undertake, we may find that the acquired assets do not further our business strategy as expected, or that we paid more than what the assets are later worth, or that economic conditions change, all of which may generate future impairment charges. There may be difficulty integrating the operations and personnel of the acquired business, and we may have difficulty retaining the key personnel of the acquired business. We may have difficulty in incorporating the acquired technologies or products with our existing product lines. Our ongoing business and management's attention may be disrupted or diverted by transition or integration issues and the complexity of managing geographically and culturally diverse locations. We may have difficulty maintaining uniform standards, controls, procedures and policies across locations. We may experience significant problems or liabilities associated with the product quality, technology and other matters.

Our inability to successfully operate and integrate newly-acquired businesses appropriately, effectively and in a timely manner, or to retain key personnel of any acquired business, could have a material adverse effect on our ability to take advantage of further growth in demand for integrated traffic management and security solutions and other advances in technology, as well as on our revenues, gross margins and expenses.

**Table of Contents****Our success depends on our key personnel and our ability to attract and retain qualified sales and marketing, operations, product development and professional services personnel**

Our success depends to a significant degree upon the continued contributions of our key management, product development, sales, marketing and finance personnel, many of whom may be difficult to replace. The complexity of our application delivery networking products and their integration into existing networks and ongoing support, as well as the sophistication of our sales and marketing effort, requires us to retain highly trained professional services, customer support and sales personnel. Competition for qualified professional services, customer support and sales personnel in our industry is intense because of the limited number of people available with the necessary technical skills and understanding of our products. Our ability to retain and hire these personnel may be adversely affected by volatility or reductions in the price of our common stock, since these employees are generally granted stock options. The loss of services of any of our key personnel, the inability to retain and attract qualified personnel in the future or delays in hiring qualified personnel, may harm our business and results of operations.

**We face litigation risks**

We are a party to lawsuits in the normal course of our business. Litigation in general and intellectual property and securities litigation in particular, can be expensive, lengthy and disruptive to normal business operations. Moreover, the results of complex legal proceedings are difficult to predict. Responding to the allegations has been, and will likely continue to be, expensive and time-consuming for us. An unfavorable resolution of the lawsuits could adversely affect our business, results of operations, or financial condition.

Our historical stock option practices and the restatement of our prior financial statements have exposed us to greater risks associated with litigation. In May 2006, several derivative actions were filed against certain current and former directors and officers based on allegations relating to our historical stock option practices. We cannot assure you that this current litigation will result in the same conclusions reached by the Special Committee.

We may in the future be subject to additional litigation arising in relation to our historical stock option practices and the restatement of our prior period financial statements. Litigation may be time consuming, expensive and distracting for management from the conduct of our business. The adverse resolution of any lawsuit could have a material adverse effect on our business, financial condition and results of operations. We cannot assure you that any future litigation relating to our historical stock option practices will result in the same conclusions reached by the Special Committee. Furthermore, if we are subject to adverse findings in any of these matters, we could be required to pay damages or penalties or have other remedies imposed upon us which could adversely affect our business, results of operations, or financial condition.

**The matters relating to the Special Committee's review of our historical stock option practices and the restatement of our consolidated financial statements has resulted in regulatory proceedings against us and may result in future regulatory proceedings, which could have a material adverse impact on our financial condition**

On November 8, 2006, we announced that the Special Committee had completed its review of our historical stock option practices. Upon completion of its review, the Special Committee found that the recorded grant dates for certain stock options granted during fiscal years 1999 to 2004 should not be relied upon as the measurement date for accounting purposes and the accounting treatment used for the vesting of certain stock options was incorrect. Based on the Special Committee's review, to correct the accounting treatment, we have amended the Original Report, our Quarterly Report on Form 10-Q for the three months ended December 31, 2005 and our Annual Report on Form 10-K/A (as amended) for the year ended September 30, 2005, to restate the consolidated financial statements contained in those reports.

We have received notice from both the SEC and the Department of Justice that they are conducting informal inquiries into our historical stock option practices, and we have continually cooperated with both agencies. Considerable legal and accounting expenses related to our historical stock option practices have already been incurred to date and significant expenditures may continue to be incurred in the future. We may in the future be subject to additional regulatory proceedings or actions arising in relation to our historical stock option practices and the restatement of our prior period financial statements. Any potential regulatory proceeding or action may be time consuming, expensive and distracting for management from the conduct of our business. The adverse resolution of any potential regulatory proceeding or action could adversely affect our business, results of operations, or financial

condition. We cannot assure you that the SEC and Department of Justice inquiries, or any future regulatory action relating to our historical stock option practices, will result in the same conclusions reached by the Special Committee. Furthermore, if we are subject to adverse findings in any of these matters, we could be required to pay damages or penalties or have other remedies imposed upon us, including

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criminal penalties, which could adversely affect our business, results of operations, or financial condition.

**As a result of our delayed filing of our Form 10-Q for the quarter ended June 30, 2006, our inability to maintain our Form S-3 eligibility may adversely affect our ability to raise future capital**

As a result of our delayed filing of our Quarterly Report on Form 10-Q for the quarter ended June 30, 2006, we will be ineligible to register our securities on Form S-3 for sale by us or resale by other security holders until we have timely filed all periodic reports under the Securities Exchange Act of 1934 for one year from the date our Quarterly Report on Form 10-Q for the quarter ended June 30, 2006 was originally due. In the meantime, we have the ability to use Form S-1 to raise capital or complete acquisitions, which could increase the transaction costs and adversely affect our ability to raise capital or complete acquisitions of other companies during this period.

**Anti-takeover provisions could make it more difficult for a third party to acquire us**

Our Board of Directors has the authority to issue up to 10,000,000 shares of preferred stock and to determine the price, rights, preferences, privileges and restrictions, including voting rights, of those shares without any further vote or action by the shareholders. The rights of the holders of common stock may be subject to, and may be adversely affected by, the rights of the holders of any preferred stock that may be issued in the future. The issuance of preferred stock may have the effect of delaying, deferring or preventing a change of control of our company without further action by our shareholders and may adversely affect the voting and other rights of the holders of common stock. Further, certain provisions of our bylaws, including a provision limiting the ability of shareholders to raise matters at a meeting of shareholders without giving advance notice, may have the effect of delaying or preventing changes in control or management of our company, which could have an adverse effect on the market price of our common stock. In addition, our articles of incorporation provide for a staggered board, which may make it more difficult for a third party to gain control of our board of directors. Similarly, state anti-takeover laws in the State of Washington related to corporate takeovers may prevent or delay a change of control of our company.

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

Management believes there have been no material changes to our quantitative and qualitative disclosures about market risk during the six month period ended March 31, 2006, compared to those discussed in our Annual Report on Form 10-K No. 2 for the year ended September 30, 2005.

**Item 4. Controls and Procedures**

**Evaluation of Disclosure Controls and Procedures**

The Company maintains disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the Exchange Act)) that are designed to ensure that required information is recorded, processed, summarized and reported within the required timeframe, as specified in the rules set forth by the Securities and Exchange Commission. Our disclosure controls and procedures are also designed to ensure that information required to be disclosed is accumulated and communicated to management, including the Chief Executive Officer and Chief Accounting Officer, to allow timely decisions regarding required disclosures.

Our management, with the participation of our Chief Executive Officer and Chief Accounting Officer, evaluated the effectiveness of our disclosure controls and procedures as of March 31, 2006 and, based on this evaluation, our Chief Executive Officer and Chief Accounting Officer had previously concluded that our disclosure controls and procedures were effective as of March 31, 2006. Subsequent to that evaluation, our Chief Executive Officer and Chief Accounting Officer concluded that our disclosure controls and procedures were not effective at a reasonable assurance level, as of March 31, 2006, due to the existence of the material weakness described below.

A material weakness is a control deficiency, or combination of control deficiencies, that results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected. In connection with the restatement discussed under the heading Restatement of Previously Issued Financial Statements in Note 2 to our consolidated financial statements included in this Quarterly Report on Form 10-Q/A, the following material weakness was identified in the Company's internal control over financial reporting as of September 30, 2005 that continued to exist as of March 31, 2006. We did not maintain effective controls over our granting and modification of stock options and the related accounting for and disclosure of stock-based compensation expense. Specifically, effective controls, including monitoring, were not designed and in place to ensure the existence, completeness, accuracy, valuation and presentation of activity related to our granting and modification of stock

options. This control deficiency resulted in the misstatement of our stock-based compensation expense, additional paid-in capital and related income tax accounts and related disclosures, and in the restatement of our 2005, 2004 and 2003 annual consolidated financial statements and the interim consolidated financial statements for the first and second quarters of 2006 and all quarters of 2005 and 2004 and an audit adjustment to the interim consolidated financial statements for the third quarter of 2006. Further, this control deficiency could result in misstatements of the aforementioned accounts and disclosures that would result in a material misstatement of our annual or interim consolidated financial statements that would not be prevented or detected.



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**Remediation of Material Weakness**

Management is committed to remediating the material weakness described above by implementing changes to our internal control over financial reporting.

On July 1, 2005, we adopted the fair value recognition provision of FAS 123(R). We also began granting restricted stock unit awards instead of stock options in the fourth quarter of fiscal 2005 as our primary form of stock-based compensation. FAS 123(R) requires the recognition as expense of all stock-based compensation. In connection with the adoption of FAS 123(R) we revised certain of our policies, processes, procedures and controls relating to grants of stock-based compensation.

Although improvements were made to our internal control over financial reporting, as they relate to the granting and modification of stock-based compensation, in connection with the adoption of FAS 123(R), as of March 31, 2006, we had not fully remediated the material weakness describe above.

Subsequent to the initiation of our investigation into our stock-option granting practices in May 2006, we considered the effectiveness of both the design and operation of our internal control over financial reporting, as they relate to the granting and modification of stock-based compensation. We implemented a number of significant improvements in our internal control over financial reporting during the fourth quarter of 2006. In particular, we developed and implemented the following policies, processes, procedures and controls over the granting and modification of stock-based compensation:

Review and approval of all stock-based compensation awards by the accounting and finance function.

Enhanced and standardized documentation required to be maintained for the granting of all such stock-based compensation awards.

Enhanced and standardized documentation required to be maintained for the exercise and/or cancellation of all such stock-based compensation awards.

A quarterly review and reconciliation of all such stock-based compensation awards by the accounting and finance function.

Formal communication to all relevant personnel involved in the stock-based compensation process regarding the importance of the accounting and legal implications of the Company's stock-based compensation process.

As of September 30, 2006, management has implemented these additional policies, procedures and controls. Additionally, we have evaluated the design of these new controls, which have been placed into operation for a sufficient period of time, and tested their operating effectiveness. We consider that the steps identified and implemented above have improved the effectiveness of our internal control over financial reporting and, as of September 30, 2006, have remediated the material weakness described above.

**Changes in Internal Control over Financial Reporting**

There have been no changes in our internal control over financial reporting that occurred during the quarter ended March 31, 2006, that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

**PART II OTHER INFORMATION**

**Item 1. Legal Proceedings**

Information about legal proceedings is set forth in Note 3 to the unaudited consolidated financial statements included in this Amendment. Reference is also made to Item 3, Legal Proceedings in our Annual Report on Form 10-K/A No. 2 for the year ended

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September 30, 2005, filed December 12, 2006 (the 2005 10-K Amendment ) for descriptions of our legal proceedings. We continue to believe that the resolution of these legal proceedings will not have a material adverse effect on us and there have been no material developments since the filing of the 2005 10-K Amendment.

We are not aware of any other pending legal proceedings that, individually or in the aggregate, would have a material adverse effect on our business, operating results, or financial condition. We may in the future be party to litigation arising in the ordinary course of business, including claims that allegedly infringe upon third-party trademarks or other intellectual property rights. Such claims, even if not meritorious, could result in the expenditure of significant financial and managerial resources.

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

We held our Annual Meeting of Shareholders on March 2, 2006, to elect two Class I directors to hold office until the Annual Meeting of Shareholders for the fiscal year end 2008 or until their successors are duly elected and qualified. At the Annual Meeting, the following nominees were elected as follows:

	<b>Votes</b>	
	<b>For</b>	<b>Withheld</b>
Karl D. Guelich	33,589,979	2,860,914
Keith D. Grinstein	34,579,504	1,871,889
<u>Directors with continuing terms:</u>		
John McAdam		
Alan J. Higginson		
Rich Malone		
A. Gary Ames		

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**Item 6. Exhibits**

<b>Exhibit Number</b>	<b>Exhibit Description</b>
3.1	Second Amended and Restated Articles of Incorporation of the Registrant (1)
3.2	Amended and Restated Bylaws of the Registrant (1)
4.1	Specimen Common Stock Certificate (1)
31.1*	Certification Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.2*	Certification Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32.1*	Certification Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

\* Filed herewith.

(1) Incorporated by  
reference from  
Registration  
Statement on  
Form S-1, File  
No. 333-75817.

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**SIGNATURES**

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized on this 13th day of December, 2006.

F5 NETWORKS, INC.

By: /s/ JOHN RODRIGUEZ  
John Rodriguez  
Chief Accounting Officer  
(Duly Authorized Officer and  
Principal Financial and Accounting  
Officer)  
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**EXHIBIT INDEX**

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32.1*	Certification Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

\* Filed herewith.

(1) Incorporated by reference from Registration Statement on Form S-1, File No. 333-75817.

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3,401

283

(3

)

(101

)

116

Net profit (loss) before provision for income taxes(1)

(34,135

)

2,729

9,762

(20,038

)

(72,819

)

Provision for income taxes

828

1,316

994

84

Net profit (loss)(1)

\$

(34,963

)

\$

1,413

\$

8,768

\$

(20,122

)

\$

(72,819

)

Net profit (loss) per share

Basic

\$

(0.55

)

\$

0.02

\$

0.15

\$

(0.35

)

\$

(1.52

)

Diluted

\$

(0.55

)

\$

0.02

\$

0.14

\$

(0.35

)

\$



(1.52

)

Shares used in computing net profit (loss) per share:

Basic

63,246

61,644

59,963

57,758

47,878

Diluted

63,246

63,152

64,089

57,758

47,878

	December 31, 2006	2005	2004	2003	2002
<b>Consolidated Balance Sheet Data:</b>					
Working capital	\$ 40,306	\$ 62,978	\$ 61,886	\$ 39,737	\$ 41,160
Total assets	151,558	142,110	130,712	102,202	92,856
Total long-term liabilities	219	64	25	1,849	3,837
Stockholders' equity	\$ 83,556	\$ 93,438	\$ 85,739	\$ 62,976	\$ 64,347

(1) In 2006 Profit (loss) from operations, Net profit (loss) before provision for income taxes and Net profit (loss) included a \$14.3 million charge for Patients First Program and settlement costs. *See Note 2 Patients First Program and settlement costs of the Notes to Consolidated Financial Statements for additional information.*

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## ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion and analysis of our financial condition and results of operations should be read together with Selected Consolidated Financial Data and our consolidated financial statements and related notes included elsewhere in this Annual Report on Form 10-K.

### Overview

Align Technology, founded in April 1997, designs, manufactures and markets Invisalign, a proprietary method for treating malocclusion, or the misalignment of teeth. Invisalign corrects malocclusion using a series of clear, nearly invisible, removable appliances that gently move teeth to a desired final position. Because it does not rely on the use of metal or ceramic brackets and wires, Invisalign significantly reduces the aesthetic and other limitations associated with braces. Invisalign is appropriate for treating adults and teens with mature dentition. We received FDA clearance to market Invisalign in 1998, and we began commercial operations and sales of full Invisalign treatment in July 1999.

Each Invisalign treatment plan is unique to the individual patient. Our full Invisalign treatment consists of as many Aligners as indicated by ClinCheck in order to achieve the doctors' treatment goals. In the third quarter of 2005, we launched Invisalign Express, a low-cost solution for less complex orthodontic cases. Invisalign Express is a dual arch orthodontic treatment for cases that meet certain predetermined clinical criteria and consist of up to ten Aligners. Invisalign Express is intended to assist dental professionals to treat a broader range of patients by providing a lower cost option for adult relapse cases, minor crowding and spacing or as a pre-cursor to restorative or cosmetic treatment such as veneers.

We generate the vast majority of our revenues from the sales of the Invisalign system (which includes full Invisalign treatment and Invisalign Express) to orthodontists and GPs in the United States and Canada, our domestic market. Sales of the Invisalign system in our domestic GP channel and our domestic orthodontic channel represented approximately 45% and 33% of our total net revenues during fiscal 2006, respectively. Our domestic full Invisalign and Invisalign Express revenues represented 66% and 13% of our total net revenue during 2006, respectively. Our international revenues represented 16% of our total net revenue during fiscal 2006.

A number of factors, the most important of which are set forth below, may affect our results during the remainder of 2007 and beyond.

- *Settlement with OrthoClear.* In the fourth quarter of 2006, we entered into a formal agreement with OrthoClear, Inc., OrthoClear Holdings, Inc., and OrthoClear Pakistan Pvt. Ltd. ( OrthoClear ), together with certain individuals associated with OrthoClear (the OrthoClear Agreement ) to end all pending litigation between the parties. In addition, OrthoClear agreed, among other things, to stop accepting new patient cases for treatment, consent to the entry of an exclusion order by the ITC prohibiting the importation of OrthoClear aligners into the United States, assign and transfer to Align all intellectual property rights with application to the correction of malocclusion and to discontinue all design, manufacture, marketing and sales of removable dental aligners worldwide. Certain OrthoClear principals also signed five year non-compete agreements. In accordance with the terms of the OrthoClear Agreement, we made a one-time cash payment of \$20.0 million to OrthoClear Holdings, Inc. *See Part I, Item 3 Legal Proceedings of this Annual Report on Form 10-K for a more complete summary of the OrthoClear Agreement.* During the fourth quarter of 2006, we engaged a third-party firm to assist us in assessing the value of the assets received in conjunction with the OrthoClear Agreement. Based on this valuation, \$14.0 million of the \$20.0 million we paid to OrthoClear represented the fair value of the non-compete agreements. These intangible assets were capitalized on our balance sheet and are being amortized over 5 years beginning in the fourth quarter of 2006. The intellectual property transferred to us was determined not to have any

alternative future use and therefore had no fair value. We recorded the remaining \$6.0 million as settlement costs. Through the OrthoClear Agreement we achieved our primary objectives in the litigation as well as eliminated the costs and risks of protracted litigation. As a result of the OrthoClear Agreement, we expect our legal expenses will be reduced significantly in fiscal 2007 and our management and technical personnel will be able to refocus their energy and resources on our customers and product development.

- *Patients First Program* . As part of the OrthoClear Agreement, OrthoClear agreed to stop the importation of aligners into the United States and discontinue all aligner business operations worldwide. As a result, most OrthoClear patients were unable to complete their orthodontic treatment with OrthoClear. In an attempt to help minimize treatment disruptions for these patients and their doctors, we committed to make Invisalign treatment available to OrthoClear patients at no additional charge from Align. Therefore, we will receive no revenue for any additional cases we start under this program while incurring significant expenses. In the fourth quarter of 2006, we recorded an expense of \$8.3 million for the anticipated cost of completing this program. This amount is based on the number of OrthoClear cases registered under the Patients First Program as of December 31, 2006 and the estimated costs that will be incurred in order to fulfill our obligations as a result of this program. If the actual number of OrthoClear cases under the program changes or the actual costs differ significantly from our estimates, we would be required to adjust the accrual for the Patient s First Program, which could materially impact our financial statements. As of December 31, 2006, \$6.8 million remained in accrued liabilities for this program.

Additionally, this program has generated increased demands on our sales and customer service representatives and on our manufacturing processes, including increased headcount. In the fourth quarter of 2006, we hired approximately 100 additional dental technicians at our facility in Costa Rica. Training these technicians to use the sophisticated computer modeling program necessary to create ClinCheck treatment forms, takes approximately 90 to 120 days. Therefore, although we hired these additional technicians in the fourth quarter of 2006, these individuals were not able to provide meaningful contribution to our manufacturing process until the beginning of 2007. As a result of this manufacturing constraint, although we initially sought to implement the Patients First Program without impacting our existing customers, or new, paid Invisalign cases, the influx of Patients First Program cases, as well as a higher than expected number of paid Invisalign case submissions in the fourth quarter, caused a delay in ClinCheck preparation time for some new cases by approximately 10 days. Difficulties such as these in managing the deployment of this program, could cause us to lose existing customers, face potential customer disputes or limit the number of new customers who purchase our products or services as well as result in lost or delayed revenue which could cause a decline in our revenues, gross margins and net profits and adversely affect our operating results. We currently anticipate that we will be able to complete the Patients First Program by the end of the second quarter of fiscal 2007. We expect that as we complete the Patients First Program cases, the incremental capacity and workforce created as a result of this program will be utilized by the anticipated increase in paid Invisalign cases.

- *Penetration into our Domestic Market.* As specialists, orthodontists are a critical part of our business, and we expect that orthodontists will continue to treat the majority of complex cases and continue to drive research for expanding Invisalign applications. However, there exists a significantly greater number of GPs in North America than orthodontists. As the primary provider of dental care, GPs have access to a greater number of patients than orthodontists, and possess a unique opportunity to educate these patients on the benefits of oral care and introduce them to Invisalign. GPs also have the ability to refer appropriate cases to orthodontists and may choose to treat less complex cases themselves. Largely due to the fact that there are significantly more GPs than orthodontists, we expect that an increasingly larger percentage of our revenues will be

generated by GPs. In fact, in fiscal 2006, our domestic GP channel generated 45% of our total net revenue, while the orthodontic channel represented 33%. We continue to believe that by focusing on increasing utilization rates among our existing GP customers, the overall market for Invisalign will increase, as patients who would not have otherwise sought orthodontic treatment are introduced to Invisalign by their GPs. In 2007, we expect to increase the overall marketing spend in the United States with a focus on programs designed to raise the profile of Invisalign and drive more consumers to our most experienced doctors. We anticipate that this increased consumer awareness of Invisalign will increase the market for our product. In addition, by educating dental students and orthodontic residents on the benefits of the Invisalign technique, we believe they will be more likely to use this technology in their future practices and offer Invisalign as a treatment option. As of December 31, 2006, we have integrated the Invisalign technique into the curriculums of 38 university programs, including Harvard University, Columbia University, Temple University and the University of Texas at San Antonio. We expect additional dental schools to integrate the Invisalign technique into their curriculums in the future.

- *Product Mix.* In the third quarter of 2005, we launched Invisalign Express, a low-cost solution for less complex orthodontic cases. In the fourth quarter of 2006, we experienced a decline in the number of Invisalign Express cases as compared to the third quarter of 2006. Although we expect that the number of Invisalign Express cases in the first quarter of 2007 will be relatively consistent compared to the fourth quarter of 2006, we expect to see an increasing number of Invisalign Express cases during the remaining quarters of 2007.
- *Continued Product Leadership.* We are committed to investing in delivering new products, enhancing the user experience and introducing new product features to our existing products. In addition to Invisalign Express, launched in 2005, in the second half of 2006 we announced a phased rollout of ClinAdvisor, a new suite of software tools designed to make Invisalign case selection and submission processes more efficient for doctors. During 2007, we expect to extend the product features and functionality of ClinAdvisor and release it to an increasing number of practices. In addition, we plan to introduce further software enhancements directed at our more experienced doctors that will provide these doctors with a robust set of tools for greater predictability, wider applicability and more control. We are also continuing to focus our research and development efforts on a next generation Aligner material as well as a compliance indicator which will help doctors and patients understand if the patients have worn their Aligners for enough time to effectively move their teeth. We expect these efforts to extend at least through 2008. By investing in developing these new products and continually enhancing our existing products, we expect to increase market share.
- *Expansion of International Markets.* We will focus our efforts towards increasing adoption of Invisalign by dental professionals in key international markets, including Europe and Japan. We will consider expanding into additional countries on a case by case basis. In 2006, our international channel represented approximately 16% of our total net revenue primarily as a result of growth in Europe. In 2007, we expect to increase our consumer marketing efforts in key European markets. We expect our international revenue to continue to increase in absolute dollars, and we expect international revenue as a percentage of total net revenue will be comparable in the foreseeable future.
- *Increasing Reliance on International Manufacturing Operations.* Our manufacturing efficiency has been and will be an important factor in our future profitability. Currently, two of our key production steps are performed in operations located outside of the U.S. At our facility in Costa Rica, dental technicians use a sophisticated, internally developed computer-modeling program to prepare electronic treatment plans, which are transmitted electronically back to the U.S. These electronic files form the basis of ClinCheck and are used to manufacture Aligner molds. In

addition, we use IMS, a third party based in Juarez, Mexico, for the fabrication and packaging of Aligners. Our success will depend in part on the efforts and abilities of management to effectively manage these international operations, including our relationship with IMS. In addition, we currently are and will become increasingly dependant on IMS's and our ability to hire and retain employees generally, as well as hire and retain employees with the necessary skills to perform the more technical aspects of our operations. If our management and/or IMS fail in any of these respects, we could experience production delays and lost or delayed revenue. In addition, even if we have case submissions in the manufacturing backlog, if for these or other reasons we do not have sufficient number of trained dental technicians in Costa Rica to create the ClinCheck treatment forms or if IMS is unable to ship our product to our customers on a timely basis, our revenue will be delayed or lost which will cause our operating results to fluctuate. See Part I, Item 1A Risk Factors for risks related to our international operations.

*Stock-based compensation.* Effective January 1, 2006, we adopted Statement of Financial Accounting Standards No. 123 (Revised 2004), Share-based Payment ( FAS 123R ) using the modified prospective transition method, which requires the measurement and recognition of compensation expense for all share-based payment awards made to our employees and directors and employee stock purchases related to the Employee Stock Purchase Plan based on estimated fair values over the requisite service period. In accordance with the modified prospective method, our financial statements for the prior periods have not been restated to reflect and do not include the impact of FAS 123R. For the year ended December 31, 2006, stock-based compensation expense recognized in accordance with FAS 123R is as follows (in thousands):

	<b>Year Ended December 31, 2006</b>	
	<b>Stock-based Compensation</b>	<b>% of net revenues</b>
Cost of revenues	\$ 700	0.3 %
Sales and marketing	2,862	1.4 %
General and administrative	4,054	2.0 %
Research and development	1,294	0.6 %
Total stock-based compensation expense	\$ 8,910	4.3 %

## Results of Operations

### Comparison of Years Ended December 31, 2006, 2005 and 2004:

#### *Revenues:*

Our total net revenues decreased by \$0.7 million or 0.4% to \$206.4 million in 2006 compared to \$207.1 million in 2005. The decline in total net revenues resulted from reduced revenues in the orthodontic channel offset by increases in the GP channel, international and other revenues. In 2006, the domestic orthodontic and GP channels were impacted by lower overall average selling prices due to new pricing initiatives and the full-year effect of our lower-priced Invisalign Express product, all of which were introduced in the second half of 2005.

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Invisalign product revenues by channel and other revenue, which represented training and sales of ancillary products for the years ended December 31, 2006, 2005 and 2004, are as follows:

Net revenues	Years Ended December 31,			2005	Change	% Change	2004
	2006 (in millions)	Change	% Change				
<b>Domestic:</b>							
Ortho full	\$ 58.4	\$ (24.3 )	-29.4 %	\$ 82.7	\$ (3.4 )	-3.9 %	\$ 86.1
Ortho Express(1)	10.2	7.5	278.8 %	2.7	2.7		
Total Ortho revenues	68.6	(16.8 )	-19.6 %	85.4	(0.7 )	-0.8 %	86.1
GP full	77.2	(7.6 )	-9.0 %	84.8	22.8	36.8 %	62.0
GP Express(1)	16.7	12.4	282.1 %	4.3	4.3		
Total GP revenues	93.9	4.8	5.3 %	89.1	27.1	43.9 %	62.0
International	32.1	8.9	38.3 %	23.2	6.8	40.6 %	16.4
Total Invisalign revenues	194.6	(3.1 )	-1.6 %	197.7	33.2	20.2 %	164.5
Other revenue	11.8	2.4	25.6 %	9.4	1.1	13.0 %	8.3
Total net revenues	\$ 206.4	\$ (0.7 )	-0.4 %	\$ 207.1	\$ 34.3	19.8 %	\$ 172.8

(1) Invisalign Express was launched in the third quarter of 2005.

Case volume data which represents Invisalign case shipment by channel, for the years ended December 31, 2006, 2005 and 2004 are as follows:

Case Volume	Years Ended December 31,			2005	Change	% Change	2004
	2006 (in thousands)	Change	% Change				
<b>Domestic:</b>							
Ortho full	41.8	(5.3 )	-11.1 %	47.1	(3.7 )	-7.3 %	50.8
Ortho Express(1)	13.7	10.0	268.5 %	3.7	3.7		
Total Ortho volume	55.5	4.7	9.2 %	50.8			50.8
GP full	53.0	(0.1 )	-0.1 %	53.1	12.2	29.7 %	40.9
GP Express(1)	22.4	16.5	280.6 %	5.9	5.9		
Total GP volume	75.4	16.4	27.9 %	59.0	18.1	44.1 %	40.9
International	19.2	6.0	45.0 %	13.2	4.6	52.8 %	8.6
Total Invisalign volume	150.1	27.1	22.0 %	123.0	22.7	22.5 %	100.3

(1) Invisalign Express was launched in the third quarter of 2005.

Revenues from our domestic orthodontic channel decreased \$16.8 million or 19.6% in 2006 compared to 2005 as a result of a decline in full Invisalign revenues of \$24.3 million partially offset by a \$7.5 million increase in Invisalign Express revenues. The decline in full Invisalign revenues is attributed to lower average selling prices and case volumes. In 2006 the reduced average selling price of the full Invisalign product reflects the full year impact of pricing initiatives introduced in the second half of 2005, including the reduction in the list price of our full Invisalign product and the expansion of our volume based discount program. Additionally, the increase in Invisalign Express revenue resulted from higher case volumes in 2006 compared to 2005, since this product was launched in the third quarter of 2005.

Revenues from our domestic GP channel increased \$4.8 million or 5.3% in 2006 compared to 2005 primarily due to an increase in Invisalign Express revenues of \$12.4 million partially offset by a \$7.6 million

decline in full Invisalign revenues. Invisalign Express revenues increased resulting from higher case volumes in 2006 compared to 2005, since this product was launched in the third quarter of 2005. The reduction in full Invisalign revenues is attributed to lower average selling prices which reflect the full year impact of the pricing initiatives mentioned above.

International revenues increased \$8.9 million or 38.3% in 2006 compared to 2005 primarily due to a significant increase in our international Invisalign case volumes partially offset by a lower average selling price as a result of pricing initiatives introduced in the first quarter of 2006.

Other revenues, which primarily consisted of training and sales of ancillary products, increased \$2.4 million in fiscal 2006 compared to 2005 mainly due to a \$1.8 million increase in training revenues resulting from an increase in training fees.

Net revenue grew by 19.8% for the year ended December 31, 2005, compared to the year ended December 31, 2004. The growth in net revenues resulted primarily from an increase in overall case shipment volume in the domestic GP channel driven by an increase in the number of participating clinicians and the launch of Invisalign Express in the third quarter of 2005. Additionally, our international sales improved primarily as a result of increased number of participating clinicians and case utilization by our European practitioners.

For fiscal year 2007, we expect our total net revenues will increase compared to 2006 primarily due to the anticipated case volume increases in our domestic orthodontic and GP channels, as well as in international markets. We expect our average selling price to be flat to slightly lower compared to 2006 primarily due to increased participation in our volume based discount programs.

*Cost of revenues:*

	Years Ended December 31,		2005	Change	2004
	2006	Change			
	(in millions)				
Cost of revenues	\$ 64.8	\$ 1.0	\$ 63.8	\$ 6.3	\$ 57.5
% of net revenues	31.4	%	30.8	%	33.3
Gross profits	\$ 141.6	\$ (1.7 )	\$ 143.3	\$ 28.0	\$ 115.3
% of net revenues	68.6	%	69.2	%	66.7

Cost of revenues includes salaries for staff involved in the production process, costs incurred by IMS, a third party shelter service provider in Juarez, Mexico, the cost of materials, packaging, shipping costs, depreciation on capital equipment used in the production process, training costs and stock-based compensation expense.

Gross margin decreased to 68.6% of net revenues in 2006 compared to 69.2% in 2005 primarily due to lower average selling prices. This decline in average selling prices is attributable to the reduction in the list price of full Invisalign and increased sales of our lower priced Invisalign Express product. Reductions in product costs driven by increased volumes and manufacturing efficiencies including the relocation of the SLA mold operations to Juarez, Mexico, partially offset the impact of lower average selling prices. In addition, as a result of these efficiencies, we also released a \$2.2 million provision for estimated losses on case refinement sales during fiscal 2006.

Gross margin improved to 69.2% of net revenues for the fiscal year ended December 31, 2005, compared to 66.7% of net revenues for the year ended December 31, 2004. This improvement in gross margin is primarily the result of cost savings achieved from manufacturing process improvements and increased cost absorption due to higher production volumes partially offset by increased training costs as a result of dental professionals auditing training classes for no charge.



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For the fiscal year 2007, we anticipate that our gross margin will be slightly higher compared to 2006 primarily due to impact of the expected increase in case volume and manufacturing efficiencies including a full year effect of the relocation of the SLA mold operations to Juarez, Mexico.

### *Sales and marketing:*

	Years Ended December 31,		2005	Change	2004
	2006 (in millions)	Change			
Sales and marketing	\$ 82.0	\$ 1.9	\$ 80.1	\$ 24.2	\$ 55.9
% of net revenues	39.7	%	38.7	%	32.4

Sales and marketing expense includes sales force compensation (combined with travel related costs and expenses for professional marketing programs), conducting workshops and market surveys, advertising, dental professional trade show attendance and stock-based compensation expense.

Sales and marketing expense increased \$1.9 million in 2006 compared to 2005 primarily due to a \$2.8 million increase in payroll expense mainly attributable to an increase in headcount and the replacement of orthodontic sales representatives who left Align in the first half of 2005, and a \$2.9 million increase in stock-based compensation expense. These increases were partially offset by a \$3.9 million decrease in media, advertising and other marketing expenses due to the initial launch of our consumer marketing campaign in the second quarter of 2005.

Sales and marketing expense increased by \$24.2 million for the year ended December 31, 2005, compared to the year ended December 31, 2004. This increase was primarily related to incremental headcount which resulted in higher payroll costs of \$10.3 million, \$6.7 million related to increased advertising, media and trade show costs, an additional \$4.8 million on outside services and other sales and marketing support costs, and \$2.4 million of expenses attributable to retention incentives and guarantees paid to our sales force in response to the solicitation of our sales force by OrthoClear during the first quarter of 2005.

For fiscal 2007, we expect sales and marketing expense, including stock-based compensation, to be slightly higher than 2006, as we expand our international markets, continue to increase our investment in media programs and provide clinical education.

### *General and administrative:*

	Years Ended December 31,		2005	Change	2004
	2006 (in millions)	Change			
General and administrative	\$ 64.3	\$ 22.1	\$ 42.2	\$ 8.3	\$ 33.9
% of net revenues	31.2	%	20.4	%	19.6

General and administrative expense includes salaries for administrative personnel, outside consulting services, legal expenses and stock-based compensation expense.

General and administrative expense increased by \$22.1 million in 2006 compared to 2005 primarily due to a \$15.0 million increase in external legal fees primarily related to the OrthoClear litigation, a \$3.8 million increase in payroll related expenses primarily resulting from the hiring of additional legal and administrative staff, and a \$4.0 million increase in stock-based compensation expense. Partially offsetting these increases was a \$0.8 million decrease in bad debt expense.

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General and administrative expense increased by \$8.3 million for the year ended December 31, 2005, compared to the year ended December 31, 2004 primarily due to incremental expenses related to the OrthoClear litigation, which included a \$5.8 million increase in external legal fees, a \$1.3 million increase in consulting costs and a \$3.2 million increase in payroll expense for employee retention and the hiring of additional legal staff. This increase was partially offset by a \$2.6 million decrease in stock-based compensation expense in connection with the amortization of deferred stock-based compensation related to option grants prior to 2001.

For fiscal year 2007, we expect that general and administrative expense will decrease from fiscal 2006 primarily as a result of the significant reduction in legal and other expenses following the settlement agreement we entered into with OrthoClear in the fourth quarter of 2006.

### *Research and development:*

	Years Ended December 31,		2005	Change	2004
	2006	Change			
Research and development	\$ 18.5	\$ (0.1 )	\$ 18.6	\$ 2.8	\$ 15.8
% of net revenues	9.0	%	9.0	%	9.1

Research and development expense includes the personnel costs associated with software engineering, the cost of designing, developing and testing our products, conducting clinical and post-marketing trials and stock-based compensation expense. We expense our research and development costs as they are incurred.

Research and development expense decreased \$0.1 million in 2006 compared to 2005, primarily due to a \$1.4 million decrease in temporary services and outside consulting expenses partially offset by \$1.3 million increase in stock-based compensation.

Research and development expense increased by \$2.8 million for the year ended December 31, 2005, compared to the year ended December 31, 2004. The primary reasons for the higher expenses in 2005, compared to 2004, were an increase of \$1.3 million in outside service and consulting expenses, \$1.1 million of additional payroll related costs due to higher headcount and a \$0.4 million increase in training and other research and development expenses.

For fiscal 2007, we expect research and development spending to increase from fiscal 2006 as we continue to invest in research and development efforts to bring new products to market, conduct clinical research and focus on product improvement initiatives.

### *Patients First Program and settlement costs:*

	Years Ended December 31,		2005	Change	2004
	2006	Change			
Patients First Program and settlement costs	\$ 14.3	\$ 14.3	\$	\$	\$
% of net revenues	7.0	%			

Patients First Program and settlement costs consisted of a \$8.3 million charge for anticipated costs of Patients First Program combined with \$6.0 million in settlement cost, for a total of \$14.3 million. This amount is separately disclosed on our December 31, 2006 Consolidated Statement of Operations.

As part of the OrthoClear Agreement, OrthoClear agreed to stop the importation of aligners into the United States and discontinue all aligner business operations worldwide. As a result, most OrthoClear patients were unable to complete their orthodontic treatment with OrthoClear. In an attempt to help

minimize treatment disruptions for the OrthoClear patients and their doctors, we committed to make treatment available to these patients at no additional cost under the Patients First Program . We will receive no revenue for the program, and will incur significant expense to complete these cases. In the fourth quarter of 2006, we recorded an \$8.3 million charge for the anticipated costs of completing this program in accordance with FASB Statement 5, Accounting for Contingencies ( FAS 5 ). This amount is based on the number of OrthoClear cases registered under the Patients First Program as of December 31, 2006 and the estimated costs that will be incurred to fulfill our obligations as a result of this program. If the actual number of OrthoClear cases under the program changes or the actual costs differs significantly from our estimates, we would be required to adjust the accrual for the Patients First Program, and it could materially impact our financial statements. We currently anticipate that we will be able to complete the Patients First Program by the end of the second quarter of fiscal 2007.

We paid \$20.0 million to OrthoClear during the fourth quarter of 2006 in accordance with the terms of the OrthoClear Agreement, of which \$14.0 million was capitalized on our balance sheet representing the fair value of the non-compete agreements and is being amortized over 5 years. In accordance with Emerging Issues Task Force 04-01 Accounting for Pre-existing Contractual Relationships between the Parties to a Purchase Business Combination (EITF 04-01), we recorded the remaining \$6.0 million as settlement costs in the fourth quarter of fiscal 2006.

*Interest and other income (expense), net:*

	Years Ended December 31,				
	2006	Change	2005	Change	2004
	(in millions)				
Interest income	\$ 3.2	\$ 1.3	\$ 1.9	\$ 1.2	\$ 0.7
Interest expense	\$ (0.3 )	\$ (0.2 )	\$ (0.1 )	\$ 0.2	\$ (0.3 )
Other income (expense), net	0.5	2.0	(1.5 )	(1.1 )	(0.4 )
Total interest and other, net	\$ 3.4	\$ 3.1	\$ 0.3	\$ 0.3	\$

Interest and other income (expense), net, includes interest income earned on cash balances, interest expense on debt, foreign currency translation gains and losses for the dollar against other currencies related to international businesses and other miscellaneous charges.

Interest income (expense), net for the year ended December 31, 2006 increased \$1.1 million compared to 2005. The increase was primarily due to increased interest income as a result of higher effective interest rates.

Other income (expense) increased \$2.0 million in 2006 compared to 2005, primarily due to a \$2.1 million increase in foreign currency translation gains resulted primarily from the remeasurement of foreign currency denominated assets and liabilities.

Interest and other income and expenses for the year ended December 31, 2005, included interest income of \$1.9 million, which resulted from higher interest rates and average cash balances during 2005, offset by exchange losses of \$1.0 million and \$0.6 million of interest expense, bank charges and other expense.

*Income tax provision:*

	Years Ended December 31,				
	2006	Change	2005	Change	2004
	(in millions)				
Provision for income taxes	\$ (0.8 )	\$ 0.5	\$ (1.3 )	\$ (0.3 )	\$ (1.0 )

We recorded an income tax provision of \$0.8 million for fiscal 2006, \$1.3 million for fiscal 2005 and \$1.0 million in fiscal 2004, representing effective tax rates of -2.4%, 48.2% and 10.2% for 2006, 2005 and 2004, respectively. As of December 31, 2006, we have recorded a full valuation allowance for our existing deferred tax assets due to uncertainties about whether we will be able to utilize these assets before they expire. As a result, our income tax provision is based upon our operating results for each taxable jurisdiction in which we operate and the amount of statutory tax that we incur in each jurisdiction.

At December 31, 2006, we had net operating loss carryforwards of approximately \$214.9 million for federal tax purposes and \$73.5 million for California state tax purposes. If not utilized, these carryforwards will begin to expire in 2017 for federal purposes and 2007 for California purposes. SFAS 123R prohibits recognition of a deferred income tax asset for excess tax benefits due to stock option exercises that have not yet been realized through a reduction in income taxes payable. Such unrecognized deferred tax benefits totaled \$14.1 million as of December 31, 2006 and will be accounted for as a credit to additional paid-in capital, if and when realized through a reduction in income taxes payable. The Internal Revenue Code imposes an annual limitation on the use of a corporation's tax attributes if a corporation undergoes an ownership change for tax purposes. If an ownership change is determined to have occurred, our ability to use the net operating loss carryforwards would be subject to an annual limitation. However, based on our current estimate of the total net operating losses at December 31, 2006 and our current estimate of the annual limitation, we do not expect our net operating loss carryforwards to be limited. At December 31, 2006, we had research credit carryforwards of approximately \$4.0 million for federal purposes and \$5.4 million for California state tax purposes. If not utilized, the federal credit carryforwards will begin to expire in 2017. The California state credit can be carried forward indefinitely.

We have not provided additional U.S. income taxes on undistributed earnings from non- U.S. operations as of December 31, 2006 because such earnings are intended to be reinvested indefinitely outside of the United States.

#### Liquidity and Capital Resources

We fund our operations from the proceeds of the sale of our common stock, from cash generated from sales of our product and occasional borrowing under available credit facilities. As of December 31, 2006, 2005 and 2004, we had the following cash, cash equivalents and short-term investments:

	Years Ended December 31,		
	2006	2005	2004
	(in thousands)		
Cash and cash equivalents	\$ 55,113	\$ 74,219	\$ 69,659
Restricted cash	93	150	303
Short-term Investments	8,931		
Total cash, cash equivalents and short-term investments	\$ 64,137	\$ 74,369	\$ 69,962

Net cash used in operating activities for the year ended December 31, 2006 was \$14.0 million, resulting primarily from our operating loss of \$35.0 million adjusted for non-cash items such as depreciation and amortization and stock-based compensation totaling \$19.2 million. Additionally, a \$6.4 million increase in current assets and a \$5.8 million reduction in deferred revenue partially offset by a \$14.3 million increase in accounts payable and accrued liabilities also contributed to the cash used in operating activities.

Net cash provided by operating activities for the year ended December 31, 2005, was \$16.1 million, primarily from operating profits adjusted for non cash items and increases in accrued liabilities partially offset by reductions in accounts payable.

Net cash used in investing activities was \$32.8 million for the year ended December 31, 2006, primarily due to a \$14.0 million purchase of intangible assets resulting from the OrthoClear Agreement, \$10.0 million for the purchase of capital assets and \$8.9 million net purchase of short-term marketable securities. We used \$15.3 million of cash for our investing activities during the year ended December 31, 2005. This included \$13.8 million of cash used to purchase capital assets, and \$0.9 million of net cash used to purchase General Orthodontics, LLC.

Net cash provided by financing activities was \$27.7 million for the year ended December 31, 2006 and primarily consisted of \$16.2 million in proceeds from the issuance of common stock, primarily from exercises of employee stock options and \$11.5 million in net proceeds from our line of credit. Net cash provided by financing activities was \$3.7 million for the year ended December 31, 2005, which consisted of proceeds from the issuance of common stock, primarily from exercises of employee stock options, partially offset by payments on debt obligations related to the equipment-based term loan and capital lease obligations.

Net proceeds from the issuance of common stock related to the exercise of employee stock options have historically been a significant component of our liquidity. However, in 2006, we began granting RSUs which, unlike stock options, do not generate cash from exercise. In addition, because RSUs are taxable to the individuals when they vest, the number of shares we issued to each of our executive officers will be net of applicable payroll withholding taxes which taxes will be paid by us on their behalf. As a result, we will likely generate less cash from the proceeds of the sale of our common stock in future periods.

In December 2005, we renegotiated and amended our existing revolving line of credit to increase the available borrowings under the then existing revolving line to \$20.0 million. Included in the revolving line of credit is a letter of credit facility of up to \$5 million, a foreign exchange facility of up to \$5 million and an equipment facility of up to \$10 million. We may elect interest rates on our borrowing calculated by reference to bank's prime rate less one-half of one percent or LIBOR plus two percent. The credit facility matures on December 16, 2007, at which time all outstanding borrowings must be repaid. The credit facility contains certain restrictive loan covenants, including, among others, financial covenants requiring a minimum quick ratio and minimum tangible net worth, and covenants limiting our ability to dispose of assets, make acquisitions, be acquired, incur indebtedness, grant liens, make investments, pay dividends and repurchase stock. In December 2006, we amended our credit agreement whereby the only financial covenant for the fourth quarter of 2006 was a certain minimum cash balance. As of December 31, 2006, we are in compliance with the financial covenant of these credit facilities.

During the third quarter of 2006, we borrowed \$15.0 million against these credit facilities and made a \$20.0 million one-time payment to OrthoClear Holdings, Inc in accordance with the terms of the OrthoClear Agreement. We elected LIBOR plus two percent as an interest rate of 7.29% as of December 31, 2006. We repaid \$3.5 million of this borrowing in the fourth quarter of 2006, the outstanding balance as of December 31, 2006 was \$11.5 million and is classified as current liability.

On March 7, 2007, we renegotiated and amended our existing credit facility with Comerica Bank. The amendment, among other things, reduced financial covenants to require only a quick ratio covenant. Additionally, the amendment also increased the available borrowings under the existing revolving line of credit from \$20 million to \$25 million effective January 1, 2008. The amended credit facility matures on December 31, 2008 at which point all outstanding borrowing under this credit facility must be repaid.

**Contractual Obligations / Off Balance Sheet Arrangements**

The impact that our contractual obligations as of December 31, 2006 are expected to have on our liquidity and cash flow in future periods is as follows (in thousands):

	Total	Payments Due by Period			
		Less than 1 Year	1-3 Years	3-5 Years	More than 5 Years
Principal payment on line of credit	\$ 11,500	\$ 11,500	\$	\$	\$
Other contractual obligations:					
Operating lease obligations(1)	\$ 7,419	\$ 3,261	\$ 3,691	\$ 467	\$
Computer support services	499	499			
Total other contractual obligation	7,918	3,760	3,691	467	
Total	\$ 19,418	\$ 15,260	\$ 3,691	\$ 467	\$

(1) Includes an early termination fee on facility in Amsterdam, The Netherlands. The lease expires in 2014 with an option to cancel in 2009.

We have no significant contractual obligations not fully recorded on our consolidated balance sheets or fully disclosed in the notes to our consolidated financial statements. We had no off-balance sheet arrangements as defined in Regulation S-K Item 303(a)(4) as of December 31, 2006.

We expect that our expense levels for 2007 will remain comparable to 2006, depending on our level of business activity. We expect that any increases will be focused on continued marketing and international sales efforts and research and development expenses as we develop new products and improvements to our existing products. In addition, we may use cash to fund acquisitions of complementary businesses or technologies. Our capital requirements depend on market acceptance of our products and our ability to market, sell and support our products on a worldwide basis.

We believe that our current cash and cash equivalents will be sufficient to fund our operations for at least the next 12 months. If we are unable to generate adequate operating cash flows, we may need to seek additional sources of capital through equity or debt financing, collaborative or other arrangements with other companies, bank financing and other sources in order to realize our objectives and to continue our operations. There can be no assurance that we will be able to obtain additional debt or equity financing on terms acceptable to us, or at all. If adequate funds are not available, we could be required to delay establishing a national brand, building manufacturing infrastructure and developing our product and process technology, and reduce our expenditures in general. Accordingly, the failure to obtain sufficient funds on acceptable terms when needed could have a material adverse effect on our business, results of operations and financial condition.

**Critical Accounting Policies**

Management's discussion and analysis of our financial condition and results of operations is based upon our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America. The preparation of financial statements requires our management to make estimates and judgments that affect the reported amounts of assets and liabilities, revenue and expenses and disclosures at the date of the financial statements. We evaluate our estimates on an on-going basis, including those related to revenue recognition, stock-based compensation and income taxes. We use authoritative pronouncements, historical experience and other assumptions as the basis for making estimates. Actual results could differ from those estimates.

We believe the following critical accounting policies affect our more significant judgments and estimates used in the preparation of our consolidated financial statements.

### *Revenue Recognition*

We enter into arrangements to sell products, services, and other arrangements that contain multiple elements or multiple deliverables of products in the future. Revenues are recognized when persuasive evidence of an arrangement exists, delivery has occurred or services have been rendered, the price is fixed or determinable, and collectibility is reasonably assured. Revenues from product sales, net of discounts and rebates, are recognized upon shipment. Service revenues are recorded when performance is completed. Other revenue arrangements with multiple elements are recognized as delivery occurs. We use vendor-specific objective evidence of fair value to allocate revenue to the undelivered elements and recognize the residual revenue for the delivered items upon shipment. Revenues for the undelivered elements are deferred based on a historical case refinement utilization rate, or breakage factor, and are recognized when delivery occurs. Actual utilization rates could differ from the historical breakage factor requiring future adjustments to revenue. In addition, changes to the elements in an arrangement and the ability to establish objective and reliable evidence of fair value for those elements could affect the timing of revenue recognition but would not change the total revenue recognized.

### *Stock-based Compensation Expense*

Effective January 1, 2006, we adopted the modified prospective transition method of Statement of Financial Accounting Standards No. 123 (Revised 2004), *Share-Based Payment* ( FAS 123R ), which requires the measurement and recognition of compensation expense for all share-based payment awards made to employees and directors, including stock options and restricted stock units related to our 2001 Plan and our 2005 Plan and employee stock purchases related to our Employee Stock Purchase Plan based on estimated fair values over requisite employee service period. In accordance with the modified prospective transition method, our financial statements for prior periods have not been restated to reflect, and do not include, the impact of FAS 123R. Our Consolidated Financial Statements as of and for the year ended December 31, 2006 reflect the impact of FAS 123R related to share-based payment awards granted prior to, but not yet vested as of December 31, 2005 based on the grant date fair value estimated in accordance with the pro forma provisions of FASB Statement 123, *Accounting for Stock-Based Compensation* ( FAS 123 ) and stock-based payment awards granted subsequent to December 31, 2005 based on the grant date fair value estimated in accordance with the provisions of FAS 123R. In conjunction with the adoption of FAS 123R, we changed our method of attributing the value of stock-based compensation to expense from the accelerated multiple-option approach to the straight-line single option method.

We estimate the fair value of stock options using a Black-Scholes valuation model, consistent with the provisions of FAS 123R and the SEC issued Staff Accounting Bulletin No. 107 ( SAB 107 ). Option-pricing models require the input of highly subjective assumptions, including the option's expected term and stock price volatility. Judgment is also required in estimating the number of stock-based awards that are expected to be forfeited. As stock-based compensation expense recognized in our financial statements for the year ended December 31, 2006 is based on awards ultimately expected to vest, it has been reduced for estimated forfeitures. FAS 123R requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. Forfeitures were estimated based on historical experience. If our estimates change or if we employ different assumptions in the application of FAS 123R in future periods, the compensation expense that we record under FAS 123R may differ significantly from what we have recorded in the current period and could materially impact our results of operations. *See Note 10 Shareholders' Equity of the Notes to Consolidated Financial Statements for additional information.*

On October 6, 2005, the Compensation Committee of the Board of Directors approved the acceleration of the vesting for all unvested stock options with exercise prices greater than \$7.10. Options held by non-employee directors were excluded from the vesting acceleration. The fair market value of our

common stock on the date of acceleration was \$6.41 as quoted on the NASDAQ Global Market. As a result of the acceleration, approximately 3.8 million options or 35% of the then total outstanding options became immediately exercisable as of October 6, 2005. The purpose of the acceleration was to eliminate future compensation expense we would otherwise recognize in our statement of operations with respect to these accelerated options upon the adoption of FAS 123R.

*Long-lived assets, including finite lived purchased intangible assets*

Intangible assets other than goodwill are amortized over their useful lives, unless these lives are determined to be indefinite. Intangible assets are carried at cost less accumulated amortization. Amortization is computed over the estimated useful life of the respective asset. Intangible assets are reviewed for impairment in accordance with Statement of Financial Accounting Standards No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets* ( FAS 144 ). We perform an impairment test whenever events or changes in circumstances indicate that the carrying value of such assets may not be recoverable. Examples of such events or circumstances include significant underperformance relative to historical or projected future operating results, significant changes in the manner of use of acquired assets or the strategy for its business, significant negative industry or economic trends, and/or a significant decline in our stock price for a sustained period. Impairments are recognized based on the difference between the fair value of the asset and its carrying value, and fair value is generally measured based on discounted cash flow analyses. No intangible asset impairment was recorded for the periods presented.

*Patients First Program*

As part of the OrthoClear Settlement Agreement, OrthoClear agreed to stop the importation of aligners into the United States and discontinue all aligner business operations worldwide. As a result, most OrthoClear patients were unable to complete their orthodontic treatment with OrthoClear. In an attempt to help minimize treatment disruptions for the OrthoClear patients and their doctors, we committed to make treatment available to these patients at no additional cost under the Patients First Program . We will receive no revenue for the program, and will incur significant expense to complete these cases. In the fourth quarter of 2006, we recorded a \$8.3 million charge for the anticipated costs of completing this program in accordance with FASB Statement 5, *Accounting for Contingencies* ( FAS 5 ). This amount is based on the number of OrthoClear cases registered under the Patients First Program as of December 31, 2006 and the estimated costs that will be incurred to fulfill our obligations as a result of this program. If the actual number of OrthoClear cases under the program changes or the actual costs differs significantly from our estimates, we would be required to adjust the accrual for the Patients First Program, and it could materially impact our financial statements. We currently anticipate that we will be able to complete the Patients First Program by the end of the second quarter of fiscal 2007.

*Product Warranty*

We warrant our products against defects in materials and workmanship until the Invisalign case is completed. We accrue for estimated warranty in costs of goods sold upon the shipment of products. The amount of accrued estimated warranty costs are primarily based on historical experience as to product failures as well as current information on repair costs. Actual warranty costs could differ from the estimated amounts. We regularly review the accrued balances and update these balances based on historical warranty cost trends. Actual warranty costs incurred have not materially differed from those accrued. If we were to experience higher rates of warranty events, we would be required to accrue additional warranty costs, which would negatively affect our operating results.



*Deferred Tax Valuation Allowance*

We have established a full valuation allowance because we believe the realization of our deferred tax assets is not likely. Deferred tax assets and liabilities are based on temporary differences that result from differing treatments of certain items for tax and accounting purposes. These differences result in deferred tax assets and liabilities, which we show on our balance sheet. We must then assess the likelihood that our deferred tax assets will be realized. To the extent we believe that realization is not likely, we establish a valuation allowance.

While we have considered future taxable income in assessing the need for the full valuation allowance, we would decrease the valuation allowance to take into account deferred tax assets that we could realize. A decrease in the valuation allowance could have a favorable impact, which could be material, on our income tax provision and net income in the period in which we make the decrease.

*Recent Accounting Pronouncements*

*See Note 1 Summary of Significant Accounting Policies of the Notes to Consolidated Financial Statements in Item 8 for a full description of recent accounting pronouncements, including the expected dates of adoption and estimated effects on results of operations and financial condition, which is incorporated herein.*

**ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

In the normal course of business, we are exposed to foreign currency exchange rate and interest rate risks that could impact our financial position and results of operations.

*Interest Rate Risk*

Changes in interest rates could impact our anticipated interest income on our cash equivalents and investments in marketable equity securities. Due to the short duration of our cash and cash equivalents an immediate 10% decrease or more in interest rates would not have a material adverse impact on our future operating results and cash flows. Periodically we invest our excess cash in low risk and short-term available for sale marketable equity securities. These investments are primarily at fixed interest rates. As of December 31, 2006, we had \$8.9 million investments in available for sale marketable equity securities.

As of December 31, 2006, we had \$11.5 million outstanding borrowing against our line of credit, which bears interest rate of LIBOR plus two percent being 7.29% as of December 31, 2006 and are not subject to risks from immediate interest rate increases. An increase of 10% or more in interest rates may affect our future cost of financing. In the past we had used fixed rates long-term financing to minimize our risk on interest rates increases.

*Currency Rate Risk*

The functional currency of Align and its subsidiaries is the U.S. dollar and, accordingly, gains and losses resulting from the translation of monetary assets and liabilities denominated in Euro, Cost Rican Colon, and other currencies are reflected in the determination of net income or loss. We do not enter into forward exchange contracts to reduce our exposure to foreign exchange gains and losses. Included in other income (expense) for the year ended December 31, 2006, was an exchanges gain of \$1.1 million. For years 2005 and 2004 we experienced exchange loss of \$1.0 million and an exchange gain of \$0.3 million, respectively, primarily related to Euro denominated balances. An aggregate decline of 10% in foreign currency exchange rates relative to USD may have an adverse effect of approximately \$1.2 million on our results of operations and financial position.

## ITEM 8. CONSOLIDATED FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

## Quarterly Results of Operations

	Three Months Ended 2006				2005			
	Dec 31	Sep 30	Jun 30	Mar 31	Dec 31	Sep 30	Jun 30	Mar 31
	(in thousands, except per share data) (unaudited)							
Net revenues	\$ 55,191	\$ 49,034	\$ 53,221	\$ 48,908	\$ 51,164	\$ 50,866	\$ 53,940	\$ 51,155
Gross profit	37,994	32,245	36,729	34,611	34,453	35,891	37,320	35,677
Operating profit (loss)(1)	(18,067 )	(10,965 )	(3,291 )	(5,213 )	663	(1,539 )	1,193	2,129
Net profit (loss)(1)	\$ (17,269 )	\$ (10,320 )	\$ (2,610 )	\$ (4,764 )	\$ 528	\$ (1,516 )	\$ 538	\$ 1,863
Net profit (loss) per share,								
Basic	\$ (0.27 )	\$ (0.16 )	\$ (0.04 )	\$ (0.08 )	\$ 0.01	\$ (0.02 )	\$ 0.01	\$ 0.03
Diluted	\$ (0.27 )	\$ (0.16 )	\$ (0.04 )	\$ (0.08 )	\$ 0.01	\$ (0.02 )	\$ 0.01	\$ 0.03
Shares used in computing net profit (loss) per share:								
Basic	64,252	63,230	62,966	62,518	62,045	61,788	61,484	61,246
Diluted	64,252	63,230	62,966	62,518	63,247	61,788	62,953	63,148

(1) December 2006 Profit (loss) from operations and Net profit (loss) included a \$14.3 million charge for Patients First Program and settlement costs. See Note 2 *Patients First Program and settlement costs* of the Notes to Consolidated Financial Statements for additional information.

**INDEX TO CONSOLIDATED FINANCIAL STATEMENTS**

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*Invisalign, Align, ClinCheck and ClinAdvisor, amongst others, are trademarks belonging to Align Technology, Inc. and are pending or registered in the United States and other countries.*

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**REPORT OF MANAGEMENT ON INTERNAL CONTROL OVER FINANCIAL REPORTING**

Management of Align is responsible for establishing and maintaining adequate internal control over financial reporting as defined in Rules 13a-15(f) and 15d-15(f) under the Securities Exchange Act of 1934. Align's internal control over financial reporting is designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. Internal control over financial reporting includes those policies and procedures that:

- pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company;
- provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and
- provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. In addition, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions and that the degree of compliance with the policies or procedures may deteriorate.

Management assessed the effectiveness of Align's internal control over financial reporting as of December 31, 2006. In making this assessment, management used the criteria set forth in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

Based on its assessment and those criteria, management has concluded that, as of December 31, 2006, Align's internal control over financial reporting was effective to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles.

Align's independent registered public accounting firm, PricewaterhouseCoopers LLP, has issued an audit report on our assessment of Align's internal control of financial reporting. Their report may be found immediately after this report.

/s/ THOMAS M. PRESCOTT

Thomas M. Prescott

*President and Chief Executive Officer*

March 12, 2007

/s/ ELDON M. BULLINGTON

Eldon M. Bullington

*Vice President, Finance and Chief Financial Officer*

March 12, 2007

**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

To the Stockholders and Board of Directors of Align Technology, Inc. and subsidiaries:

We have completed integrated audits of Align Technology, Inc.'s consolidated financial statements and of its internal control over financial reporting as of December 31, 2006 in accordance with the standards of the Public Company Accounting Oversight Board (United States). Our opinions, based on our audits, are presented below.

*Consolidated financial statements and financial statement schedule*

In our opinion, the consolidated financial statements listed in the index under item 15(a)(i) present fairly, in all material respects, the financial position of Align Technology, Inc. and its subsidiaries at December 31, 2006 and 2005, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2006 in conformity with accounting principles generally accepted in the United States of America. In addition, in our opinion, the financial statement schedule listed in the accompanying index appearing under item 15(a)(ii) presents fairly, in all material respects, the information set forth therein when read in conjunction with the related consolidated financial statements. These financial statements and financial statement schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and financial statement schedule based on our audits. We conducted our audits of these statements in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit of financial statements includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As discussed in Note 10 to the Consolidated Financial Statements, the Company changed the manner in which it accounts for stock-based compensation in fiscal 2006.

*Internal control over financial reporting*

Also, in our opinion, management's assessment, included in Management's Report on Internal Control Over Financial Reporting appearing immediately above this report, that the Company maintained effective internal control over financial reporting as of December 31, 2006 based on criteria established in Internal Control - Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), is fairly stated, in all material respects, based on those criteria. Furthermore, in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2006, based on criteria established in Internal Control - Integrated Framework issued by the COSO. The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express opinions on management's assessment and on the effectiveness of the Company's internal control over financial reporting based on our audit. We conducted our audit of internal control over financial reporting in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. An audit of internal control over financial reporting includes obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we consider necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinions.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

/s/ PricewaterhouseCoopers LLP  
San Jose, CA  
March 12, 2007

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## ALIGN TECHNOLOGY, INC. AND SUBSIDIARIES

## CONSOLIDATED STATEMENTS OF OPERATIONS

(in thousands, except per share data)

	Years Ended December 31,		
	2006	2005	2004
Net revenues:			
Invisalign	\$ 194,582	\$ 197,749	\$ 164,536
Ancillary products and other services	11,772	9,376	8,294
Total net revenues	206,354	207,125	172,830
Cost of revenues:			
Invisalign	55,759	(1) 54,549	50,315
Ancillary products and other services	9,016	9,235	7,211
Total cost of revenues	64,775	63,784	57,526
Gross profit	141,579	143,341	115,304
Operating expenses:			
Sales and marketing	81,993	(1) 80,068	55,932
General and administrative	64,305	(1) 42,242	33,851
Research and development	18,474	(1) 18,585	15,756
Patients First Program and settlement costs	14,343		
Total operating expenses	179,115	140,895	105,539
Profit (loss) from operations	(37,536)	) 2,446	9,765
Interest income	3,179	1,918	713
Interest expense	(296)	) (110)	) (271)
Other income (expense)	518	(1,525)	) (445)
Net profit (loss) before provision for income taxes	(34,135)	) 2,729	9,762
Provision for income taxes	828	1,316	994
Net profit (loss)	\$ (34,963)	) \$ 1,413	\$ 8,768
Net profit (loss) per share:			
Basic	\$ (0.55)	) \$ 0.02	\$ 0.15
Diluted	\$ (0.55)	) \$ 0.02	\$ 0.14
Shares used in computing net profit (loss) per share:			
Basic	63,246	61,644	59,963
Diluted	63,246	63,152	64,089

(1) Amounts for the year ended December 31, 2006 include stock-based compensation expense recognized under FAS 123R for stock options, restricted stock units and employee stock purchases (*See Note 10 Shareholders Equity of the Notes to Consolidated Financial Statements*). The Company recognized \$8.9 million in total stock-based compensation expense in the year ended December 31, 2006, including \$0.7 million in cost of revenues, \$2.9 million in sales and marketing, \$4.0 million in general and administrative and \$1.3 million in research and development.

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

## ALIGN TECHNOLOGY, INC. AND SUBSIDIARIES

## CONSOLIDATED BALANCE SHEETS

(in thousands, except per share data)

	December 31, 2006	2005
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 55,113	\$ 74,219
Restricted cash	93	150
Marketable securities, short-term	8,931	
Accounts receivable, net of allowance for doubtful accounts of \$844 and \$1,626 at December 31, 2006 and 2005, respectively	33,635	29,305
Inventories, net	3,090	2,930
Prepaid expenses and other current assets	7,227	4,982
Total current assets	108,089	111,586
Property and equipment, net	26,904	26,427
Goodwill	478	478
Intangible assets, net	13,824	818
Other assets	2,263	2,801
Total assets	\$ 151,558	\$ 142,110
<b>LIABILITIES AND STOCKHOLDERS EQUITY</b>		
Current liabilities:		
Line of credit	\$ 11,500	\$
Accounts payable	5,034	2,489
Accrued liabilities	40,307	29,372
Deferred revenue	10,942	16,747
Total current liabilities	67,783	48,608
Other long term liabilities	219	64
Total liabilities	68,002	48,672
Commitments and contingencies (Notes 7 and 9)		
Stockholders' equity:		
Preferred stock, \$0.0001 par value; Authorized: 5,000 shares at December 31, 2006 and 2005; Issued and Outstanding: no shares at December 31, 2006 and 2005		
Common stock, \$0.0001 par value, Authorized: 200,000 shares at December 31, 2006 and 2005; Issued: 64,899 and 62,120 shares at December 31, 2006 and 2005, respectively; Outstanding: 64,859 and 62,080 shares at December 31, 2006 and 2005, respectively		
	6	6
Additional paid-in capital	408,921	383,836
Accumulated other comprehensive income	3	7
Accumulated deficit	(325,374 )	(290,411 )
Total stockholders' equity	83,556	93,438
Total liabilities and stockholders' equity	\$ 151,558	\$ 142,110

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



## ALIGN TECHNOLOGY, INC. AND SUBSIDIARIES

## CONSOLIDATED STATEMENTS OF STOCKHOLDERS EQUITY (DEFICIT)

For the years ended December 31, 2006, 2005 and 2004

(in thousands)

	Common Stock		Additional	Deferred	Notes	Accumulated	Accumulated	Total
	Shares	Amount	Paid-In	Stock-Based	Receivable	Other	Deficit	
			Capital	Compensation	from	Income (Loss)		
					Stockholders			
Balances at December 31, 2003	58,753	\$ 6	\$ 368,796	\$ (5,219 )	\$ (17 )	\$ 2	\$ (300,592 )	\$ 62,976
Net profit							8,768	8,768
Net change in unrealized loss from available-for sale securities						(4 )		(4 )
Comprehensive net income								8,764
Issuance of common stock relating to employee stock purchase plan	429		1,726					1,726
Issuance of common stock upon exercise of stock options	1,695		6,389					6,389
Repurchase of common stock	(1 )		(1 )					(1 )
Payments on stockholder notes receivable					17			17
Cancellations, net of deferred stock compensation			(130 )	130				
Amortization of deferred stock compensation				5,089				5,089
Charge for compensation expense on non-employee stock options			429					429
Charge for accelerated vesting of employee stock options			350					350
Balances at December 31, 2004	60,876	\$ 6	\$ 377,559	\$	\$	\$ (2 )	\$ (291,824 )	\$ 85,739
Net profit							1,413	1,413
Net change in unrealized gain from available-for sale securities						9		9
Comprehensive net income								1,422
Issuance of common stock relating to employee stock purchase plan	374		2,167					2,167
Issuance of common stock upon exercise of stock options	830		3,417					3,417
Tax benefit from stock option transactions			581					581
Charge for compensation expense on non-employee stock options			45					45
Charge for accelerated vesting of employee stock options			67					67
Balances at December 31, 2005	62,080	\$ 6	\$ 383,836	\$	\$	\$ 7	\$ (290,411 )	\$ 93,438
Net loss							(34,963 )	(34,963 )
Net change in unrealized loss from available-for sale securities						(4 )		(4 )
Comprehensive net loss								(34,967 )
Issuance of common stock relating to employee stock purchase plan	462		2,583					2,583
Issuance of common stock upon exercise of stock options	2,317		13,592					13,592
Stock-based compensation			8,910					8,910
Balances at December 31, 2006	64,859	\$ 6	\$ 408,921	\$	\$	\$ 3	\$ (325,374 )	\$ 83,556

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



## ALIGN TECHNOLOGY, INC. AND SUBSIDIARIES

## CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands)

	Years Ended December 31,		
	2006	2005	2004
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>			
Net profit (loss)	\$ (34,963 )	\$ 1,413	\$ 8,768
Adjustments to reconcile net profit (loss) to net cash provided by (used in) operating activities:			
Depreciation and amortization	9,279	10,099	9,597
Stock-based compensation	8,910	45	429
Amortization of intangibles	992	352	36
Amortization of deferred stock-based compensation			5,089
Compensation expense for accelerated vesting of stock options		67	350
Provision for (benefit of) doubtful accounts	(288 )	503	541
Loss on retirement, disposal and impairment of fixed assets	40	92	70
Changes in assets and liabilities, net of acquisition effect			
Accounts receivable	(4,042 )	(985 )	(8,085 )
Inventories	(160 )	(78 )	(518 )
Prepaid expenses and other current assets	(2,245 )	229	634
Accounts payable	2,997	(1,998 )	221
Accrued and other long term liabilities	11,255	6,485	4,326
Deferred revenues	(5,805 )	(145 )	3,144
Net cash provided by (used in) operating activities	(14,030 )	16,079	24,602
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>			
Purchase of property and equipment	(10,028 )	(13,801 )	(9,061 )
Proceeds from sale of property and equipment	366		858
Restricted cash	57	153	136
Purchase of marketable securities	(18,416 )	(2,217 )	(523 )
Maturities of marketable securities	9,481	2,226	2,811
Payments for acquisition, net of cash acquired		(856 )	
Purchase for intangible assets	(14,000 )		
Other assets	(211 )	(760 )	(245 )
Net cash used in investing activities	(32,751 )	(15,255 )	(6,024 )
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>			
Proceeds from issuance of common stock	16,175	5,585	8,115
Proceeds from payment on stockholders' notes receivable			17
Repurchase of common stock			(1 )
Proceeds from line of credit	15,000		
Payments on line of credit	(3,500 )	(1,667 )	(1,667 )
Payments on capital lease obligations		(182 )	(322 )
Net cash provided by financing activities	27,675	3,736	6,142
Net increase (decrease) in cash and cash equivalents	(19,106 )	4,560	24,720
Cash and cash equivalents, beginning of year	74,219	69,659	44,939
Cash and cash equivalents, end of year	\$ 55,113	\$ 74,219	\$ 69,659

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

**ALIGN TECHNOLOGY, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**Note 1. Summary of Significant Accounting Policies**

*Business Description*

Align Technology, Inc. ( Align or the Company ) was incorporated in April 1997 and is engaged in the development, manufacturing and marketing of Invisalign, used for treating malocclusion, or the misalignment of teeth. Invisalign uses a series of clear plastic Aligners to move the patients teeth in small increments from their original state to a final treated state.

*Basis of presentation and preparation*

The consolidated financial statements include the accounts of the Company and its wholly owned subsidiaries after elimination of intercompany transactions and balances.

*Use of estimates and reclassifications*

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires the Company s management to make estimates and assumptions that affect the amounts reported in the consolidated financial statements and accompanying notes. Actual results could differ materially and adversely from those estimates.

Certain reclassifications have been made to prior period reported amounts to conform to the current year presentation.

*Fair value of financial instruments*

The carrying amounts of the Company s cash and cash equivalents, accounts receivable, accounts payable and other current liabilities approximate the fair value. The carrying value of marketable securities approximates their fair value as determined by market quotes. Based on borrowing rates currently available to the Company for debt with similar terms, the carrying value of its debt obligations approximates fair value.

*Cash equivalents and marketable securities*

Cash equivalents consist of highly liquid instruments purchased with an original maturity of three months or less. The Company invests primarily in money market funds, commercial paper, and United States government securities, accordingly, these investments are subject to minimal credit and market risks.

Marketable securities are classified as available-for-sale and are carried at fair value. Marketable securities classified as current assets have maturities of less than one year. Unrealized holding gains or losses on such securities are included in accumulated other comprehensive income (loss) in stockholders equity. Realized gains and losses on sales of all such securities are reported in earnings and computed using the specific identification cost method. Realized gains or losses and charges for other-than-temporary declines in value, if any, on available-for-sale securities are reported in other income or expense as incurred. The Company periodically evaluates these investments for other-than-temporary impairment.

*Restricted cash*

The Company s restricted cash as of December 31, 2006 and 2005 were \$0.1 million and \$0.2 million, respectively, primarily comprised of security against a leasing arrangement in Europe.

*Foreign currency*

The Company analyzes the functional currency determination for its international subsidiaries on an annual basis, or more often if necessary. For the years ended December 31, 2006, 2005 and 2004, the Company and its subsidiaries use the U.S. dollar as its functional currency. Assets and liabilities denominated in foreign currencies are remeasured into U.S. dollars at current exchange rates for monetary assets and liabilities, and historical exchange rates for non-monetary assets and liabilities. Revenues and expenses are remeasured at average exchange rates in effect during each period. Gains or losses from foreign currency remeasurement are included in other income (expense). For the years ended December 31, 2006, 2005 and 2004, the Company included in other income (expense) a gain of \$1.1 million, a loss of \$1.0 million and a gain of \$0.3 million, respectively.

*Certain risks and uncertainties*

The Company's operating results depend to a significant extent on the Company's ability to market and develop its products. The life cycles of the Company's products are difficult to estimate due in part to the effect of future product enhancements and competition. The inability of the Company to successfully develop and market its products as a result of competition or other factors would have a material adverse effect on the Company's business, financial condition and results of operations.

Financial instruments which potentially expose the Company to concentrations of credit risk consist primarily of cash equivalents and accounts receivable. The Company invests excess cash primarily in money market funds of major financial institutions, commercial paper and notes. The Company provides credit to customers in the normal course of business. Collateral is not required for accounts receivable, but ongoing evaluations of customers' credit worthiness are performed. The Company maintains reserves for potential credit losses and such losses have been within management's expectations. No individual customer accounted for 10% or more of the Company's accounts receivable at December 31, 2006 and 2005, or net revenues in fiscal 2006, 2005 and 2004.

In the United States of America, the Food and Drug Administration (FDA) regulates the design, manufacture, distribution, preclinical and clinical study, clearance and approval of medical devices. Products developed by the Company may require approvals or clearances from the FDA or other international regulatory agencies prior to commercialized sales. There can be no assurance that the Company's products will receive any of the required approvals or clearances. If the Company was denied approval or clearance or such approval was delayed, it may have a material adverse impact on the Company.

The Company has manufacturing operations located outside the United States of America. The Company currently relies on its manufacturing facilities in Costa Rica to create virtual treatment plans with the assistance of sophisticated software. In addition, the Company relies on a third party shelter services provider in Juarez, Mexico to fabricate Aligners and to ship the completed product to the Company's customers. The Company's reliance on international operations exposes it to related risks and uncertainties, including difficulties in staffing and managing international operations; controlling quality of manufacture; political, social and economic instability; interruptions and limitations in telecommunication services; product and/or material transportation delays or disruption; trade restrictions and changes in tariffs; import and export license requirements and restrictions; fluctuations in currency exchange rates; and potential adverse tax consequences. If any of these risks materialize, the Company's international manufacturing operations, as well as its operating results, may be harmed.

The Company receives certain of its components from sole suppliers. Additionally, the Company relies on a limited number of hardware manufacturers. The inability of any supplier or manufacturer to fulfill supply requirements of the Company could materially impact future operating results.

### *Inventories*

Inventories are valued at standard cost, which approximates actual cost computed on a first-in, first-out basis, not in excess of market value.

### *Property and equipment*

Property and equipment are stated at historical cost less accumulated depreciation and amortization. Depreciation and amortization are computed using the straight-line method over the estimated useful lives of the assets. Upon sale or retirement, the asset's cost and related accumulated depreciation are removed from the general ledger and any related gain or loss is reflected in operations. Maintenance and repairs are charged to operations as incurred.

### *Development costs for internal use software*

Costs relating to internal use software are accounted for in accordance with the provisions of Statement of Position 98-1, Accounting for the Costs of Computer Software Developed or Obtained for Internal Use (SOP 98-1). In 2004, the Company implemented a new version of its enterprise resource planning system and new software for the Company's manufacturing execution system and capitalized approximately \$3.2 million in related internal use software costs. As of December 31, 2006, and 2005, capitalized internal use software at cost was \$4.7 million and \$4.4 million, respectively. The associated accumulated amortization was \$3.5 million and \$2.2 million as of December 31, 2006 and 2005, respectively. Capitalized software costs are amortized over the estimated useful lives of the software, which generally range from three to five years.

### *Acquisition*

In January 2005, the Company acquired all the membership interests of privately held General Orthodontics, LLC ( GO ). The acquisition was accounted for as a purchase and accordingly, the operating results of GO have been included in the consolidated financial statements since date of acquisition. See Note 5 Acquisitions of the Notes to Consolidated Financial Statements for more information.

### *Goodwill*

Goodwill represents the excess of the purchase price paid over the fair value of tangible and identifiable intangible net assets acquired in business combinations. Goodwill is reviewed annually in the fourth quarter and whenever events or circumstances occur which indicate that goodwill might be impaired.

### *Long-lived assets, including finite lived purchased intangible assets*

Other intangible assets primarily consist of intangible assets purchased as part of the OrthoClear Agreement and GO acquisition. These assets are amortized using the straight-line method over their estimated useful lives of three to five years, reflecting the period in which the economic benefits of the assets are expected to be realized.

The Company regularly monitors events and changes in circumstances that could indicate if the carrying values of long-lived assets, including intangible assets, may not be recoverable. When such events or changes in circumstances occur, the Company assesses the recoverability of long-lived assets by determining whether the carrying value of such assets will be recovered through future net undiscounted cash flows. If such assets are considered to be impaired, the impairment to be recognized is measured by

the amount by which the carrying amount of the assets exceeds the fair value, as measured by the discounted future cash flows.

*Product Warranty*

The Company warrants its products against material defects until the Invisalign case is completed. The Company accrues for estimated warranty in costs of goods sold upon shipment of products. The amount of accrued estimated warranty costs are primarily based on historical experience as to product failures as well as current information on repair costs. Actual warranty costs could differ from the estimated amounts. The Company regularly reviews the accrued balances and updates these balances based on historical warranty cost trends. Actual warranty costs incurred have not materially differed from those accrued.

*Allowance for Doubtful Accounts*

The Company maintains allowances for doubtful accounts for estimated losses resulting from the inability of the Company's customers to make payments. The Company periodically reviews these estimated allowances, including an analysis of the customers' payment history and information regarding the customers' creditworthiness. Actual doubtful account write-offs have not materially differed from the estimated allowance.

*Revenue Recognition*

Align recognizes revenue in accordance with SEC Staff Accounting Bulletin No. 104 Revenue Recognition ( SAB 104 ), and Emerging Issues Task Force No. 00-21 Revenue Arrangements with Multiple Deliverables ( EITF 00-21 ). SAB 104 requires that four basic criteria must be met before revenue can be recognized: persuasive evidence of an arrangement exists, delivery has occurred, the price is fixed or determinable, and collectibility is reasonably assured. Determination of whether persuasive evidence of an arrangement exists and whether delivery has occurred or services rendered involve management's judgments based on 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.

Revenue from product sales, net of discounts and rebates, is recognized upon shipment. Service revenues related to the training of dental professionals and staff on the Invisalign treatment process, and case consultations are recorded when the services are completed.

Align enters into multiple element arrangements that involve delivery of products in the future. Included in the price of a full Invisalign treatment, the Company offers case refinement, which is a finishing tool used to adjust a patient's teeth to the final desired position. Case refinement may be elected by the dental professional in the last stages of orthodontic treatment. The Company uses vendor specific objective evidence of fair value to allocate revenue to the case refinement deliverable and recognizes the residual revenue for full Invisalign upon shipment. Through June 2005, Align deferred the fair value of case refinement for each full Invisalign case shipped. For these full Invisalign cases, case refinement revenue is recognized upon shipment or case expiration, whichever occurs earlier. A full Invisalign case is deemed expired six months after the expected end of treatment. Since the third quarter of fiscal 2005, Align defers the fair value of case refinement upon shipment of full Invisalign based on a breakage factor, which is determined by sufficient historical experience of case refinement utilization. The Company believes that the use of a breakage factor is reasonable and appropriate because of the relative stability of case refinement utilization since case refinement was first offered. The Company has seen no material changes in the breakage factor in the reporting periods presented.

The Company estimates and records a provision for amounts of estimated losses on sales, if any, in the period such sales occur. Provisions for discounts and rebates to customers are provided for in the same period that the related product sales are recorded based upon historical discounts and rebates.

*Shipping and Handling Costs*

Shipping and handling charges to customers are included in the net revenue, and the associated cost incurred recorded in cost of sales for all periods presented.

*Research and development*

Research and development costs are expensed as incurred.

*Advertising costs*

The cost of advertising and media is expensed as incurred. For the years ended December 31, 2006, 2005 and 2004 advertising costs totaled \$9.2 million, \$11.3 million and \$6.3 million respectively.

*Income taxes*

We estimate our income taxes based on the various jurisdictions where we conduct business. Significant judgment is required in determining our income tax provision. Deferred tax assets and liabilities are recognized for differing treatments of certain items for tax and accounting purposes. These differences result in deferred tax assets and liabilities. We must then assess the likelihood that our deferred tax assets will be realized. To the extent we believe that realization is not likely, we establish a valuation allowance.

*Stock-based compensation*

Effective January 1, 2006, the Company adopted Statement of Financial Accounting Standards ( FAS 123 ) No. 123 (Revised 2004), Share-Based Payment ( FAS 123R ), which requires the measurement and recognition of compensation expense for all stock-based payment awards made to employees and directors, including stock options, restricted stock units and employee stock purchases related to the Employee Stock Purchase Plan based on estimated fair values of these awards over the requisite employee service period. FAS 123R supersedes Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees ( APB 25 ), which the Company previously followed in accounting for stock-based awards. In March 2005, the SEC issued Staff Accounting Bulletin No. 107 ( SAB 107 ) to provide guidance on FAS 123R. The Company has applied SAB 107 in its adoption of FAS 123R.

Under the provisions of FAS 123R, the Company adopted the modified prospective transition method which requires stock-based compensation cost to be recognized for share-based payments awards granted to, but not yet vested as of, December 31, 2005 based on the grant date fair value estimated in accordance with the pro forma provisions of FASB Statement 123, Accounting for Stock-Based Compensation ( FAS 123 ) and stock-based payment awards granted subsequent to December 31, 2005 based on the grant date fair value estimated in accordance with the provisions of FAS 123R. In accordance with the modified prospective transition method, the Company's Consolidated Financial Statements as of and for the year ended December 31, 2006 reflects the impact of FAS 123R, and prior periods have not been restated to reflect, and do not include the impact of FAS 123R. In conjunction with the adoption of FAS 123R, the Company changed its method of attributing the value of stock-based compensation from accelerated multiple-option approach to the straight-line single method.

In November 2005, the Financial Accounting Standards Board ( FASB ) issued FASB Staff Position No. FAS 123(R)-3, Transition Election Related to Accounting for Tax Effects of Share-Based Payment Awards ( FSP 123R-3 ). The Company has elected to adopt the alternative transition method provided in



the FSP 123R-3 that includes simplified methods to establish the beginning balance of the additional paid-in capital pool related to the tax effect of stock-based compensation and to determine the subsequent impact on the additional paid-in capital pool and the Consolidated Statement of Cash Flows for stock-based compensation awards that are outstanding upon the adoption of FAS 123R. *See Note 10 Shareholders' Equity of the Notes to Consolidated Financial Statements for more information.*

*Comprehensive Income (loss)*

Comprehensive income (loss), as defined, includes all changes in equity (net assets) during a period from non-owner sources. Net profit (loss) and other comprehensive (loss), including unrealized gains and losses on short-term investments, are reported, net of their related tax effect.

*Recent Accounting Pronouncements*

In July 2006, the FASB issued FASB Interpretation ( FIN ) No. 48 Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement 109 . FIN 48 prescribes a comprehensive model for recognizing, measuring, presenting and disclosing in the financial statements tax positions taken or expected to be taken on a tax return, including a decision whether to file or not to file in a particular jurisdiction. FIN 48 is effective for fiscal years beginning after December 15, 2006. If there are changes in net assets as a result of application of FIN 48, these will be accounted for as an adjustment to retained earnings. The Company does not expect that the adoption of FIN 48 will have a material impact on its results from operations or consolidated financial position.

In September 2006, the SEC staff issued Staff Accounting Bulletin ( SAB ) 108 Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements (SAB 108). SAB 108 requires that public companies utilize a dual-approach to assessing the quantitative effects of financial misstatements. This dual approach includes both an income statement focused assessment and a balance sheet focused assessment. The guidance in SAB 108 must be applied to annual financial statements for fiscal years ending after November 15, 2006. The adoption of SAB 108 did not have a material impact on its results from operations or consolidated financial position.

In September 2006, the FASB issued FASB Statement No. 157, *Fair Value Measurements*, which defines fair value, establishes a framework for measuring fair value under GAAP, and expands disclosures about fair value measurements. FASB Statement No. 157 applies to other accounting pronouncements that require or permit fair value measurements. The new guidance is effective for financial statements issued for fiscal years beginning after November 15, 2007, and for interim periods within those fiscal years. The Company is currently evaluating the potential impact, if any, of the adoption of FASB Statement No. 157 on its consolidated financial position, results of operations and cash flows.

Other recent accounting pronouncements issued by the FASB (including its Emerging Issues Task Force), the American Institute of Certified Public Accountants and the SEC did not or are not believed by management to have a material impact on our present or future consolidated financial statements.

**Note 2. Patients First Program and settlement costs**

On October 13, 2006, the Company entered into a formal agreement with OrthoClear, Inc., OrthoClear Holdings, Inc., and OrthoClear Pakistan Pvt. Ltd. ( OrthoClear ), together with certain individuals associated with OrthoClear (the OrthoClear Agreement ) to end all pending litigation between the parties. In addition, OrthoClear agreed, among other things, to stop accepting new patient cases for treatment, consent to the entry of an exclusion order by the ITC prohibiting the importation of OrthoClear aligners into the United States, assign and transfer to Align all intellectual property rights with application to the correction of malocclusion and discontinue all design, manufacture, marketing and sales of removable dental aligners worldwide. In addition, certain OrthoClear principles also signed five year non-compete agreements. *See Note 7 Legal Proceedings of the Notes to Consolidated Financial Statements for a more complete summary of the OrthoClear Agreement.* The Company evaluated this transaction under the provisions of Emerging Issues Task Force 98-3 Determining Whether a Non-Monetary Transaction Involves a Receipt of Productive Assets or of a Business (EITF 98-3) and concluded that this transaction is not a business acquisition and will be accounted for as an asset purchase.

In accordance with the terms of the OrthoClear Agreement, the Company made a \$20.0 million one-time cash payment to OrthoClear Holdings, Inc. on October 16, 2006. The Company engaged a third-party firm to assist management in assessing the fair value of the identifiable assets received in conjunction with the OrthoClear Agreement. Using an income valuation approach, it was determined that \$14.0 million represented the fair value of the non-compete agreements, which are being amortized over the estimated useful life of 5 years. The intellectual property transferred to Align was determined not to have any alternative future use and therefore had no fair value. In accordance with Emerging Issues Task Force 04-01 Accounting for Pre-existing Contractual Relationships between the Parties to a Purchase Business Combination (EITF 04-01), the remaining \$6.0 million of the \$20.0 million payment was recorded as settlement costs.

As part of the OrthoClear Agreement, OrthoClear agreed to stop the importation of aligners into the United States and discontinue all aligner business operations worldwide. As a result, most OrthoClear patients were unable to complete their orthodontic treatment with OrthoClear. In an attempt to help minimize treatment disruptions for the OrthoClear patients and their doctors, the Company committed to make treatment available to these patients at no additional cost under the Patients First Program . Therefore, Align will receive no revenue for the program, while incurring significant expense. In the fourth quarter of 2006, the Company recorded a \$8.3 million charge for the anticipated costs of completing the Patients First Program in accordance with FASB Statement 5, Accounting for Contingencies ( FAS 5 ). This amount is based on the number of OrthoClear cases registered under the Patients First Program as of December 31, 2006 and the estimated costs that will be incurred in order to fulfill the obligation as a result of this program. If the actual number of OrthoClear cases under the program changes or the actual- costs differ significantly from our estimates, Align would be required to adjust the accrual for the Patients First Program, and it could materially impact the financial statements. As December 31, 2006, \$6.8 million remained in accrued liabilities for this program. Align currently anticipates that the Patients First Program will be completed by the end of the second quarter of fiscal 2007.

**Note 3. Short-term Investments**

The Company has the following short-term investments as of December 31, 2006 (in thousands):

	Amortized Costs	Gross Unrealized Gains	Gross Unrealized Loss	Fair Value
U.S. Government notes and bonds	\$ 4,880	\$ 2	\$	\$ 4,882
Corporate bonds	2,951			2,951
Commercial paper and asset-backed securities	1,098			1,098
Total:	\$ 8,929	\$ 2	\$	\$ 8,931

As of December 31, 2006, all short-term investments have maturity dates less than one year. For the years ended December 31, 2006 and 2005, no gains were realized on the sale of short-term investments. The Company had no short-term investments as of December 31, 2005.

**Note 4. Balance Sheet Components**

Inventories consist of the following (in thousands):

	December 31,	
	2006	2005
Raw materials	\$ 2,021	\$ 1,492
Work in process	763	1,060
Finished goods	306	378
	\$ 3,090	\$ 2,930

Work in process includes costs to produce the Invisalign product. Finished goods primarily represent ancillary products that support the Invisalign system.

Property and equipment consist of the following (in thousands):

	Useful Life (in years)	December 31,	
		2006	2005
Clinical and manufacturing equipment	5	\$ 39,741	\$ 28,298
Computer hardware	3	10,404	9,352
Computer software	3	7,719	6,498
Furniture and fixtures	7	4,835	4,698
Leasehold improvements	Term of the lease	9,197	8,443
Construction in progress		1,987	8,387
		\$ 73,883	\$ 65,676
Less: Accumulated depreciation and amortization		(46,979 )	(39,249 )
		\$ 26,904	\$ 26,427

As of December 31, 2006, construction in progress consisted primarily of costs for capital equipment expected to be placed in service in the next year.

Depreciation expense and amortization was \$9.3 million, \$10.1 million, and \$9.6 million for the years ended December 31, 2006, 2005 and 2004, respectively.

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Accrued liabilities consist of the following (in thousands):

	December 31, 2006	2005
Accrued payroll and benefits	\$ 17,768	\$ 12,330
Accrued Patients First Program costs	6,800	
Accrued sales rebate	3,895	1,409
Accrued loss		2,681
Accrued warranty	2,094	1,998
Other	9,750	10,954
	\$ 40,307	\$ 29,372

Warranty accrual during the years ended December 31, 2006 and 2005 consists of the following activity (in thousands):

Warranty accrual, December 31, 2004	\$ 1,616
Charged to costs and expenses	2,699
Actual warranty expenditures	(2,317 )
Warranty accrual, December 31, 2005	\$ 1,998
Charged to costs and expenses	2,694
Actual warranty expenditures	(2,598 )
Warranty accrual, December 31, 2006	\$ 2,094

### Note 5. Acquisitions

In January 2005, the Company acquired all of the membership interests of privately held General Orthodontics, LLC ( GO ). GO is the sole premier provider of consulting and education services to general practitioner dentists ( GP ) and orthodontists using the Invisalign orthodontic appliance. Upon the integration of GO, Align included GO s consulting services in its clinical education and training programs under the name of Invisalign Consulting Services. The consolidated financial statements include the operating results of GO from the date of acquisition.

The purchase price of \$1.3 million was accounted for as a business combination and allocated to the acquired assets, goodwill and other identified intangibles, as follows (in thousands):

Fair value of net liabilities assumed	\$ (174 )
Identified intangible assets acquired:	
Consultant relationships	980
Other	55
Goodwill	478
Total	\$ 1,339

The valuation of the consultant relationships represent the fair value of consultant services which include direct consulting services to GO s customers on the use of the Invisalign technology and training of GP dentists and orthodontists at the Company s certification training sessions. Consultant relationships and other intangible assets are being amortized on a straight-line basis over the estimated useful life of three years.

In accordance with the Membership Interest Purchase Agreement, the Company agreed to contingent earn-outs of up to \$1.0 million payable to certain former holders of GO membership interests upon the achievement of milestones defined in the agreement. These contingent payments were accrued on a

straight-line basis based on the estimated completion dates. The Company paid \$0.5 million related to milestone completion in July 2005, and the remaining \$0.5 million in April 2006.

In conjunction with the GO acquisition, the Company recorded \$0.5 million of goodwill, which represents the difference between the purchase price and the fair value of the acquired net assets and the identified intangible assets. As required by FASB Statement 142, *Goodwill and Other Intangible Assets* ( FAS 142 ), the Company performs its annual impairment test in the fourth quarter of the fiscal year, or more frequently if indicators of potential impairment exist, to determine if the recorded goodwill is impaired. In performing this assessment, Align compared the fair value of its single business segment to its carrying value, and determined that no goodwill impairment existed as of December 31, 2006.

#### Note 6. Intangible Assets

The following is a summary of the Company's purchased intangible assets as of December 31, 2006 and 2005 (in thousands):

	Estimated Useful Life (in years)	December 31, 2006		Net Carrying Value	December 31, 2005		Net Carrying Value
		Gross Carrying Value	Accumulated Amortization		Gross Carrying Value	Accumulated Amortization	
Non-compete agreements	5	\$ 14,000	\$ 612	\$ 13,388	\$	\$	\$
Consultant relationships	3	980	626	354	980	299	681
Patent	5	180	117	63	180	81	99
Other	3	55	36	19	55	17	38
Total		\$ 15,215	\$ 1,391	\$ 13,824	\$ 1,215	\$ 397	\$ 818

Non-compete agreements represent the fair value of assets received in conjunction with the OrthoClear Agreement. These intangible assets are being amortized on a straight-line basis over the expected useful life of five years beginning in the fourth quarter of 2006. *See Note 2 Patients First Program and settlement costs of the Notes to Consolidated Financial Statements for additional information.*

Consultant relationships and other intangible assets represent the fair value of intangible assets acquired as the result of the GO acquisition in 2005. Consultant relationships and other intangible assets are being amortized on a straight-line basis over the estimated useful life of three years. *See Note 5 Acquisitions of the Notes to Consolidated Financial Statements for additional information.*

The Company performs an impairment test whenever events or changes in circumstances indicate that the carrying value of such assets may not be recoverable. Examples of such events or circumstances include significant underperformance relative to historical or projected future operating results, significant changes in the manner of use of acquired assets or the strategy for its business, significant negative industry or economic trends, and/or a significant decline in our stock price for a sustained period. Impairments are recognized based on the difference between the fair value of the asset and its carrying value, and fair value is generally measured based on discounted cash flow analyses. No intangible asset impairment was recorded for the periods presented.

For the years ended December 31, 2006, 2005 and 2004, total amortization expense for intangible assets was \$1.0 million, \$0.4 million and \$36,000, respectively. The total estimated annual future amortization expense for these intangible assets is as follows (in thousands):

<b>Fiscal Year</b>	
2007	\$ 3,181
2008	2,856
2009	2,800
2010	2,800
2011 and thereafter	2,187
Total	\$ 13,824

#### **Note 7. Legal Proceedings**

##### *OrthoClear*

*State Action.* On February 2, 2005, the Company filed a multi-claim lawsuit in San Francisco County Superior Court against defendants OrthoClear, Inc., OrthoClear Holdings, Inc., Muhammad Ziaullah Chishti, Bao Tran, Peter Riepenhausen, Joe Breeland, Jeff Tunnell, Christopher Kawaja, and Charles Wen (the *State Action*). Among other things, the *State Action* alleged tort, contract, statutory and common law causes of action arising from OrthoClear and the individual defendants' alleged plan to unlawfully utilize the Company's intellectual property, confidential information and employees. The *State Action* also alleged that OrthoClear, Chishti and other defendants were in breach of contractual obligations, statutory law and common law for attempting to intentionally interfere and disrupt the Company's ongoing business operations and improperly gain access to its customer relationships and trade secrets. Subsequent to the initial filing date, there were extensive proceedings in the case as reported in previous Align filings.

*Federal Lanham Action.* On July 19, 2005 and June 19, 2006, the Company filed a multi-claim lawsuit in the United States District Court for the Northern District of California against OrthoClear (the *Federal Lanham Action I* and *Federal Lanham Action II*, respectively). The *Federal Lanham Action I* and *Federal Lanham Action II* alleged numerous violations of the Federal Lanham Act (15 U.S.C. §1051 et seq.) by OrthoClear and its officers and employees. These violations include unfair competition, trademark infringement and false advertising, among other things. The *Federal Lanham Action I* and *Federal Lanham Action II* also alleged violations by OrthoClear of California's Unfair Practices Act (California Business and Professions Code §17200 et seq.).

*Patent Infringement ITC Complaint.* On January 11, 2006, the Company filed a formal complaint with the United States International Trade Commission (ITC) against OrthoClear, seeking to halt the importation into the United States of infringing certain patents of the Company.

*Patent Infringement Federal Action.* On January 11, 2006, the Company filed a federal court patent infringement action against OrthoClear in the Western District of Wisconsin (Madison) (the *Patent Infringement Federal Action*) asserting infringement of certain patents of the Company.

##### *OrthoClear Agreement*

On October 13, 2006, the Company and OrthoClear, Inc., OrthoClear Holdings, Inc., and OrthoClear Pakistan Pvt. Ltd. ( *OrthoClear* ), together with certain individuals associated with OrthoClear, executed a formal agreement (the *OrthoClear Agreement* ). The *OrthoClear Agreement* included the following terms:

- OrthoClear was required immediately discontinue all design, manufacture, marketing and sales of removable dental aligners worldwide;



- OrthoClear consented to the entry of an exclusion order by the ITC, enforced by the United States Customs Service, which prevents OrthoClear from importing its dental aligner products into the U.S., either directly or through a third party and the ITC subsequently terminated the ITC action on October 27, 2006;
- The parties agreed to dismiss all pending lawsuits against each other, including the State Case, Federal Lanham Action I, Federal Lanham Action II, Patent Infringement Federal Action, with prejudice, and each such action has been subsequently dismissed;
- OrthoClear agreed to stop accepting new patient cases for treatment;
- OrthoClear and Muhammad Ziaullah Chishti its CEO, and Charles Wen, its President, transferred and assigned to Align all intellectual property rights with application to the treatment of malocclusion;
- OrthoClear principals Muhammad Ziaullah Chishti, Charles Wen, Peter Riepenhausen, and Christopher Kawaja signed 5-year, global non-compete agreements in the field of removable aligner therapy products and related software market;
- OrthoClear employees Joe Breeland and Jeff Tunnell signed 5-year U.S. non-compete agreements prohibiting their personal participation in the removable aligner therapy product and related software market;
- The Company made Invisalign treatment available to OrthoClear patients in the United States, Canada and Hong Kong at no charge from Align. The Company implemented this program as the Patients First Program.

In accordance with the terms of the OrthoClear Agreement, on October 16, 2006, the Company made a one-time cash payment of \$20.0 million to OrthoClear Holdings, Inc. *See Note 2 Patients First Programs and settlement costs of the Notes to Consolidated Financial Statements for discussion on Patients First Program.*

#### **Ormco**

On January 6, 2003, Ormco Corporation ( Ormco ) filed suit against the Company in the United States District Court for the Central District, Orange County Division, asserting infringement of certain patents. Ormco is a division of Sybron Dental Specialties. In May 2006, Danaher Corporation acquired Sybron Dental Specialties. The complaint sought unspecified monetary damages and injunctive relief. On February 18, 2003, The Company answered the complaint and asserted counterclaims seeking a declaration by the Court of invalidity and non-infringement of the asserted patents. In addition, the Company counterclaimed for infringement of one of its patents, seeking unspecified monetary damages and injunctive relief. Ormco filed a reply to its counterclaims on March 10, 2003 and asserted counterclaims against the Company seeking a declaration by the Court of invalidity and non-infringement of the patent. The Company amended its counterclaim to add Allesee Orthodontic Appliances, Inc. ( AOA ), a wholly-owned subsidiary of Ormco, as a counterdefendant in regard to its counterclaim of infringement of the patent.

On February 1, 2006, the Company entered into a settlement agreement (the Settlement Agreement ) with Ormco and AOA. In accordance with the terms of the Settlement Agreement, Ormco and AOA paid into escrow, pending the completion of the appellate process, \$884,000 to resolve the issues of past damages, willfulness and attorneys fees for the adjudged infringement of two of the Company s patents (the Align Patents ) through the manufacture and sale of Ormco s and AOA s Red, White & Blue appliances. The Company s receipt of the payments out of escrow is contingent upon the Court, in a final, non-appealable judgment, finding that Ormco or AOA infringes at least one of the claims



in the Align Patents. If, however, the Court issues a final, non-appealable judgment of non-infringement, invalidity or unenforceability with respect to each asserted claim of the Align Patents, all funds in the escrow account will be returned to Ormco and AOA. The Settlement Agreement does not affect (a) Ormco's appeal of the decisions and orders of the District Court relating to Ormco's patents; or (2) our pending cross-appeal of the orders of the District Court relating to our patents.

There have been two appeals. After the Permanent injunction was entered, Ormco and AOA appealed that injunction and the orders of the District Court on summary judgment on which that order was based. Oral argument took place on April 3, 2006. Following oral argument, the U.S. Court of Appeals for the Federal Circuit (CAFC) issued a ruling declaring two out of a total of seventy-one claims in our US Patent No. 6,398,548 and four out of a total of ten claims in US Patent No. 6,544,611 to be invalid as obvious. The CAFC's decision reverses the California District Court summary judgment order of validity.

The second appeal is from the final judgment. Once final judgment was entered, Ormco filed a Notice of Appeal from the final judgment and the Company filed a notice of cross-appeal. Ormco has appealed the ruling of the District Court that its patents are not infringed by the Company and that the asserted claims are invalid. The Company appealed the ruling of the District Court that certain claims of its 6,398,548 patent which were found to be infringed by Ormco's and AOA's Red, White & Blue appliances were invalid. Briefing on this appeal and cross-appeal is complete, and oral argument occurred on February 6, 2007.

### ***Bay Materials***

On July 25, 2005, Bay Materials, LLC (Bay) filed suit against the Company in the Superior Court of the State of California for the County of San Mateo. The complaint, as amended, asserts, among other things, breach of contract, promissory estoppel and fraud. Bay alleges that we breached the terms of a purchase order by failing to pay for unshipped goods manufactured by Bay pursuant to such order. Bay further alleges that the Company promised to purchase from Bay an alternative polyurethane product, and Bay relied on this representation to develop such an alternative product which the Company determined not to use. The complaint seeks monetary damages of \$1.1 million related to breach of contract and research and development costs incurred plus unspecified damages related to lost profit, punitive and exemplary damages, and legal expenses. On March 27, 2006, the Company filed its answer to Bay's amended complaint, and also filed a cross-complaint against Bay for breach of contract, breach of implied warranty of fitness, intentional misrepresentation, concealment, specific performance, unjust enrichment and unfair business practices. The cross-complaint seeks monetary damages against Bay exceeding \$1.0 million. In the fourth quarter of 2006, the parties agreed to settle their dispute and dismiss all claims and cross-claims against each other in exchange for a one time payment by the Company to Bay in the amount of \$750,000.

Litigating claims of these types, whether or not ultimately determined in the Company's favor or settled by the Company, is costly and diverts the efforts and attention of the Company's management and technical personnel from normal business operations. Any of these results from litigation could adversely affect the Company's results of operations. From time to time, the Company has received, and may again receive, letters from third parties drawing the Company's attention to their patent rights. While the Company does not believe that it infringes any such rights that have been brought to the Company's attention, there may be other more pertinent proprietary rights of which the Company is presently unaware.

**Note 8. Credit Facilities**

In December 2005, the Company renegotiated and amended its existing revolving line of credit to increase the available borrowings under the then existing revolving line of credit to \$20 million. Included in the revolving line of credit is a letter of credit facility of up to \$5 million, a foreign exchange facility of up to \$5 million and an equipment facility of up to \$10 million. The Company may elect interest rates on our borrowing calculated by reference to bank's prime rate less one-half of one percent or LIBOR plus two percent. The credit facility matures on December 16, 2007, at which time all outstanding borrowings must be repaid. The credit facility contains certain restrictive loan covenants, including, among others, financial covenants requiring a minimum quick ratio and minimum tangible net worth, and covenants limiting our ability to dispose of assets, make acquisitions, be acquired, incur indebtedness, grant liens, make investments, pay dividends and repurchase stock. In December 2006, the Company amended its credit agreement whereby the only financial covenant for the fourth quarter of 2006 was a certain minimum cash balance. As of December 31, 2006, the Company is in compliance with the financial covenants of this credit facility.

During the third quarter of 2006, the Company borrowed \$15.0 million against this credit facility and made a \$20.0 million one-time payment to OrthoClear Holdings, Inc in accordance with the terms of the OrthoClear Agreement. The Company elected LIBOR plus two percent as its interest rate of 7.29% as of December 31, 2006. The Company repaid \$3.5 million of this borrowing in the fourth quarter of 2006, therefore the outstanding balance as of December 31, 2006 was \$11.5 million.

On March 7, 2007, the Company renegotiated and amended its existing credit facility with Comerica Bank. The amendment, among other things, will reduce financial covenants to require only a quick ratio covenant. Additionally, the amendment will also increase the available borrowings under the existing revolving line of credit from \$20 million to \$25 million effective January 1, 2008. The amended credit facility matures on December 31, 2008 at which point all outstanding borrowing under this credit facility must be repaid.

**Note 9. Commitments and Contingencies**

*Operating leases*

Align rents its facilities and certain equipment and automobiles under non-cancelable operating lease arrangements. Facility leases expire at various dates through 2014 and provide for pre-negotiated fixed rental rates during the terms of the lease.

In February 2005, the Company renewed its Santa Clara headquarters lease allowing it to utilize the security deposit of \$1.3 million paid at the inception of the lease on July 1, 2000, to reduce the monthly rent payment by \$11,000. By the end of the lease term at June 30, 2010, the security deposit balance will reduce to \$0.6 million.

In June 2004, the Company's European headquarters signed a lease agreement for a facility in Amsterdam, The Netherlands. This lease expires in 2014 with an option to cancel in 2009 with a lease termination fee of approximately \$238,000. The Company anticipates it will cancel this lease in 2009 and is accruing for the termination fee on a straight line basis.

The Company recognizes rent expense on a straight-line basis over the lease period, and has accrued for rent expense incurred but not paid. Total rent expense was \$3.8 million, \$4.3 million and, \$4.9 million for the years ended December 31, 2006, 2005 and 2004, respectively.

Minimum future lease payments for non-cancelable leases as of December 31, 2006, are as follow (in thousands):

Years Ending December 31,	
2007	\$ 3,261
2008	2,268
2009	1,423
2010	467
2011	
Thereafter	
Total	\$ 7,419

## Note 10. Stockholders Equity

### *Preferred Stock*

As of December 31, 2006, the Company has authorized 5,000,000 shares of preferred stock, \$0.0001 par value, none of which was issued and outstanding. Pursuant to the Certificate of Designation of Rights and Privileges of Series A Participating Preferred Stock filed on October 26, 2005, 200,000 shares of such preferred stock have been designated as Series A Participating Preferred Stock.

### *Preferred Stock Rights Agreement*

On October 25, 2005, pursuant to a Preferred Stock Rights Agreement (the Rights Agreement) between the Company and EquiServe Trust Company (now Computershare Limited), as the Rights Agent, the Company's Board of Directors declared a dividend of one right (a Right) to purchase one one-thousandth share of the Company's Series A Participating Preferred Stock (Series A Preferred) for each outstanding share of common stock, par value \$0.0001 per share of the Company. The dividend was paid on November 22, 2005 to stockholders of record as of the close of business on that date. Each Right entitles the registered holder, subject to the terms of the Rights Agreement, to purchase from the Company one one-thousandth of a share of Series A Preferred at an exercise price of \$37.00, subject to adjustment. The Rights will be separate from the shares of Common Stock. Rights Certificates will be issued and the Rights will become exercisable upon the earlier of (a) the tenth business day (or such later date as may be determined by the Company's Board of Directors) after a public announcement that a person or group of affiliated or associated persons (Acquiring Person) has acquired beneficial ownership of 15% or more of the shares of Common Stock then outstanding, or (b) the tenth business day (or such later date as may be determined by the Company's Board of Directors) after a person or group announces a tender or exchange offer, the consummation of which would result in ownership by a person or group of 15% or more of the Company's then outstanding shares of Common Stock. An Acquiring Person does not include certain persons specified in the Rights Agreement. The Rights will expire on the earliest of (i) November 22, 2015, or (ii) redemption or exchange of the Rights as described below. As of December 31, 2006, no rights were exercised.

### *Common Stock*

The holders of common stock are entitled to receive dividends whenever funds are legally available and when and if declared by the Board of Directors. The Company has not declared or paid any dividends as of December 31, 2006.

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*Employee Stock Purchase Plan*

Align's Employee Stock Purchase Plan (the Purchase Plan) consists of overlapping twenty-four month offering periods with four six-month purchase periods in each offering period. Employees purchase shares at 85% of the fair market value of the common stock at either the beginning of the purchase period or the end of the purchase period, whichever price is lower. The Purchase Plan provides that the number of shares of the Company's common stock reserved for issuance thereunder will automatically increase on the first trading day of January in each calendar year by an amount equal to three percent (3%) of the total number of shares of common stock outstanding on the last trading day in December of the immediately preceding calendar year, with this annual increase not to exceed 1,500,000 shares.

During the year ended December 31, 2006, 462,404 shares were issued under the Purchase Plan. As of December 31, 2006, the Company had reserved 8,933,456 shares of common stock for future issuance and 7,272,388 shares remain available for future issuance.

As of December 31, 2006, there was \$0.5 million of total unamortized compensation costs related to employee stock purchases. These costs are expected to be recognized over a weighted average period of 0.3 years.

*Stock Option Plans*

In May 2005, stockholder approval was obtained for the 2005 Incentive Plan (2005 Plan), which replaced the 2001 Stock Incentive Plan (the 2001 Plan). The 2005 Plan, which expires December 31, 2010, provides for the granting of incentive stock options, non-statutory stock options, restricted stock units, stock appreciation rights, performance units and performance shares. Employees, non-employee directors and consultants are eligible to receive grants under the 2005 Plan. The options are granted for periods not exceeding ten years and generally vest over 4 years with 25% vesting one year from the date of grant and 1/48th each month thereafter. The Plan Administrator may, however, grant options with different vesting schedules at its option. In the first quarter of 2005, the Company granted options under the 2001 Plan (prior to the approval of the 2005 Plan), that vest over 3 years, with 25% vested at the date of grant, and 1/36th each month thereafter. Options are to be granted at an exercise price not less than the fair market value of the underlying shares at the date of grant.

Starting in the first quarter of 2006, the Compensation Committee of the Board of Directors approved the grant of restricted stock units (contracts that give the recipients the right to receive shares as the units vest) to its employees and director(s) in addition to stock options. Each restricted stock unit award generally vests over 4 years with 25% on the one year anniversary of the date of grant and 6.25% vesting quarterly thereafter. Any grants of restricted stock units will reduce shares available for grant at a 2:1 ratio.

The 2005 Plan has 9,983,379 shares of the Company's common stock reserved for issuance, plus up to an aggregate of 5,000,000 shares that are or would have been returned to the 2001 Plan as a result of termination of outstanding options or repurchase of shares granted under the 2001 Plan on or after March 28, 2005. As of December 31, 2006, 2,084,687 shares have been transferred to the 2005 Plan. As of December 31, 2006, 7,904,506 shares remain available for issuance under the 2005 Plan.

*Executive Grants*

In January 2001, the stockholders approved two option grants to purchase 1,000,000 shares of the Company's common stock at an exercise price of \$15.00 per share to each of the Company's then Chief Executive Officer and President. The options were granted outside of the 1997 Equity Incentive Plan and prior to the adoption of the 2001 Plan or the 2005 Plan. The remaining 500,000 shares were cancelled in May 2006. As of December 31, 2006, no options to purchase shares of common stock remained outstanding under these grants.

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Activity for the years ended December 31, 2005 and 2004 under the stock option and executive grant plans are set forth below (in thousands, except per share data):

	Year Ended December 31, 2005		Year Ended December 31, 2004	
	Shares	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price
Outstanding at beginning of year	9,050	\$ 10.35	8,767	\$ 7.03
Granted	5,593	7.35	2,446	17.85
Exercised	(830 )	4.04	(1,695 )	3.79
Repurchased				1.07
Cancelled	(1,506 )	11.50	(468 )	11.13
Expired	(1,003 )	15.00		
Outstanding at end of year	11,304	\$ 8.76	9,050	\$ 10.35

Activity for the years ended December 31, 2006 under the stock option and executive grant plans are set forth below (in thousands, except per share data):

	Number of Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term (in years)	Aggregate Intrinsic Value
Outstanding at December 31, 2005	11,304	\$ 8.76		
Granted	1,794	8.74		
Cancelled or expired	(1,603 )	12.37		
Exercised	(2,317 )	5.87		
Outstanding at December 31, 2006	9,178	\$ 8.86	7.5	\$ 53,160
Ending vested and expected to vest at December 31, 2006	8,847	\$ 8.88	7.4	\$ 51,217
Exercisable at December 31, 2006	6,436	\$ 9.12	6.9	\$ 37,139

The aggregate intrinsic value in the table above represents the total pretax intrinsic value (the difference between Align's closing stock price on the last trading day of fiscal 2006 of \$13.97 and the exercise price, multiplied by the number of in-the-money options) that would have been received by the option holders had all option holders exercised their options on December 31, 2006. This amount changes based on the fair market value of Align's stock.

The total intrinsic value of stock options exercised for the years ended December 31, 2006 and 2005 were \$13.2 million, and \$ 3.3 million, respectively. As of December 31, 2006, there was \$10.0 million of total unamortized compensation costs related to stock options. These costs are expected to be recognized over a weighted average period of 2.5 years. For the year ended December 31, 2006, total recognized tax benefit from exercised options was immaterial.

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The options outstanding and currently exercisable by exercise price at December 31, 2006 are as follows (in thousands, except per share data):

Range of Exercise Prices	Options Outstanding			Options Exercisable		
	Shares	Weighted Average Remaining Years	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price	
\$ 0.05 4.95	1,259,157	4.7	\$ 3.70	1,256,444	\$ 3.70	
5.30 6.15	1,021,906	6.4	5.96	836,389	5.95	
6.47 6.95	1,070,047	8.8	6.68	274,826	6.67	
6.98 7.25	285,000	9.0	7.10	145,000	7.23	
7.35 7.35	1,161,679	8.2	7.35	1,121,679	7.35	
7.40 8.33	996,597	8.2	7.81	878,764	7.76	
8.38 8.38	1,089,463	9.1	8.38			
8.39 16.51	1,035,967	7.7	11.82	726,546	11.88	
\$ 16.93 22.43	1,258,350	7.0	18.81	1,196,787	18.82	
	9,178,166	7.5	\$ 8.86	6,436,435	\$ 9.12	

### Restricted Stock Units

Starting in the first quarter of 2006, the Company began granting restricted stock units that generally vest over 4 years with 25% vesting on the one year anniversary of the date of grant and 6.25% vesting quarterly thereafter. The fair value of each award is based on the Company's closing stock price on the date of grant. As of December 31, 2006, the total fair value of vested restricted stock awards was zero. A summary of the nonvested shares for the year ended December 31, 2006 is as follows:

	Shares (in thousands)	Weighted Average Grant Date Fair Value
Nonvested as of December 31, 2005	\$	\$
Granted	442	8.69
Vested		
Forfeited	(23 )	8.22
Nonvested as of December 31, 2006	\$ 419	\$ 8.71

As of December 31, 2006, there was \$2.7 million of total unamortized compensation costs related to restricted stock units. These costs are expected to be recognized over a weighted average period of 3.2 years.

### Stock-based compensation

Effective January 1, 2006, the Company adopted Statement of Financial Accounting Standards No. 123 (Revised 2004), Share-based Payment ( FAS 123R ) using the modified prospective transition method, which requires the measurement and recognition of compensation expense for all share-based payment awards made to our employees and directors and employee stock purchases related to the Employee Stock Purchase Plan based on estimated fair values over the requisite service period. In accordance with the modified prospective method, our financial statements for the prior periods have not been restated to reflect and do not include the impact of FAS 123R Stock Options.

*Valuation assumptions*

The fair value of stock options granted and the option component of the Purchase Plan shares were estimated at the grant date using the Black-Scholes option pricing model with the following weighted average assumptions:

	The Years Ended December 31,					
	2006		2005		2004	
<b>Stock Options:</b>						
Expected term (in years)	5.0		4.5		5.0	
Expected volatility	76.2	%	85.3	%	55.9	%
Risk-free interest rate	4.6	%	4.1	%	3.4	%
Expected dividend						
Weighted average fair value at grant date	\$ 5.67		\$ 4.80		\$ 9.17	
<b>Employee Stock Purchase Plan:</b>						
Expected term (in years)	1.3		1.2		2.0	
Expected volatility	48.2	%	62.0	%	55.3	%
Risk-free interest rate	5.0	%	3.8	%	1.8	%
Expected dividend						
Weighted average fair value at grant date	\$ 2.69		\$ 3.12		\$ 7.17	

The expected term of stock options represents the weighted-average period the stock options are expected to remain outstanding. Upon the adoption of FAS 123R, the Company used a midpoint model to determine the expected term of stock options based on the Company's historical exercise and post vesting cancellation experience, and the remaining contractual life of its outstanding options.

The increase in expected life assumption used in the Black-Scholes option pricing for the year ended December 31, 2006 compared to the year ended December 31, 2005, is the result of granting options with shorter vesting in 2005.

The Company used a combination of historical volatility and peer group volatility in deriving its expected volatility assumption as allowed under FAS 123R and SAB 107. The Company's historical volatility from 2002 to 2006 was used in determining expected volatility. The Company used peer group volatility instead of its own historical data for 2001, as the Company had unusually high volatility in its stock price as the result of its Initial Public Offering in 2001. The peer group volatility was derived based on historical volatility of a comparable peer group consisting of companies of similar size and operating in a similar industry.

The risk free interest rate is based on the implied yield on a U.S. Treasury zero-coupon issue with a remaining term equal to the expected term of the option.

The dividend yield reflects that the Company has not paid any cash dividends since inception and does not anticipate paying cash dividends in the foreseeable future.

*Summary of Stock-based Compensation Expense*

Stock-based compensation expense recognized in the Consolidated Statements of Operations for the year ended December 31, 2006 is based on awards ultimately expected to vest and has been reduced for estimated forfeitures. FAS 123R requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. Forfeitures were estimated based on historical experience. In the Company's pro forma information required under FAS 123 for periods prior to fiscal 2006, the Company accounted for forfeitures as they occurred. The following

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table summarizes stock-based compensation expense related to all of the Company's stock-based awards and employee stock purchases under FAS 123R for the year ended December 31, 2006:

(In thousands, except per share amounts)	<b>For the Year Ended December 31, 2006</b>
Cost of revenues	\$ 700
Sales and marketing	2,862
General and administrative	4,054
Research and development	1,294
<b>Total share-based compensation</b>	<b>\$ 8,910</b>

In connection with the grant of stock options prior to Align's initial public offering (IPO) in 2001 and certain grants subsequent to the IPO, the Company recorded deferred stock compensation and amortized stock-based compensation expense over the option vesting period of four years using the straight-line method. The Company had fully amortized the deferred stock-based compensation balance as of December 31, 2004. Align recorded \$5.1 million in amortization of deferred stock-based compensation during fiscal 2004. If the employee terminated employment, which resulted in the cancellation of any unvested options, the Company reversed the unamortized deferred stock-based compensation related to those options. Align reversed \$0.1 million of unrecognized deferred compensation for terminated employees during fiscal 2004.

For options granted to non-employees, the Company recorded stock-based compensation expense of \$45,000 and \$0.4 million for the fiscal years of 2005 and 2004, respectively.

During fiscal 2005 and 2004, the Company accelerated the vesting of options to several employees in connection with related severance packages. In accordance with FASB Interpretation No. 44 Accounting for Certain Transactions Involving Stock Compensation (FIN 44), the acceleration charges were measured based on the intrinsic value method, which is the difference between the market value of common stock at the acceleration date and the exercise price of the option. Acceleration charges for December 31, 2005 and 2004 were \$67,000 and \$0.4 million, respectively.

Stock based compensation expense for the years ended December 31, 2005 and 2004 are as follows (in thousands):

	<b>Years Ended December 31,</b>	
	<b>2005</b>	<b>2004</b>
Cost of revenues	\$	\$ 894
Sales and marketing	22	651
General and administrative	90	2,736
Research and development		1,586
	<b>\$ 112</b>	<b>\$ 5,867</b>

### *Option Acceleration*

On October 6, 2005, the Compensation Committee of the Board of Directors approved the acceleration of the vesting for all unvested stock options with exercise prices greater than \$7.10. The fair market value of Align's common stock on the date of acceleration was \$6.41 as quoted on the NASDAQ National Market. Options held by non-employee directors were excluded from the vesting acceleration. As a result of the acceleration, approximately 3.8 million options or 35% of the then total outstanding options became immediately exercisable as of October 6, 2005. The purpose of the acceleration was to eliminate



future compensation expense the Company would otherwise recognize in its statement of operations with respect to these accelerated options upon the adoption of FAS 123R.

*Pro Forma Information Under FAS 123 for Periods Prior to Fiscal 2006*

Prior to January 1, 2006, the Company accounted for stock-based employee compensation using the intrinsic value method under Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees ( APB 25 ) and related interpretations and complied with the disclosure requirements of SFAS 148, Accounting for Stock-Based Compensation Transition and Disclosure an amendment of FASB Statement No. 123. Under the intrinsic method, the difference between the market price on the date of grant and the exercise price is charged to the results of operations over the vesting period. Accordingly, the Company was not required to recognize compensation cost for stock options issued to its employees or shares issued under the Purchase Plan because options were issued at market price on the date of grant.

FAS 123R requires the Company to present pro forma information for the comparative period prior to the adoption as if it had accounted for all of its stock options under the fair value method of FAS 123. The following table illustrates the pro forma information regarding the effect on net earnings and net earnings per share for the year ended December 31, 2005 and 2004 as if the Company had accounted for the stock-based employee compensation under the fair value method of accounting:

(In thousands, except per share amounts)	Years Ended	
	December 31, 2005	2004
Net profit, as reported	\$ 1,413	\$ 8,768
Add: Stock-based employee compensation expense included in reported net earnings under APB No. 25, net of related tax effects	70	5,956
Deduct: Total stock-based employee compensation determined under the fair value method for all awards, net of related tax effects	(40,342 )	(17,933 )
Pro forma net loss	\$ (38,859 )	\$ (3,209 )
Basic net profit (loss) per share:		
As reported	\$ 0.02	\$ 0.15
Pro forma	\$ (0.63 )	\$ (0.05 )
Diluted net earnings (loss) per share:		
As reported	\$ (0.02 )	\$ 0.14
Pro forma	\$ (0.63 )	\$ (0.05 )

**Note 11. Employee Benefit Plan**

In January 1999, the Company adopted a defined contribution retirement plan under Section 401(k) of the Internal Revenue Code. This plan covers substantially all employees who meet minimum age and service requirements and allows participants to defer a portion of their annual compensation on a pre-tax basis. Company contributions to the plan may be made at the discretion of the Board of Directors. There have been no contributions by the Company since the inception of the plan.

**Note 12. Income Taxes**

Significant deferred tax assets and liabilities were as follows (in thousands):

	<b>Years Ended December 31,</b>	
	<b>2006</b>	<b>2005</b>
Deferred tax assets, net:		
Net operating loss carryforwards	\$ 80,008	\$ 73,087
Research and development credit carryforwards	8,026	7,350
Deferred revenue	1,151	1,858
Accruals, allowances & other not currently deductible for tax purposes	12,968	7,693
Deferred tax assets	102,153	89,988
Less: Valuation allowance	(102,153 )	(89,988 )
Net deferred tax asset	\$	\$

The Company has provided a full valuation allowance at December 31, 2006 because Align believes that the net deferred tax assets are unlikely to be realized.

At December 31, 2006, the Company had net operating loss carryforwards of approximately \$214.9 million for federal purposes and \$73.5 million for California state tax purposes. If not utilized, these carryforwards will begin to expire beginning in 2017 for federal purposes and 2007 for California purposes.

The Company has research credit carryforwards of approximately \$4.0 million for federal purposes and \$5.4 million for California state tax purposes. If not utilized, the federal credit carryforwards will begin to expire in 2017. The California state credit can be carried forward indefinitely.

The differences between income taxes using the federal statutory income tax rate of 35% and the Company's effective tax rate were as follows:

	<b>Years Ended December 31,</b>					
	<b>2006</b>		<b>2005</b>		<b>2004</b>	
U.S. federal statutory income tax rate	35.00	%	35.00	%	34.00	%
State income taxes, net of federal tax benefit	5.15	%	5.14	%	6.00	%
Deferred tax benefits utilized	-21.59	%	-236.81	%	-94.37	%
Foreign losses not benefited	-12.25	%	209.43	%	46.90	%
Impact of differences in foreign tax rates	1.27	%	2.05	%		
Amortization of stock-based compensation	-7.67	%			13.27	%
Non-deductible foreign exchange losses	-0.74	%	16.74	%		
Non-deductible meals & entertainment charges	-1.29	%	14.38	%	2.19	%
Other items not individually material	-0.31	%	2.31	%	2.19	%
	-2.43	%	48.24	%	10.18	%

The provision for income taxes consisted of the following (in thousands):

	<b>Years Ended December 31,</b>		
	<b>2006</b>	<b>2005</b>	<b>2004</b>
Federal	\$ (27 )	\$ 505	\$ 282
State	55	221	197
Foreign	800	590	515
Total provision for income taxes	\$ 828	\$ 1,316	\$ 994



**Note 13. Net profit (loss) per share**

Basic net profit (loss) per share is computed using the weighted average number of shares of common stock during the year less unvested common shares subject to repurchase. Diluted net profit per share is computed using the weighted average number of shares of common stock, adjusted for the dilutive effect of potential common stock. Potential common stock, computed using the treasury stock method, includes options and unvested shares subject to repurchase.

The following table sets forth the computation of basic and diluted net profit (loss) per share attributable to common stock (in thousands, except per share amounts):

	<b>Years Ended December 31,</b>		
	<b>2006</b>	<b>2005</b>	<b>2004</b>
<b>Numerator:</b>			
Net profit (loss)	\$ (34,963 )	\$ 1,413	\$ 8,768
<b>Denominator:</b>			
Weighted-average common shares outstanding	63,246	61,644	60,036
Less: Unvested common shares subject to repurchase			(73 )
Total shares, basic	63,246	61,644	59,963
<b>Effect of dilutive securities:</b>			
Add: Dilutive common stock equivalents		1,508	4,053
Unvested common shares subject to repurchase			73
Total shares, diluted	63,246	63,152	64,089
Net profit (loss) per share, basic	\$ (0.55 )	\$ 0.02	\$ 0.15
Net profit (loss) per share, diluted	\$ (0.55 )	\$ 0.02	\$ 0.14

For the year ended December 31, 2006, 2005 and 2004 stock options and restricted stock units totaling 6.5 million, 6.6 million and 1.3 million, respectively, were excluded from diluted net loss per share because of their anti-dilutive effect.

**Note 14. Supplemental Cash Flow Information**

The supplemental cash flow information consists of the following (in thousands):

	<b>Years Ended December 31,</b>		
	<b>2006</b>	<b>2005</b>	<b>2004</b>
Taxes paid	\$ 992	\$ 1,298	\$ 258
Interest paid	\$ 223	\$ 80	\$ 190
<b>Non-cash investing and financing activities:</b>			
Fixed assets acquired as exchange	\$	\$	\$ 834
Deferred revenue assumed in the GO acquisition	\$	\$ 635	\$
Accrued liabilities assumed in the GO acquisition	\$	\$ 39	\$
Fixed assets acquired with accounts payable or accrued liabilities	\$ 541	\$ 1,112	\$ 45
Deferred stock-based compensation	\$	\$	\$ 130

**Note 15. Segments and Geographical Information***Segment*

The Company reports segment data based on the management approach which designates the internal reporting that is used by management for making operating decisions and assessing performance as the source of the Company's reportable operating segments. During all periods presented, the Company operated as a single business segment.

*Geographical Information*

Net revenues and long-lived assets are presented below by geographic area (in thousands):

	<b>For the Years Ended December 31,</b>		
	<b>2006</b>	<b>2005</b>	<b>2004</b>
<b>Net revenues:</b>			
Domestic	\$ 172,635	\$ 182,903	\$ 156,837
Europe	28,076	20,750	14,502
Other International	5,643	3,472	1,491
<b>Total net revenues</b>	<b>\$ 206,354</b>	<b>\$ 207,125</b>	<b>\$ 172,830</b>

	<b>As of December 31,</b>	
	<b>2006</b>	<b>2005</b>
<b>Long-lived assets:</b>		
Domestic	\$ 40,744	\$ 27,281
Europe	745	990
Other International	1,979	2,253
<b>Total long-lived assets</b>	<b>\$ 43,468</b>	<b>\$ 30,524</b>

**Note 16. Subsequent Events**

On March 7, 2007, the Company renegotiated and amended its existing credit facility with Comerica Bank. The amendment, among other things, reduced financial covenants to require only a quick ratio covenant. Additionally, the amendment also increased the available borrowings under the existing revolving line of credit from \$20 million to \$25 million effective January 1, 2008. The amended credit facility matures on December 31, 2008 at which point all outstanding borrowing under this credit facility must be repaid.

**ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE**

None

**ITEM 9A. CONTROLS AND PROCEDURES**

*Evaluation of disclosure controls and procedures.*

Under the supervision and with the participation of our management, including our Chief Executive Officer and our Chief Financial Officer, we have evaluated the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act). Based upon that evaluation, our Chief Executive Officer and our Chief Financial Officer have concluded that our disclosure controls and procedures are effective as of December 31, 2006 to provide reasonable assurance that information required to be disclosed by us in the reports that we file or submit under the Exchange Act is accumulated and communicated to our management, including our Chief Executive Officer and our Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure, and that such information is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission rules and forms.

*Management's annual report on internal control over financial reporting.*

See Report of Management on Internal Control over Financial Reporting on page 53 of this Annual Report on Form 10-K, which is incorporated herein by reference.

*Attestation report of the registered public accounting firm.*

See Report of Independent Registered Public Accounting Firm on page 54 of this Annual Report on Form 10-K, which is incorporated herein by this reference.

*Changes in internal control over financial reporting.* There have been no changes in our internal control over financial reporting during the quarter ended December 31, 2006 that have materially affected or are reasonably likely to material affect, our internal control over financial reporting

**ITEM 9B. OTHER INFORMATION**

*Amendment to Credit Agreement*

On March 7, 2007, we entered into an Amendment to Credit Agreement with Comerica Bank (the Credit Amendment) to the Amended and Restated Loan and Security Agreement dated as of December 16, 2005, as amended (the Credit Facility). The Credit Amendment amends the Credit Facility to:

- extend the maturity date of the Credit Facility from December 16, 2007 to December 31, 2008;
- automatically increase the aggregate principal amount of the Credit Facility from \$20 million to \$25 million on January 1, 2008;
- change the financial statement reports from a monthly obligation to quarterly;
- amend the financial covenants to delete all financial covenants other than the quick ratio and amending such ratio from 1.75 to 1.00 (excluding deferred revenue) to 1.25 to 1.00 (excluding deferred revenue);
- include in the definition of permitted transfers transfers related to the Costa Rica tax restructuring;



- amend the definition of permitted indebtedness by increasing the amount of permitted indebtedness of a subsidiary to the Company from 5% to 10% and including a carve out for Costa Rica tax restructuring; and
- raise the cross-default amount from \$2 million to \$5 million.

A copy of the Amendment is attached hereto as Exhibit 10.8A.

*Amendment to Form of RSU Agreement*

On March 8, 2007, Align and Thomas M. Prescott entered into an amendment to each of the award agreements evidencing grants of restricted stock units awarded to Mr. Prescott on February 24, 2006 and February 20, 2007. The amendment served to make restricted stock unit acceleration terms in the original restricted stock unit awards consistent with the option acceleration terms included in Mr. Prescott's amended and restated employment agreement dated as of April 19, 2005. Specifically, the amendment deletes the term that accelerated the vesting of the restricted stock units upon termination of Mr. Prescott's employment for cause or good reason and amends the term related to acceleration of vesting upon a change of control to provide that all of Mr. Prescott's restricted stock units will immediately vest upon the occurrence of such an event. The form of amendment is attached hereto as Exhibit 10.14D and should be reviewed for additional information.

Our Compensation Committee also adopted a form of Restricted Stock Unit Award Agreement attached hereto as Exhibit 10.14C to be used in connection with any future grants of restricted stock units awarded to Mr. Prescott.

*Amendment to 2005 Incentive Plan*

On March 7, 2007, our Board of Directors approved an amendment to the Align Technology, Inc. 2005 Incentive Plan (the Plan Amendment). The Plan Amendment amends Section 15 of the 2005 Incentive Plan by:

- reducing the number of options to purchase shares of common stock granted to a new outside director on the date such person first becomes a member of the Board from 75,000 shares to 30,000 shares;
- increasing the annual equity awards automatically granted to each continuing director (other than the Chairman of the Board) on the date of each annual meeting of our stockholders from an option to purchase 8,000 shares to (A) an option to purchase 10,000 shares plus (B) a grant of 3,000 restricted stock units (the Second Awards); and
- clarifying that the Second Awards shall vest on the earlier of (i) the one year anniversary of the date of grant and (ii) the date of the next annual meeting of the Company's stockholders following the date of grant; and

A copy of the Plan Amendment is attached hereto as Exhibit 10.14.



**PART III**

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Certain information required by Part III is omitted from this Form 10-K because we intend to file a definitive Proxy Statement for our 2007 Annual Meeting of Stockholders (the Proxy Statement ) not later than 120 days after the end of the fiscal year covered by this Annual Report on Form 10-K, and certain information to be included therein is incorporated herein by reference.

### **ITEM 10. DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE**

The information required by this Item concerning our directors is incorporated by reference to the Proxy Statement under the section captioned Election of Directors. The information required by this Item concerning our executive officers is set forth in Part I, Item 1 Business of this Annual Report on Form 10-K. The information required by this item concerning compliance with Section 16(a) of the Exchange Act is incorporated by reference to the section entitled Section 16(a) Beneficial Ownership Reporting Compliance contained in the Proxy Statement.

#### **Code of Ethics**

We have a code of ethics that applies to all of our employees, including our principal executive officer, principal financial officer and principal accounting officer. This code of ethics is posted on our Internet website. The Internet address for our website is <http://www.aligntech.com>, and the code of ethics may be found on the Corporate Governance section of our Investor Relations webpage.

We intend to satisfy the disclosure requirement under Item 5.05 of Form 8-K regarding an amendment to, or waiver from, a provision of this code of ethics by posting such information on our website, at the address and location specified above, or as otherwise required by the NASDAQ Global Market.

### **ITEM 11. EXECUTIVE COMPENSATION**

The information required by this Item is incorporated by reference to the Proxy Statement under the section captioned Executive Compensation.

### **ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS**

The information required by this Item is incorporated by reference to the Proxy Statement under the sections captioned Security Ownership of Certain Beneficial Owners and Management and Equity Compensation Plan Information.

**Equity Compensation Plan Information**

The following table provides information as of December 31, 2006 about our common stock that may be issued upon the exercise of options and rights granted to employees, consultants or members of our Board of Directors under all existing equity compensation plans, including the 1997 Equity Incentive Plan, the Employee Stock Purchase Plan, the 2001 Stock Incentive Plan and the 2005 Incentive Plan, each as amended, and certain individual arrangements.

Plan Category	Number of securities to be issued upon exercise of outstanding options and restricted stock units(a)	Weighted average exercise price of outstanding options (b)	Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column(a))
Equity compensation plans approved by security holders	9,597,145 (1)(2)	\$ 8.86	15,176,894 (3)
Equity compensation plans not approved by security holders			
<b>Total</b>	<b>9,597,145</b>	<b>\$ 8.86</b>	<b>15,176,894</b>

(1) This number reflects the number of securities to be issued upon exercise of outstanding options and restricted stock units under the 2005 Incentive Plan, the 2001 Stock Incentive Plan and the 1997 Equity Incentive Plan.

(2) We are unable to ascertain with specificity the number of securities to be issued upon exercise of outstanding rights under the Employee Stock Purchase Plan or the weighted average exercise price of outstanding rights under the Employee Stock Purchase Plan.

(3) This number reflects securities available for future issuance under the 2005 Stock Incentive Plan and the Employee Stock Purchase Plan. In January 2001, all outstanding options under the 1997 Equity Incentive Plan were subsumed under the 2001 Stock Incentive Plan. Since that date no options have been granted under the 1997 Equity Incentive Plan. In May 2005, stockholder approval was obtained for the 2005 Incentive Plan and the 2001 Stock Incentive Plan was terminated. Since that date, no further options have been granted under the 2001 Stock Incentive Plan. The 2005 Incentive Plan has 9,983,379 shares of common stock reserved for issuance, plus up to an aggregate of 5,000,000 shares that are or would have been returned to the 2001 Stock Incentive Plan as a result of termination of outstanding options or repurchase of shares granted under the 2001 Stock Incentive Plan after March 28, 2005. As of December 31, 2006 2,084,687 shares have been transferred to the 2005 Incentive Plan. As of December 31, 2006, the number of shares available for future issuance under the 2005 Incentive Plan was 7,904,504. Any grants of restricted stock units will reduce shares available for grant at a 2:1 ratio. The Employee Stock Purchase Plan provides that the number of shares of our common stock reserved for issuance thereunder will automatically increase on the first trading day of January in each calendar year by an amount equal to three percent (3%) of the total number of shares of common stock outstanding on the last trading day in December of the immediately preceding calendar year, with this annual increase not to exceed 1,500,000 shares. As of December 31, 2006, the total number of shares of our common stock available for future issuance under the Employee Stock Purchase Plan was 7,272,388.

**ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS, AND DIRECTOR INDEPENDENCE**

The information required by this Item is incorporated by reference to the Proxy Statement under the sections captioned Certain Relationships and Related Transactions. and Director Independence.

**ITEM 14. PRINCIPAL ACCOUNTING FEES AND SERVICES**

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The information required by this Item is incorporated by reference to the Proxy Statement under the section captioned Ratification of Appointment of Independent Registered Public Accounting Firm.

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**PART IV**

**ITEM 15. EXHIBITS, FINANCIAL STATEMENT SCHEDULES.**

(a)

1. Consolidated Financial Statements

The following documents are filed as part of this Annual Report on Form 10-K:

Report of Independent Registered Public Accounting Firm 60

Consolidated Statements of Operations for the years ended December 31, 2006, 2005  
and 2004 62

Consolidated Balance Sheets as of December 31, 2006 and 2005 63

Consolidated Statements of Stockholders' Equity (Deficit) for the years ended December 31, 2006, 2005 and 2004 64

Consolidated Statements of Cash Flows for the years ended December 31, 2006, 2005  
and 2004 65

Notes to Consolidated Financial Statements 66

2. The following financial statement schedule is filed as part of this Annual Report on Form 10-K:

Schedule II - Valuation and Qualifying Accounts and Reserves

All other schedules have been omitted as they are not required, not applicable, or the required information is otherwise included.

**SCHEDULE II: VALUATION AND QUALIFYING ACCOUNTS AND RESERVES**

	<b>Balance at Beginning of Period (in thousands)</b>	<b>Additions (reductions) to Costs and Expenses</b>	<b>Write offs</b>	<b>Reclass from Other Accounts</b>	<b>Balance at End of Period</b>
<b>Allowance for doubtful accounts:</b>					
Year ended December 31, 2004	\$ 1,259	\$ 540	\$ (311 )	\$ 5	\$ 1,493
Year ended December 31, 2005	\$ 1,493	\$ 457	\$ (324 )	\$	\$ 1,626
Year ended December 31, 2006	\$ 1,626	\$ (332 )	\$ (450 )	\$	\$ 844
<b>Allowance for deferred tax assets:</b>					
Year ended December 31, 2004	\$ 74,928	\$ 13,611	\$	\$	\$ 88,539
Year ended December 31, 2005	\$ 88,539	\$ 1,449	\$	\$	\$ 89,988
Year ended December 31, 2006	\$ 89,988	\$ 12,165	\$	\$	\$ 102,153
<b>Allowance for excess and obsolete inventory and abandoned product:</b>					
Year ended December 31, 2004	\$ 253	\$ (72 )	\$ (138 )	\$	\$ 43
Year ended December 31, 2005	\$ 43	\$ 150	\$ (15 )	\$	\$ 178
Year ended December 31, 2006	\$ 178	\$ 10	\$	\$	\$ 188

**3. Exhibits**

<b>Exhibit Number</b>	<b>Description</b>	<b>Form</b>	<b>Exhibit Number Incorporated by reference herein</b>		<b>Filed herewith</b>
			<b>Date</b>	<b>Number</b>	
3.1	Amended and Restated Certificate of Incorporation of registrant.	Form S-1, as amended (File No. 333-49932)	12/28/2000	3.1	
3.2	Amended and Restated Bylaws of registrant.	Form S-1, as amended (File No. 333-49932)	12/28/2000	3.2	
3.3	Certificate of Designations of Rights, Preferences and Privileges of Series A Participating Preferred Stock registrant	Form 8-K	10/27/2005	3.1	
4.1	Form of Specimen Common Stock Certificate.	Form S-1, as amended (File No. 333-49932)	01/17/2001	4.1	
4.2	Preferred Stock Rights Agreement dated October 25 between the registrant and EquiServe Trust Company, N.A.	Form 8-K	10/27/2005	4.1	
10.1	Lease Agreement by and between James Lindsey and registrant, dated June 20, 2000, for office space located at 881 Martin Avenue, Santa Clara, CA.	Form S-1, as amended (File No. 333-49932)	11/14/2000	10.4	
10.2	First Amendment to Lease Agreement dated February 2, 2005 for office space located at 881 Martin Avenue, Santa Clara, CA	Form 8-K	02/09/2005	10.1	
10.3	Lease Agreement dated August 30, 2001 by and between James S. Lindsey and registrant for office space located at 821 Martin Avenue, Santa Clara, CA.	Form 10-K fiscal year ended December 31, 2002	03/27/2003	10.28	
10.4	First Amendment to Lease Agreement dated February 2, 2005 for office space located at 821 Martin Avenue, Santa Clara, CA.	Form 8-K	02/09/2005	10.3	
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10.5	Lease Agreement dated March 4, 2004 by and between James S. Lindsey and registrant for office space located at 831 Martin Avenue, Santa Clara, CA.	Form 10-Q for quarter ended March 31, 2004	05/06/2004	10.40
10.6	First Amendment to Lease Agreement dated February 2, 2005 for office space located at 831 Martin Avenue, Santa Clara, CA.	Form 8-K	02/09/2005	10.2
10.7	Shelter Agreement dated December 22, 2005 between registrant and International Manufacturing Solutions Operaciones, S.R.L.	Form 8-K	12/28/2005	10.1
10.8	Amended and Restated Loan and Security Agreement dated December 16, 2005 between registrant and Comerica Bank	Form 8-K	12/19/2005	10.1
10.8A	Amendment to Amended and Restated Loan and Security Agreement dated March 7, 2007 between registrant and Comerica Bank			*
10.9	Form of Resale Restriction Agreement with T. Prescott, E. Bullington, R. George, L. Hedge and Gil Laks	Form 8-K	10/11/2005	10.1
10.10	Registrant's 2001 Stock Incentive Plan.	Form S-1 as amended (File No. 333-49932)	12/28/2000	10.13
10.11	Form of option agreement under Align s 2001 Stock Incentive Plan	Form 10-Q for quarter ended September 30, 2004	11/05/2004	10.13.1
10.12	Registrant's Employee Stock Purchase Plan.	Form S-1 as amended (File No. 333-49932)	12/28/2000	10.14
10.13	Form of Indemnification Agreement by and between registrant and its Board of Directors and its executive officers.	Form S-1 as amended (File No. 333-49932)	01/17/2001	10.15

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10.14	Amended and restated 2005 Incentive Plan				*
10.14A	Form of restricted stock unit award agreement under registrant s 2005 Incentive Plan (General Form; Officer Form: Director Form)	Form 10-K	03/01/2006	10.14B	
10.14B	Form of option award agreement under registrant s 2005 Incentive Plan	Form 10-Q	08/04/2005	10.4	
10.14C	Form of restricted stock unit award agreement under registrant s 2005 Incentive Plan with Thomas M. Prescott				*
10.14D	Form of restricted stock unit award agreement amendment under registrant s 2005 Incentive Plan with Thomas M. Prescott				*
10.15	Amended and Restated Employment Agreement dated April 19, 2005 between Thomas M. Prescott and registrant.	Form 8-K	04/19/2005	10.1	
10.16	Employment Offer Letter dated July 10, 2002 for Roger E. George, Vice-President of Legal Affairs and General Counsel.	Form 10-Q for quarter ended September 30, 2002	11/14/2002	10.18	
10.17	Employment Offer Letter dated August 22, 2002 for Eldon M. Bullington, Chief Financial Officer and Vice-President, Finance.	Form 10-Q for quarter ended September 30, 2002	11/14/2002	10.20	
10.18	Form of Employment Agreement entered into by and between registrant and each of Dan Ellis, Darrell Zoromski,, Hossein Arjomand, Gil Laks and Michael Henry	Form 10-K	03/01/2006	10.20	
10.19	Form of Employment Agreement with Sonia Clark	Form 8-K	09/25/2006	10.01	
10.20	Lease Agreement dated February 26, 2003 between KPMG FIDES (COSTA RICA) S.A., PARQUE GLOBAL S.A. and registrant.	Form 10-Q for quarter ended March 31, 2003	05/13/2003	10.36	

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10.21	Lease Agreement between Schootsepoort Onroerendgoed Beheer, for Stichting Philips Pensioenfond and Align Technology, Inc.	Form 10-Q for quarter ended June 30, 2004	08/05/2004	10.41	
10.22	Summary of 2006 Incentive Awards for Named Executive Officers	Form 8-K	01/12/2007	Item 5.02 only	
10.23	Settlement Agreement and Mutual Releases dated as of October 12, 2006 by and between registrant and OrthoClear, Inc., among others	Form 8-K	10/19/2006	10.1	
21.1	Subsidiaries of the registrant.				*
23.1	Consent of PricewaterhouseCoopers LLP, Independent Registered Public Accounting Firm.				*
31.1	Certifications of Chief Executive Officer pursuant to Exchange Act Rules 13a-14(a) and 15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2003.				*
31.2	Certifications of Chief Financial Officer pursuant to Exchange Act Rules 13a-14(a) and 15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2003.				*
32	Certification of Chief Executive Officer and Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2003.				*

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Management contract or compensatory plan or arrangement filed as an Exhibit to this form pursuant to Items 14(a) and 14(c) of Form 10-K.

**SIGNATURES**

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized, on March 12, 2007.

ALIGN TECHNOLOGY, INC.

By: */s/ THOMAS M. PRESCOTT*  
 Thomas M. Prescott  
*President and Chief Executive Officer*

Know All Men By These Presents, that each person whose signature appears below constitutes and appoints Thomas M. Prescott, his or her attorney-in-fact, with the power of substitution, for him or her in any and all capacities, to sign any amendments to this Report on Form 10-K and to file the same, with exhibits thereto and other documents in connection therewith, with the Securities and Exchange Commission, hereby ratifying and confirming all that each of said attorneys-in-fact, or his or her substitute or substitutes, may do or cause to be done by virtue hereof.

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the Registrant and in the capacities and on the dates indicated.

Signature	Title	Date
<i>/s/ THOMAS M. PRESCOTT</i>	President and Chief Executive Officer	March 12, 2007
Thomas M. Prescott	(Principal Executive Officer)	
<i>/s/ ELDON M. BULLINGTON</i>	Chief Financial Officer and Vice President,	March 12, 2007
Eldon M. Bullington	Finance(Principal Financial Officer and Principal Accounting Officer)	
<i>/s/ H. KENT BOWEN</i>	Director	March 12, 2007
H. Kent Bowen		
<i>/s/ DAVID E. COLLINS</i>	Director	March 12, 2007
David E. Collins		
<i>/s/ JOSEPH LACOB</i>	Director	March 12, 2007
Joseph Lacob		
<i>/s/ C. RAYMOND LARKIN</i>	Director	March 12, 2007
C. Raymond Larkin		
<i>/s/ GEORGE J. MORROW</i>	Director	March 12, 2007
George J. Morrow		
<i>/s/ GREG J. SANTORA</i>	Director	March 12, 2007
Greg J. Santora		
<i>/s/ WARREN S. THALER</i>	Director	March 12, 2007
Warren S. Thaler		

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Exhibit Number	Description	Form	Exhibit Number Incorporated by reference herein		Filed herewith
			Date	Number	
3.1	Amended and Restated Certificate of Incorporation of registrant.	Form S-1, as amended (File No. 333-49932)	12/28/2000		3.1
3.2	Amended and Restated Bylaws of registrant.	Form S-1, as amended (File No. 333-49932)	12/28/2000		3.2
3.3	Certificate of Designations of Rights, Preferences and Privileges of Series A Participating Preferred Stock registrant	Form 8-K	10/27/2005		3.1
4.1	Form of Specimen Common Stock Certificate.	Form S-1, as amended (File No. 333-49932)	01/17/2001		4.1
4.2	Preferred Stock Rights Agreement dated October 25 between the registrant and EquiServe Trust Company, N.A.	Form 8-K	10/27/2005		4.1
10.1	Lease Agreement by and between James Lindsey and registrant, dated June 20, 2000, for office space located at 881 Martin Avenue, Santa Clara, CA.	Form S-1, as amended (File No. 333-49932)	11/14/2000		10.4
10.2	First Amendment to Lease Agreement dated February 2, 2005 for office space located at 881 Martin Avenue, Santa Clara, CA	Form 8-K	02/09/2005		10.1
10.3	Lease Agreement dated August 30, 2001 by and between James S. Lindsey and registrant for office space located at 821 Martin Avenue, Santa Clara, CA.	Form 10-K fiscal year ended December 31, 2002	03/27/2003		10.28
10.4	First Amendment to Lease Agreement dated February 2, 2005 for office space located at 821 Martin Avenue, Santa Clara, CA.	Form 8-K	02/09/2005		10.3
10.5	Lease Agreement dated March 4, 2004 by and between James S. Lindsey and registrant for office space located at 831 Martin Avenue, Santa Clara, CA.	Form 10-Q for quarter ended March 31, 2004	05/06/2004		10.40

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10.6	First Amendment to Lease Agreement dated February 2, 2005 for office space located at 831 Martin Avenue, Santa Clara, CA.	Form 8-K	02/09/2005	10.2	
10.7	Shelter Agreement dated December 22, 2005 between registrant and International Manufacturing Solutions Operaciones, S.R.L.	Form 8-K	12/28/2005	10.1	
10.8	Amended and Restated Loan and Security Agreement dated December 16, 2005 between registrant and Comerica Bank	Form 8-K	12/19/2005	10.1	
10.8A	Amendment to Amended and Restated Loan and Security Agreement dated March 7, 2007 between registrant and Comerica Bank				*
10.9	Form of Resale Restriction Agreement with T. Prescott, E. Bullington, R. George, L. Hedge and Gil Laks	Form 8-K	10/11/2005	10.1	
10.10	Registrant's 2001 Stock Incentive Plan.	Form S-1 as amended (File No. 333-49932)	12/28/2000	10.13	
10.11	Form of option agreement under Align s 2001 Stock Incentive Plan	Form 10-Q for quarter ended September 30, 2004	11/05/2004	10.13.1	
10.12	Registrant's Employee Stock Purchase Plan.	Form S-1 as amended (File No. 333-49932)	12/28/2000	10.14	
10.13	Form of Indemnification Agreement by and between registrant and its Board of Directors and its executive officers.	Form S-1 as amended (File No. 333-49932)	01/17/2001	10.15	
10.14	Amended and restated 2005 Incentive Plan				*
10.14A	Form of restricted stock unit award agreement under registrant s 2005 Incentive Plan (General Form; Officer Form: Director Form)	Form 10-K	03/01/2006	10.14B	

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10.14B	Form of option award agreement under registrant's 2005 Incentive Plan	Form 10-Q	08/04/2005	10.4	
10.14C	Form of restricted stock unit award agreement under registrant's 2005 Incentive Plan with Thomas M. Prescott				*
10.14D	Form of restricted stock unit award agreement amendment under registrant's 2005 Incentive Plan with Thomas M. Prescott				*
10.15	Amended and Restated Employment Agreement dated April 19, 2005 between Thomas M. Prescott and registrant.	Form 8-K	04/19/2005	10.1	
10.16	Employment Offer Letter dated July 10, 2002 for Roger E. George, Vice-President of Legal Affairs and General Counsel.	Form 10-Q for quarter ended September 30, 2002	11/14/2002	10.18	
10.17	Employment Offer Letter dated August 22, 2002 for Eldon M. Bullington, Chief Financial Officer and Vice-President, Finance.	Form 10-Q for quarter ended September 30, 2002	11/14/2002	10.20	
10.18	Form of Employment Agreement entered into by and between registrant and each of Dan Ellis, Darrell Zoromski,, Hossein Arjomand, Gil Laks and Michael Henry	Form 10-K	03/01/2006	10.20	
10.19	Form of Employment Agreement with Sonia Clark	Form 8-K	09/25/2006	10.01	
10.20	Lease Agreement dated February 26, 2003 between KPMG FIDES (COSTA RICA) S.A., PARQUE GLOBAL S.A. and registrant.	Form 10-Q for quarter ended March 31, 2003	05/13/2003	10.36	
10.21	Lease Agreement between Schootsepoort Onroerendgoed Beheer, for Stichting Philips Pensioenfond and Align Technology, Inc.	Form 10-Q for quarter ended June 30, 2004	08/05/2004	10.41	
10.22	Summary of 2006 Incentive Awards for Named Executive Officers	Form 8-K	01/12/2007	Item 5.02 only	

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10.23	Settlement Agreement and Mutual Releases dated as of October 12, 2006 by and between registrant and OrthoClear, Inc., among others	Form 8-K	10/19/2006	10.1	
21.1	Subsidiaries of the registrant.				*
23.1	Consent of PricewaterhouseCoopers LLP, Independent Registered Public Accounting Firm.				*
31.1	Certifications of Chief Executive Officer pursuant to Exchange Act Rules 13a-14(a) and 15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2003.				*
31.2	Certifications of Chief Financial Officer pursuant to Exchange Act Rules 13a-14(a) and 15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2003.				*
32	Certification of Chief Executive Officer and Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2003.				*

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Management contract or compensatory plan or arrangement filed as an Exhibit to this form pursuant to Items 14(a) and 14(c) of Form 10-K.

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