EXTREME NETWORKS INC
Form 10-Q
May 09, 2006
Table of Contents

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D. C. 20549

Form 10-Q

(Mark One)

x **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the quarter ended April 2, 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 000-25711

EXTREME NETWORKS, INC.

(Exact name of Registrant as specified in its charter)

DELAWARE	**77-0430270**
[State or other jurisdiction of incorporation or organization]	**[I.R.S. Employer Identification No.]**
3585 Monroe Street Santa Clara, California	**95051**
[Address of principal executive offices]	**[Zip Code]**

Registrant s telephone number, including area code: (408) 579-2800

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

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

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

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

The number of shares of the Registrant s Common Stock, $.001 par value, outstanding at

April 21, 2006 was 119,191,970.

Table of Contents

EXTREME NETWORKS, INC.

FORM 10-Q

QUARTERLY PERIOD ENDED APRIL 2, 2006

INDEX

Table of Contents

Part I. Financial Information

Item 1. Financial Statements

EXTREME NETWORKS, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS

(In thousands)

	April 2, 2006 (Unaudited)	July 3, 2005 (Note 1)
ASSETS		
Current assets:		
Cash and cash equivalents	$ 82,696	$ 127,470
Short-term investments	312,527	127,889
Accounts receivable, net	27,490	30,778
Inventories, net	20,583	25,943
Prepaid expenses and other current assets	13,713	12,410
Total current assets	457,009	324,490
Property and equipment, net	47,801	50,438
Marketable securities	49,489	185,045
Other assets	21,859	23,641
TOTAL ASSETS	$ 576,158	$ 583,614
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 21,562	$ 18,283
Accrued compensation and benefits	13,124	14,032
Restructuring liabilities	5,857	6,066
Lease liability		471
Accrued warranty	6,428	7,471
Deferred revenue	34,100	36,688
Convertible subordinated notes	200,000	
Other accrued liabilities	23,802	21,893
Total current liabilities	304,873	104,904
Restructuring liabilities, less current portion	9,565	13,890
Deferred revenue, less current portion	9,026	13,785
Deferred income taxes	830	757
Other long-term liabilities	2,266	2,266
Convertible subordinated notes		200,000
Commitments and contingencies (Note 3)		
Stockholders equity:		
Common stock and capital in excess of par value	701,977	693,158
Treasury stock	(20,606)	
Accumulated other comprehensive loss	(2,358)	(2,887)
Accumulated deficit	(429,415)	(442,259)
Total stockholders equity	249,598	248,012

TOTAL LIABILITIES AND STOCKHOLDERS EQUITY	$ 576,158	$ 583,614

See accompanying notes to the unaudited condensed consolidated financial statements.

Table of Contents

EXTREME NETWORKS, INC.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(In thousands, except per share amounts)

(Unaudited)

	Three Months Ended		Nine Months Ended	
	April 2, 2006	March 27, 2005	April 2, 2006	March 27, 2005
Net revenues:				
Product	$ 69,148	$ 76,835	$ 228,063	$ 243,770
Service	16,302	15,073	48,096	43,525
Total net revenues	85,450	91,908	276,159	287,295
Cost of revenues:				
Product [1]	30,432	35,692	99,875	109,951
Service [1]	8,806	8,954	26,002	25,568
Total cost of revenues	39,238	44,646	125,877	135,519
Gross margin:				
Product	38,716	41,143	128,188	133,819
Service	7,496	6,119	22,094	17,957
Total gross margin	46,212	47,262	150,282	151,776
Operating expenses:				
Sales and marketing [1]	23,148	23,946	73,026	70,941
Research and development [1]	14,456	15,329	46,389	45,586
General and administrative [1]	6,505	7,254	19,732	21,918
Amortization of deferred stock compensation [1]		2		69
Technology agreement		2,000		2,000
Total operating expenses	44,109	48,531	139,147	140,514
Operating income (loss)	2,103	(1,269)	11,135	11,262
Other income, net	1,383	829	3,739	4,582
Income (loss) before income taxes	3,486	(440)	14,874	15,844
Provision for income taxes	645	817	2,030	3,025
Net income (loss)	$ 2,841	$ (1,257)	$ 12,844	$ 12,819
Net income (loss) per share basic	$ 0.02	$ (0.01)	$ 0.11	$ 0.11
Net income (loss) per share diluted	$ 0.02	$ (0.01)	$ 0.10	$ 0.10

Shares used in per share calculation basic	120,940	121,444	122,230	121,041
Shares used in per share calculation diluted	122,818	121,444	124,050	124,211

(1) Includes stock-based compensation expense as follows:

Cost of product revenue	$ 147	$	$ 513	$
Cost of service revenue	77		277	
Sales and marketing	500	14	1,876	39
Research and development	363	4	1,330	98
General and administrative	228		763	
Amortization of deferred stock compensation		2		69
Total stock-based compensation expense	$ 1,315	$ 20	$ 4,759	$ 206

See accompanying notes to the unaudited condensed consolidated financial statements.

Table of Contents

EXTREME NETWORKS, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)

(Unaudited)

	Nine Months Ended April 2, 2006	March 27, 2005
Cash flows from operating activities:		
Net income	$ 12,844	$ 12,819
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	9,141	12,605
Provision for doubtful accounts	1,166	
Provision for excess and obsolete inventory	929	795
Deferred income taxes	3	15
Amortization of warrant	3,679	5,675
Amortization of deferred stock compensation		69
Loss on disposal of assets		50
Stock-based compensation	4,759	
Net changes in operating assets and liabilities:		
Accounts receivable	3,533	1,422
Inventories	4,448	2,990
Prepaid expenses and other current assets and other assets	(4,542)	(10,751)
Accounts payable	3,279	3,045
Accrued compensation and benefits	(907)	1,190
Restructuring liabilities	(4,534)	(4,965)
Lease liability	(471)	(1,413)
Accrued warranty	(1,044)	(424)
Deferred revenue	(7,347)	(4,834)
Other accrued liabilities	1,739	1,809
Net cash provided by operating activities	26,675	20,097
Cash flows from investing activities:		
Capital expenditures	(6,504)	(4,647)
Purchases of investments	(218,200)	(247,516)
Sales and maturities of investments	169,817	234,180
Net cash used in investing activities	(54,887)	(17,983)
Cash flows from financing activities:		
Proceeds from issuance of common stock	4,044	4,264
Repurchase of common stock	(20,606)	
Net cash provided by (used in) financing activities	(16,562)	4,264
Net increase (decrease) in cash and cash equivalents	(44,774)	6,378
Cash and cash equivalents at beginning of period	127,470	59,164

Cash and cash equivalents at end of period	$ 82,696	$ 65,542

See accompanying notes to the unaudited condensed consolidated financial statements.

Table of Contents

EXTREME NETWORKS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

1. Summary of Significant Accounting Policies

Basis of Presentation

The unaudited condensed consolidated financial statements of Extreme Networks, Inc. (referred to as Extreme Networks and as we , us and our) included herein have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission (SEC). Certain information and footnote disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles have been condensed or omitted pursuant to such rules and regulations. The condensed consolidated balance sheet at July 3, 2005 was derived from audited financial statements as of that date but does not include all disclosures required by generally accepted accounting principles for complete financial statements. These interim financial statements and notes should be read in conjunction with our audited consolidated financial statements and notes thereto included in our Annual Report on Form 10-K for the fiscal year ended July 3, 2005.

The unaudited condensed consolidated financial statements reflect all adjustments, consisting only of normal recurring adjustments, that, in the opinion of management, are necessary for a fair presentation of the results of operations and cash flows for the interim periods presented and the financial condition of Extreme Networks at April 2, 2006. The results of operations for the third quarter of fiscal 2006 are not necessarily indicative of the results that may be expected for fiscal 2006 or any future periods.

Revenue Recognition

We derive the majority of our revenue from sales of our modular and stackable networking equipment, with the remaining revenue generated from service fees relating to the service contracts and training on our products. We generally recognize product revenue from our value-added resellers and end-users at the time of shipment, provided that persuasive evidence of an arrangement exists, delivery has occurred, the price of the product is fixed or determinable and collection of the sales proceeds is reasonably assured. Revenue from service obligations under service contracts is deferred and recognized on a straight-line basis over the contractual service period. Service contracts typically range from one to five years. When sales arrangements contain multiple deliverables, such as hardware, service contracts and other services, we determine whether the deliverables represent separate units of accounting and then allocate revenue to each unit of accounting based on their relative fair values. We recognize revenue for each unit of accounting when the revenue recognition criteria for each unit of accounting are met. Shipping costs are included in cost of product revenues.

We make certain sales to partners in two distribution channels, or tiers. The first tier consists of a limited number of independent distributors that sell primarily to resellers and, on occasion, to end-user customers. We defer recognition of revenue on all sales to these distributors until the distributors sell the product, as evidenced by monthly sales-out reports that the distributors provide to us. We grant these distributors the right to return a portion of unsold inventory to us for the purpose of stock rotation. We also grant these distributors certain price protection rights. The distributor-related deferred revenue and receivables are adjusted at the time of the stock rotation return or price reduction. We also provide distributors with credits for changes in selling prices, and allow them to participate in cooperative marketing programs. Cooperative advertising expenses are recorded as marketing expenses to the extent that an advertising benefit separate from the revenue transaction can be identified and the cash paid does not exceed the fair value of that advertising benefit received. We maintain estimated accruals and allowances for these exposures based upon our historical experience. The second tier of the distribution channel consists of a large number of third-party resellers that sell directly to end-users and are not granted return privileges, except for defective products during the warranty period. We reduce product revenue for certain price protection rights that may occur under contractual arrangements we have with our resellers.

Inventories

Inventories consist of raw materials and finished goods and are stated at the lower of cost, determined on a first-in, first-out basis, or market. Inventories, which are net of an allowance for excess and obsolete inventory (which we determine primarily based on future demand forecasts) of $5.2 million and $4.8 million at April 2, 2006 and July 3, 2005, respectively, consist of (in thousands):

	April 2, 2006	July 3, 2005
Raw materials	$ 2,009	$ 369

Finished goods	18,574	25,574
Total	$ 20,583	$ 25,943

Table of Contents

Sales to Distributors

We defer recognition of revenue on all sales to distributors until the distributor successfully resells the product, typically to an authorized reseller. Distributors regularly provide us their sales-out reports for this purpose. Until it is sold, inventory held by distributors is included in our reported finished goods inventory and was $2.8 million and $3.7 million at April 2, 2006 and July 3, 2005, respectively. The accounts receivable owed us by distributors, net of the deferred revenue from sales to distributors, is recorded in prepaid expenses and other current assets, as reflected in the following table (in thousands):

	April 2, 2006	July 3, 2005
Accounts receivable, net of allowance for doubtful accounts of $264 ($619 at July 3, 2005)	$ 19,663	$ 23,249
Deferred revenue	(11,865)	(16,779)
Net, included in Prepaid expenses and other current assets	$ 7,798	$ 6,470

Guarantees and Product Warranties

Financial Accounting Standards Board (FASB) Interpretation No. 45, *Guarantor s Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others* (FIN 45) requires that upon issuance of a guarantee, the guarantor must disclose and recognize a liability for the fair value of the obligation it assumes under that guarantee.

We have determined that the requirements of FIN 45 apply to our standard product warranty liability. The following table summarizes the activity related to our product warranty liability during the nine months ended April 2, 2006 and March 27, 2005 (in thousands):

	Nine Months Ended	
	April 2, 2006	March 27, 2005
Balance beginning of period	$ 7,471	$ 8,297
New warranties issued	8,376	8,779
Warranty expenditures	(9,419)	(10,331)
Change in estimate		1,128
Balance end of period	$ 6,428	$ 7,873

Our standard hardware warranty period is typically 12 months from the date of shipment to end-users. Upon shipment of products to our customers, we estimate expenses for the cost to repair or replace products that may be returned under warranty and accrue a liability in cost of product revenue for this amount. The determination of our warranty requirements is based on actual historical experience with the product or product family, estimates of repair and replacement costs and any product warranty problems that are identified after shipment. We estimate and adjust these accruals at each balance sheet date in accordance with changes in these factors. The change in estimate in the nine months of fiscal 2005 results from a change in the method we used to accumulate warranty return rates. There was no change in estimate for the first nine months of fiscal 2006.

In the normal course of business to facilitate sales of our products, we indemnify our resellers and end-user customers with respect to certain matters. We have agreed to hold the customer harmless against losses arising from a breach 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. It is not possible to estimate 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. Historically, payments made by us under these agreements have not had a material impact on our operating results or financial position.

Table of Contents

Deferred Support Revenue

We offer renewable support arrangements, including extended warranty contracts, to our customers that range generally from one to five years. The change in our deferred support revenue balance in relation to these arrangements was as follows (in thousands):

	Nine Months Ended	
	April 2, 2006	March 27, 2005
Balance beginning of period	$ 47,849	$ 50,178
New support arrangements	37,340	36,066
Recognition of support revenue	(43,767)	(39,243)
Balance end of period	41,422	47,001
Less current portion	32,396	32,560
Non-current deferred revenue	$ 9,026	$ 14,441

Recently Issued Accounting Standards

Identification of Impaired Investments

In November 2005, the FASB issued FASB Staff Position Paper (FSP) 115-1, *The Meaning of Other-Than-Temporary Impairment and its Application to Certain Investments* (FSP 115-1). FSP 115-1 provides new guidance for evaluating impairment losses on debt and equity investments, as well as new disclosure requirements for investments that are determined to be other-than-temporarily impaired. FSP 115-1 is effective for other-than-temporary impairment analyses conducted in periods beginning after December 15, 2005.

As substantially all of our investments are investment grade government and corporate debt securities that have maturities of less than 3 years, and we have both the ability and intent to hold the investments until maturity, we do not expect FSP 115-1 to have a material impact on our financial position and results of operations.

Accounting for Electronic Equipment Waste Obligations

In June 2005, the FASB issued FSP No. FAS 143-1, *Accounting for Electronic Equipment Waste Obligations* (FSP 143-1). FSP 143-1 provides guidance in accounting for obligations associated with Directive 2002/96/EC (the Directive) on Waste Electrical and Electronic Equipment adopted by the European Union. FAS 143-1 is required to be applied to the later of the first reporting period ending after June 6, 2005 or the date of the Directive s adoption into law by the applicable EU member countries in which we have significant operations. The Directive distinguishes between new and historical waste. New waste relates to products put on the market after August 13, 2005. FSP 143-1 directs commercial users to apply the provisions of FASB Statement No. 143, *Accounting for Asset Retirement Obligations*, and the related FASB Interpretation No. 47, *Accounting for Conditional Asset Retirement Obligations*, for the measurement and recognition of the liability and asset retirement obligation associated with the historical waste management requirements of the Directive. Additionally, FSP 143-1 provides guidance for the accounting by producers for the financing of the obligations of historical waste held by private households.

We adopted FAS 143-1 in the first quarter of fiscal 2006 and concluded that no significant liability had been incurred as of April 2, 2006. We are continuing to analyze the impact of the Directive, and FSP 143-1, on our financial position and results of operations as additional EU member countries adopt the Directive.

Separate from the requirements of FSP 143-1, we believe that the internal cost of compliance with the Directive, and the liability associated with new waste obligations, which according to the Directive is to be borne solely by the producers of the new equipment, was not significant for the quarter and nine months ended April 2, 2006, but could be significant in the future.

Table of Contents

2. Stock-Based Compensation

On July 4, 2005, we adopted the fair value recognition provisions of Financial Accounting Standards Board (FASB) Statement No. 123(R), *Share-Based Payment*, (FAS 123R). Prior to July 4, 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 method. Under that transition method, compensation cost recognized in the nine months ended April 2, 2006 includes: a) compensation cost for all share-based payments granted prior to, but not yet vested as of July 4, 2005, based on the grant-date fair value estimated in accordance with the original provisions of Statement 123, and b) compensation cost for all share-based payments granted subsequent to July 4, 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.

As a result of adopting FAS 123R on July 4, 2005 our net income for the third quarter and nine months ended April 2, 2006 is $1.3 million and $4.8 million lower, respectively, than if we had continued to account for share-based compensation under APB 25 as we did in the comparable prior year periods. Diluted earnings per share for the quarter and nine months ended April 2, 2006 would have been $0.03 and $0.14, respectively, if we had not adopted FAS 123R, compared to reported diluted earnings per share of $0.02 and $0.10, respectively. We have not recognized, and do not expect to recognize in the near future, any tax benefit related to employee stock based compensation cost as a result of the full valuation allowance on our net deferred tax assets and our net operating loss carryforwards. The total compensation cost capitalized in inventory was less than $0.1 million as of April 2, 2006. Stock-based compensation cost of less than $0.1 million and $0.2 million was recognized in expense in accordance with APB 25 for the three and nine month periods ended March 27, 2005, respectively.

As of April 2, 2006, we have the following share-based compensation plans:

2005 Equity Incentive Plan

The 2005 Equity Incentive Plan (the 2005 Plan) was adopted by our Board of Directors on October 20, 2005, and approved by stockholders on December 2, 2005. The 2005 Plan replaces the 1996 Stock Option Plan (the 1996 Plan), 2000 Stock Plan (the 2000 Plan) and 2001 Stock Plan (the 2001 Plan).

Under the 2005 Plan, we may grant stock options, stock appreciation rights, restricted stock, restricted stock units, performance shares, performance units, and other stock-based or cash-based awards to employees and consultants. The 2005 Plan also authorizes the grant of awards of stock options, stock appreciation rights, restricted stock and restricted stock units to non-employee members of the board of directors and deferred compensation awards to officers, directors and certain management or highly compensated employees. The 2005 Plan authorizes the issuance of up to 12,000,000 shares of our common stock, and up to 11,000,000 shares subject to awards that remain outstanding under the 1996 Plan, 2000 Plan and 2001 Plan as of December 2, 2005 and which subsequently terminate without having been exercised or which are forfeited, will be added to the shares available under the 2005 Plan. As of April 2, 2006, 22,633,219 shares were available for future grant under the 2005 Plan.

1999 Employee Stock Purchase Plan

In January 1999, the Board of Directors approved the adoption of Extreme Network s 1999 Employee Stock Purchase Plan (the Purchase Plan). On December 2, 2005, the stockholders approved an amendment to the Purchase Plan to increase the maximum number of shares of common stock that may be issued under the plan by 5,000,000 to a total of 12,000,000 shares. The Purchase Plan permits eligible employees to acquire shares of our common stock through periodic payroll deductions of up to 15% of total compensation. No more than 625 shares may be purchased on any purchase date per employee. Each offering period has a maximum duration of 12 months. The price at which the common stock may be purchased is 85% of the lesser of the fair market value of our common stock on the first day of the applicable offering period or on the last day of the respective purchase period. Through April 2, 2006, 5,980,387 shares had been purchased under the Purchase Plan. As of April 2, 2006, the total unrecognized compensation cost related to the Purchase Plan was $0.1 million and is expected to be recognized over a weighted average period of approximately five months.

Table of Contents

Amended 1996 Stock Option Plan

In January 1999, the Board of Directors approved an amendment to the 1996 Stock Option Plan (the 1996 Plan) to (i) increase the share reserve by 10,000,000 shares, (ii) to remove certain provisions which are required to be in option plans maintained by California privately-held companies and (iii) to rename the 1996 Plan as the Amended 1996 Stock Option Plan.

Under the 1996 Plan, which was originally adopted in September 1996, options may be granted for common stock, pursuant to actions by the Board of Directors, to eligible participants. A total of 56,387,867 shares were reserved under the 1996 Plan. Options granted are exercisable as determined by the Board of Directors. Options vest over a period of time as determined by the Board of Directors, generally four years. Options have a contractual term of ten years. Effective December 2, 2005, the 1996 Plan was terminated.

2000 Stock Option Plan

In March 2000, the Board of Directors adopted the 2000 Nonstatutory Stock Option Plan (the 2000 Plan). Options may be granted for common stock, pursuant to actions by the Board of Directors, to eligible participants. Generally, only non-officer employees are eligible to participate in the 2000 Plan, except that options may be granted to officers under this plan in connection with written offers of employment. A total of 4,000,000 shares were reserved under the 2000 Plan. Options vest over a period of time as determined by the Board of Directors, generally four years. Options have a contractual term of ten years. Effective December 2, 2005, the 2000 Plan was terminated.

2001 Stock Option Plan

In May 2001, the Board of Directors adopted the 2001 Nonstatutory Stock Option Plan (the 2001 Plan). Options may be granted for common stock, pursuant to actions by the Board of Directors, to eligible participants. Generally, only non-officer employees are eligible to participate in the 2001 Plan, except that options may be granted to officers under this plan in connection with written offers of employment. A total of 4,000,000 shares were reserved under the 2001 Plan. Options vest over a period of time as determined by the Board of Directors, generally four years. Options have a contractual term of ten years. Effective December 2, 2005, the 2001 Plan was terminated.

A summary of the status of our non-vested shares as of April 2, 2006 and changes during the first nine months of fiscal 2006, is presented below:

	Number of Shares (000 s)	**Weighted-Average Grant-Date Fair Value**
Non-vested shares at July 3, 2005	33	$ 6.28
Granted	165	4.75
Vested	(29)	6.26
Canceled	(6)	5.58
Non-vested shares at April 2, 2006	163	$ 4.75

During the first nine months of fiscal 2006, we granted non-vested stock awards under the 2001 Plan for 165,000 shares of common stock with a weighted average grant date fair value per share of $4.75. The shares were placed in an escrow account and will be released to the recipients as the shares vest over periods of up to twenty-four months. If a participant terminates employment prior to the vesting dates, the unvested shares will be canceled and returned to the 2001 Plan. We recognize compensation expense on the awards over the vesting period based on an intrinsic value calculation as of the date of grant. As of April 2, 2006, there was approximately $0.4 million in unrecognized compensation costs related to non-vested stock. This cost is expected to be recognized over a weighted-average period of approximately 1.0 year.

The following table summarizes stock option activity during the first nine months of fiscal 2006 under all plans:

Weighted- Average

	Number of Shares (000 s)	Exercise Price Per Share	Weighted-Average Remaining Contractual Term	Aggregate Intrinsic Value ($ 000 s)
Options outstanding at July 3, 2005	21,138	$ 6.87		
Granted	4,570	$ 4.52		
Exercised	(466)	$ 3.13		
Canceled	(3,270)	$ 7.11		
Options outstanding at April 2, 2006	21,972	$ 6.42	7.53	$ 7,088
Exercisable at April 2, 2006	15,995	$ 7.03	6.98	$ 4,731

10

Table of Contents

As of April 2, 2006, there was $7.1 million of total unrecognized compensation cost related to unvested stock options. This cost is expected to be recognized over a weighted-average period of approximately 1.4 years. The total intrinsic value of options exercised in the first nine months of fiscal 2006 and fiscal 2005 was $0.8 million and $1.2 million, respectively. The fair value of options vested in the first nine months of fiscal 2006 is $3.1 million.

The fair value of each option award is estimated on the date of grant using the Black-Scholes-Merton option valuation model with the weighted average assumptions noted in the following table. The expected term of options granted is derived from historical data on employee exercise and post-vesting employment termination behavior. The risk-free rate for periods within the contractual life of the option is based on the U.S. Treasury yield curve in effect at the time of grant. Expected volatility is based on both the implied volatilities from traded options on our stock and historical volatility on our stock.

For options granted prior to July 4, 2005, and valued in accordance with FAS 123, the expected volatility used to estimate the fair value of the options was based solely on the historical volatility on our stock; we used the graded vesting method for expense attribution; and we recognized option forfeitures as they occurred as allowed by FAS 123.

For options granted after July 3, 2005, and valued in accordance with FAS 123R, we use the straight-line method for expense attribution, and we estimate forfeitures and only recognize expense for those shares expected to vest. Our estimated forfeiture rate in the first nine months of fiscal 2006, based on our historical forfeiture experience, is approximately 20%.

	Stock Option Plans				Employee Stock Purchase Plan			
	Three months ended		Nine months ended		Three months ended		Nine months ended	
	April 2, 2006	March 27, 2005	April 2, 2006	March 27, 2005	April 2, 2006	March 27, 2005	April 2, 2006	March 27, 2005
Expected life	2.8 yrs	2.5 yrs	2.5 yrs	2.5 yrs	0.6 yrs	0.6 yrs	0.6 yrs	0.8 yrs
Risk-free interest rate	4.7%	3.4%	4.1%	2.8%	4.7%	2.8%	4.3%	1.9%
Volatility	58.0%	76.0%	61.0%	83.0%	40.0%	45.0%	42.0%	55.0%
Expected dividend yield	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%

The Black-Scholes-Merton option valuation model requires the input of highly subjective assumptions, including the expected life of the stock-based award and stock price volatility. The assumptions listed above represent management s best estimates, but these estimates involve inherent uncertainties and the application of management judgment. As a result, if other assumptions had been used, our recorded and pro forma stock-based compensation expense could have been materially different from that depicted above and below. In addition, we are required to estimate the expected forfeiture rate and only recognize expense for those shares expected to vest. If our actual forfeiture rate is materially different from our estimate, the share-based compensation expense could be materially different.

The weighted-average grant-date per share fair value of options granted in the third quarter of fiscal 2006 and fiscal 2005 was $1.97 and $2.83, respectively. The weighted-average estimated per share fair value of shares granted under the Purchase Plan in the third quarter of fiscal 2006 and fiscal 2005 was $1.60 and $1.81, respectively.

The following table illustrates the effect on net income and earnings per share if we had applied the fair value recognition provisions of FAS 123 to options granted under our stock option plans, non-vested stock awards granted and shares issued under the Purchase Plan in the three and nine month periods ended March 27, 2005. For purposes of pro forma disclosures, the value of the options is estimated using a Black-Scholes-Merton option-pricing formula and amortized to expense over the options vesting periods; using the graded vested method. The following pro forma information sets forth our net income

Table of Contents

(loss) and net income (loss) per share assuming that we had used the FAS 123 fair value method in accounting for employee stock options and purchases during the third quarter and nine months of fiscal 2005 (in thousands, except per share amounts):

	Three Months Ended March 27, 2005	Nine Months Ended March 27, 2005
Net income (loss) as reported	$ (1,257)	$ 12,819
Add: APB 25 stock-based employee compensation expense, as reported, net of tax	20	206
Less: Stock-based compensation expense determined under fair value based method, net of tax	(4,650)	(17,034)
Pro forma net loss	$ (5,887)	$ (4,009)
Basic net income (loss) per share:		
As reported	$ (0.01)	$ 0.11
Pro forma	$ (0.05)	$ (0.03)
Diluted net income (loss) per share:		
As reported	$ (0.01)	$ 0.10
Pro forma	$ (0.05)	$ (0.03)

3. Commitments and Contingencies

Stock Repurchase Program

On October 20, 2005, our Board of Directors authorized the repurchase of up to $50 million of our common stock. This authorization will expire in October 2007. In the quarter ended April 2, 2006, we repurchased approximately 2.8 million shares for approximately $13.8 million, bringing the year-to-date total to 4.2 million repurchased shares for approximately $20.6 million. We expect to repurchase stock over the next nine months, primarily through open market purchases. The repurchases will be made in compliance with the Securities and Exchange Commission s Rule 10b-18, and are subject to market conditions as well as applicable legal and other considerations.

Line of Credit

We have a revolving line of credit for $10.0 million with a major lending institution. Borrowings under this line of credit bear interest at the bank s prime rate. As of April 2, 2006, there were no outstanding borrowings under this line of credit. The line of credit contains a provision for the issuance of letters of credit not to exceed the unused balance of the line. As of April 2, 2006, we had letters of credit totaling $0.8 million. These letters of credit were primarily issued to satisfy requirements of certain of our customers for performance bonds. The line of credit requires us to maintain specified financial covenants related to tangible net worth and liquidity with which we were in compliance as of April 2, 2006. The line of credit expires on January 25, 2007.

Purchase Commitments

We currently have arrangements with one contract manufacturer and other suppliers for the manufacture of our products. Our arrangements allow them to procure long lead-time component inventory on our behalf based upon a rolling production forecast provided by us. We are obligated to the purchase of long lead-time component inventory that our contract manufacturer procures in accordance with the forecast, unless we give notice of order cancellation outside of applicable component lead-times. As of April 2, 2006, we had non-cancelable commitments to purchase approximately $22.7 million of such inventory during the fourth quarter of fiscal 2006.

Legal Proceedings

On December 27, 2006, Broadband Office Inc. (Broadband) served an amended complaint, adding Extreme Networks as a defendant in its lawsuit against Technology Credit Corporation (TCC) and Key Equipment Finance, Inc., seeking recovery of an alleged preferential payment in the amount of $0.8 million plus interest, purportedly paid by Broadband to TCC within ninety days prior to Broadband s petition for bankruptcy protection. Extreme disputes that it owes any money to Broadband, and intends vigorously to defend against the claims.

Table of Contents

On June 21, 2005, Enterasys filed suit against Extreme Networks and Foundry Networks, Inc. (Foundry) in the United States District Court for the District of Delaware, Civil Action No.05-11298 DPW. The complaint alleges willful infringement of U. S. Patent Nos. 5,251,205; 5,390,173; 6,128,665; 6,147,995; 6,539,022; and 6,560, 236, and seeks: a) a judgment that Extreme willfully infringed each of the patents; (b) a permanent injunction from infringement, inducement of infringement and contributory infringement of each of the six patents; (c) damages and a reasonable royalty to be determined at trial; (d) trebled damages; (e) attorneys fees, costs and interest; and (f) equitable relief at the court s discretion. The Markman hearing has been scheduled for January 2007. We intend to vigorously defend against Enterasys assertions, which we believe to be without merit.

On May 27, 2003, Lucent filed suit against Extreme Networks and Foundry in the United States District Court for the District of Delaware, Civil Action No. 03-508. The complaint alleged willful infringement of U.S. Patent Nos. 4,769,810, 4,769,811, 4,914,650, 4,922,486 and 5,245,607. The judge split the case into three parts to be tried separately: phase 1 to cover infringement, willfulness and damages; phase 2 to cover invalidity; and phase 3 to cover equitable defenses and our counterclaims. On May 9, 2005, a jury in Delaware awarded a verdict to Extreme in the phase 1 trial of non-infringement on 18 out of the 19 claims asserted. The jury did award Lucent damages of approximately $275,000 on the remaining claim; which covers a feature that is not offered in our current product line. The parties each filed post-trial motions; and on August 16, 2005, the judge granted Lucent s motion for a new trial, ruling that Extreme impermissibly introduced to the jury evidence of its prior relationship with Lucent. Extreme s motion for reconsideration was denied. The new trial on phase 1 has been scheduled for September 18, 2006 and the remaining phases of the trial have not yet been scheduled. We intend to vigorously defend against Lucent s claims, which we continue to believe to be without merit.

Beginning on July 6, 2001, purported securities fraud class action complaints were filed in the United States District Court for the Southern District of New York. The cases were consolidated and the litigation is now captioned as In re Extreme Networks, Inc. Initial Public Offering Securities Litigation, Civ. No. 01-6143 (SAS) (S.D.N.Y.), related to In re Initial Public Offering Securities Litigation, 21 MC 92 (SAS) (S.D.N.Y.). The operative amended complaint names as defendants Extreme Networks; six of our present and former officers and/or directors, including our CEO (the Extreme Networks Defendants); and several investment banking firms that served as underwriters of our initial public offering and October 1999 secondary offering. The complaint alleges liability under Sections 11 and 15 of the Securities Act of 1933 and Sections 10(b) and 20(a) of the Securities Exchange Act of 1934, on the grounds that the registration statement for the offerings did not disclose that: (1) the underwriters had agreed to allow certain customers to purchase shares in the offerings in exchange for excess commissions paid to the underwriters; and (2) the underwriters had arranged for certain customers to purchase additional shares in the aftermarket at predetermined prices.

Similar allegations were made in other lawsuits challenging over 300 other initial public offerings and follow-on offerings conducted in 1999 and 2000. The cases were consolidated for pretrial purposes. We have executed a settlement agreement in which plaintiffs will dismiss and release all claims against the Extreme Network Defendants, in exchange for a contingent payment by the insurance companies collectively responsible for insuring the issuers in all of the IPO cases, and for the assignment or surrender of control of certain claims we may have against the underwriters. The Extreme Networks Defendants will not be required to make any cash payments in the settlement, unless the pro rata amount paid by the insurers in the settlement exceeds the amount of the insurance coverage, a circumstance which we do not believe will occur. The settlement will require approval of the Court, which cannot be assured. If the settlement is not approved, we cannot assure you that we will prevail in the lawsuit. Failure to prevail could have a material adverse effect on our consolidated financial position, results of operations and cash flows in the future.

We are subject to other legal proceedings, claims and litigation arising in the ordinary course of business. While the outcome of these matters, including the specific matters discussed above, is currently not determinable, the ultimate costs to resolve these matters could have a material adverse effect on our consolidated financial position, results of operations or cash flows.

Table of Contents

4. Comprehensive Income (Loss)

Comprehensive income (loss) was as follows (in thousands):

	Three Months Ended		Nine Months Ended	
	April 2, 2006	March 27, 2005	April 2, 2006	March 27, 2005
Net income (loss)	$ 2,841	$ (1,257)	$ 12,844	$ 12,819
Other comprehensive income (loss):				
Change in unrealized gain (loss) on investments:				
Net unrealized gain (loss) on investments	633	(1,999)	716	(2,062)
Less: Net gain (loss) on investments realized and included in interest income			(17)	
Net unrealized gain (loss) on investments	633	(1,999)	699	(2,062)
Net unrealized loss on derivatives			(12)	
Foreign currency translation adjustments	142	(25)	(158)	315
Total comprehensive income (loss)	$ 3,616	$ (3,281)	$ 13,373	$ 11,072

5. Income Taxes

We recorded an income tax provision of $0.6 million and $0.8 million for the third quarter of fiscal 2006 and the third quarter of fiscal 2005, respectively. We recorded an income tax provision of $2.0 million and $3.0 million for the nine months ended April 2, 2006 and March 27, 2005, respectively. The effective tax rates were 19% and (186%) for the three months ended April 2, 2006 and March 27, 2005, respectively, and 14% and 19% for the nine months ended April 2, 2006 and March 27, 2005, respectively. The effective tax rates in all periods differ from the statutory tax rate due to benefits to U.S. taxes from net operating loss carryforwards and tax credit carryforwards, offset by the tax impact of income from foreign operations.

We recognize deferred tax assets and liabilities based on the differences between the financial statement carrying amounts and the tax bases of assets and liabilities. Significant management judgment is required in determining our deferred tax assets and liabilities and any valuation allowance recorded against our net deferred tax assets. We make an assessment of the likelihood that our net deferred tax assets will be recovered from future taxable income, and to the extent that recovery is not believed to be likely, a valuation allowance is established. During fiscal 2003, we established a full valuation allowance for our net deferred tax assets.

The valuation allowance was calculated in accordance with the provisions of SFAS 109, which requires an assessment of both negative and positive evidence when measuring the need for a valuation allowance. In accordance with SFAS 109, evidence, such as operating results during the most recent three-year period, is given more weight than our expectations of future profitability, which are inherently uncertain. Our most recent three year history of losses, as of the date of the establishment of the valuation allowance, represented sufficient negative evidence to require a full valuation allowance against our net deferred tax assets under SFAS 109. This valuation allowance will be evaluated periodically and can be reversed partially or totally if business results have sufficiently improved to support realization of our deferred tax assets.

6. Net Income (Loss) Per Share

Basic earnings (loss) per share is calculated by dividing net income (loss) by the weighted average number of common shares outstanding during the period, less shares subject to repurchase, and excludes any dilutive effects of options, warrants and convertible subordinated notes. Dilutive earnings (loss) per share is calculated by dividing net income (loss) by the weighted average number of common shares used in the basic earnings per share calculation plus the dilutive effect of shares subject to repurchase, options, warrants and convertible subordinated notes.

The following table presents the calculation of basic and diluted net income (loss) per share (in thousands, except per share data):

	Three Months Ended		Nine Months Ended	
	April 2, 2006	March 27, 2005	April 2, 2006	March 27, 2005
Net income (loss)	$ 2,841	$ (1,257)	$ 12,844	$ 12,819
Weighted-average shares of common stock outstanding	120,940	121,444	122,230	121,046
Less: Weighted-average shares subject to repurchase				(5)
Weighted-average shares used in per share calculation basic	120,940	121,444	122,230	121,041
Incremental shares using the treasury stock method	1,878		1,820	3,170
Weighted-average shares used in per share calculation diluted	122,818	121,444	124,050	124,211
Net income (loss) per share basic	$ 0.02	$ (0.01)	$ 0.11	$ 0.11
Net income (loss) per share diluted	$ 0.02	$ (0.01)	$ 0.10	$ 0.10

The following table sets forth potential shares of common stock that are not included in the diluted net income (loss) per share calculation above because to do so would be antidilutive for the periods (in thousands):

	Three Months Ended		Nine Months Ended	
	April 2, 2006	March 27, 2005	April 2, 2006	March 27, 2005
Stock options outstanding:				
In-the-money options		1,668		
Out-of-the-money options	18,687	14,761	19,463	15,694
Warrants outstanding		1,716		
Convertible subordinated notes	9,542	9,542	9,542	9,542
Total potential shares of common stock excluded from the computation of earnings per share	28,229	27,687	29,005	25,236

The computation of diluted net income (loss) per share for the third fiscal quarter and first nine months of fiscal 2006 and 2005 excludes the impact of the conversion of the convertible subordinated notes, which are convertible into approximately 9.5 million shares of common stock, as the impact of adding back to income the after tax interest expense associated with the convertible subordinated notes, and including the impact of the common shares to be issued, would be anti-dilutive in these periods.

Stock options outstanding with an exercise price lower than our average stock price for the periods presented (In-the-money options) are excluded from the calculation of diluted net loss per share in the periods presented since the effect would have been anti-dilutive due to the net loss. Stock options outstanding with an exercise price higher than our average stock price for the periods presented (Out-of-the-money stock options) are excluded from the calculation of diluted net income per share since the effect would have been anti-dilutive under the treasury stock method.

7. Restructuring Liabilities

As of April 2, 2006, restructuring liabilities were $15.4 million and consisted of obligations under excess facility operating leases, net of projected future sublease receipts. The excess facility charge was initially recognized during fiscal 2002 to permanently reduce occupancy or vacate certain domestic and international facilities. At several of the facilities, we have not yet been able to find suitable tenants to sublease the facilities. The commercial real estate market in these areas continues to be weak. The actual cost could differ from this estimate, and additional facilities charges could be incurred if we are unsuccessful in negotiating reasonable termination fees on certain facilities, if facility operating lease rental rates continue to decrease in these markets, if it takes longer than expected to find a suitable tenant to sublease these facilities or if other estimates and assumptions change.

Activity with respect to restructuring liabilities is as follows (in thousands):

	April 2, 2006
Balance at July 3, 2005	$ 19,956
Cash payments	(4,534)
Balance at April 2, 2006	15,422
Less: current portion	5,857
Restructuring liabilities at April 2, 2006, less current portion	$ 9,565

Table of Contents

8. Alliance with Avaya

On October 30, 2003, Extreme Networks and Avaya Inc. entered into a strategic alliance to jointly develop and market converged communications solutions, by executing a Joint Development Agreement, and a Distribution Agreement under which Avaya is entitled to resell Extreme Networks products. Extreme issued to Avaya a warrant with a ten-year expiration period to purchase up to 2,577,794 shares of Extreme Networks common stock at a price of $0.01 per share, with Avaya having the right to exercise the warrant with respect to one third of such shares 90 days after the date of the agreements, and the remaining shares become exercisable based upon the completion of certain milestones by Avaya. Even if the milestones are not completed, however, the warrant will become fully exercisable for all shares 90 days prior to the expiration of the warrant. Avaya exercised the warrant with respect to one third of the shares subject to the warrant on March 17, 2004 and, accordingly, approximately 859,000 shares of our common stock were issued to Avaya on that date. Avaya exercised the warrant with respect to the second third of the shares subject to the warrant on August 8, 2005 and, accordingly, approximately 859,000 shares of our common stock were issued to Avaya on that date.

We engaged an independent valuation firm to assist us in estimating the fair value of the warrant and to assist us with the allocation of the fair value to the two agreements entered into. The independent valuation firm estimated the fair value of the warrant at $22.7 million, which has been allocated $17.9 million to the Joint Development Agreement and $4.8 million to the distribution agreement based on the assumptions by management related to the projected revenue and expenses for the respective agreements. The fair value of the warrant, net of accumulated amortization, is recorded in other assets in our consolidated balance sheets. The warrant values assigned to the respective agreements are being amortized over the terms of the agreements.

On October 31, 2005, the Joint Development Agreement was amended to, among other things, extend the term one additional year. The estimated amortization period was changed in the second quarter of fiscal 2006 to extend the amortization period over the remaining term of the amended Joint Development Agreement. The amortization of the warrant cost related to the Joint Development Agreement recorded as research and development expense was $0.7 million and $3.2 million in the three and nine months of fiscal 2006, respectively, as compared to $1.5 million and $4.5 million in the three and nine months of fiscal 2005, respectively. On October 14, 2004, the Distribution Agreement was amended to, among other things, extend the term by one additional year. During the quarter ended January 1, 2006, we determined that the amortization period for the portion of the warrant value assigned to the Distribution Agreement should have been extended when the term of the Distribution Agreement was extended in October 2004. We recorded the cumulative adjustment to the amortization of approximately $0.5 million in the quarter ended January 1, 2006. We concluded that the effect of this adjustment was not material to the affected prior annual or interim periods. The amortization of the warrant value related to the Distribution Agreement, recorded as a reduction of product revenue, was $0.3 million and $0.4 million in the three and nine months of fiscal 2006, respectively, compared to $0.4 million and $1.2 million in the three and nine months of fiscal 2005.

9. Subsequent Event - Campus Sale

In April 2006, we entered into a contract for the sale of our corporate headquarters campus in Santa Clara, California, at a price of $70 million. Completion of the transaction is contingent upon successful rezoning of the property for residential development and is expected to close in 15 to 21 months. When we are certain that a sale transaction will close, we intend to relocate our corporate headquarters to a separate campus in the Santa Clara area. We expect to continue to classify the corporate headquarters campus as an asset held for use until the purchase contingencies have been eliminated and we have identified a new corporate headquarters campus, and it is probable that the sale will be concluded within 12 months.

Table of Contents

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

This quarterly report on Form 10-Q, including the following sections, contains forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995, particularly statements relating to our expectations regarding results of operations, our ability to expand our market penetration, our ability to expand our distribution channels, customer acceptance of our products, our ability to meet the expectations of our customers, product demand and revenue, cash flows, product gross margins, our expectations to continue to develop new products and enhance existing products, our expectations on warranty expenses, our expectations regarding the amount of our research and development expenses, our expectations relating to our selling, general and administrative expenses, our ability to successfully conclude the sale of our corporate campus, our efforts to achieve additional operating efficiencies and to review and improve our business systems and cost structure, our expectations to continue investing in technology, resources and infrastructure, our expectations concerning the availability of products from suppliers and contract manufacturers, anticipated product costs and sales prices, our expected income tax rate, our expectations that we have sufficient capital to meet our requirements for at least the next twelve months, our expectations regarding the estimates of excess facilities, and our expectations regarding materials and inventory management. These forward-looking statements involve risks and uncertainties, and the cautionary statements set forth below and those contained in the section entitled Risk Factors identify important factors that could cause actual results to differ materially from those predicted in any such forward-looking statements. We caution investors that actual results may differ materially from those projected in the forward-looking statements as a result of certain risk factors identified in this Form 10-Q and other filings we have made with the Securities and Exchange Commission.

Business Overview

We develop and sell a family of modular and stackable network infrastructure equipment and offer related service contracts for extended warranty and maintenance agreements. Substantially all of our revenue is derived from the sale of networking equipment and the related service contracts. We believe that understanding the following key developments is helpful to an understanding of our operating results for the third quarter of fiscal 2006.

Increased Product Breadth

We believe that continued success in the marketplace will depend on our ability to develop new and enhanced products employing leading-edge technology. In the past two years, we introduced several new products that allow for the continued deployment of secure, converged networks as well as the expansion of the ExtremeWare® XOS operating system from the core to the edge of the network. The following products have been introduced since the beginning of fiscal 2005: the BlackDiamond 8800 modular switch, a next generation Layer 3 chassis switch for converged networks; the Summit 400-24p fixed switch featuring Power over Ethernet (PoE) Gigabit ports to support IP phones as well as UniStack stacking capabilities to manage multiple devices as one; the Summit 300-24 switch, a Unified Access switch designed for the edge of the network with lower port densities and support for Wireless LANs; and the Summit X450 fixed switch, the first fixed device featuring the ExtremeWare® XOS operating system and IPv6 capabilities. Extreme also announced during fiscal 2005 its first network security device, Sentriant, an automated threat detection, containment and mitigation device utilizing the CLEAR-Flow network security rules engine. In the third quarter of fiscal 2006, we announced the introduction of our BlackDiamond® 12K carrier ethernet switch.

Convergence of Voice, Video and Data

We have a vision of providing customers with the systems to build a converged communications infrastructure that can easily accommodate voice, video and data on a seamless wired and wireless network. We believe that these two aspects of convergence: the convergence of voice, video and data, and the convergence of wired and wireless are important underlying demand creators in the Enterprise market.

In October 2003, we announced our comprehensive strategic alliance with Avaya, Inc. to jointly develop and market converged communications solutions. The alliance brings together Avaya s global market leadership in IP voice and telephony with Extreme s expertise in high performance IP data network infrastructure. Under the Joint Development Agreement the companies are developing next generation, standards-based technologies in the areas of network management and provisioning, Quality of Service, security, and network resilience. Additionally, Avaya is selling, servicing and supporting Extreme s entire portfolio of data networking products through their worldwide sales organization and the Avaya Global Services organization.

Business Environment

Throughout fiscal 2003 and early 2004, the primary factor that impacted our operations and financial performance was weak demand for networking equipment resulting from the continuing weakness of the global and U.S. economies. Weak economic conditions persisted through most of fiscal 2004, but beginning in the third quarter of fiscal 2004, we began to see evidence of strengthening demand for our products. In fiscal 2005 we continued to generate revenue growth, although not each and every quarter, and not in all geographic markets. In fiscal 2006, we continue to experience inconsistent trends in revenue quarter to quarter and across geographic markets.

Expanded Focus on Service Offering

Extreme s service offering is primarily the provision of service contracts for extended warranty and maintenance agreements related to our networking equipment. To a lesser extent, the service revenue includes professional services related to the design and installation of data networks and training. In the third quarter of fiscal 2006, we continued to focus our service sales efforts on increasing the number of service contracts sold with new equipment and on securing renewals on expiring contracts. Service revenue increased by 8.2% in the third quarter of fiscal 2006 compared to the third quarter of fiscal 2005, and represented 19.1% of total revenues in the third quarter of fiscal 2006 compared to 16.4% in the third quarter of fiscal 2005. Cost of service revenue decreased by $0.1 million in the third quarter of fiscal 2006 to $8.8 million and service gross margins improved to 46.0% in the third quarter of fiscal 2006 from 40.6% in the third quarter of fiscal 2005.

Stock-Based Compensation

On July 4, 2005, we adopted the fair value recognition provisions of Financial Accounting Standards Board (FASB) Statement No. 123(R), *Share-Based Payment*, (FAS 123R). As a result of adopting Statement 123R in fiscal 2006, our net income for the quarter and nine months ending April 2, 2006 is $1.3 million and $4.8 million lower, respectively, than if we had continued to account for share-based compensation under APB 25 as we did in the comparable prior year period. Diluted earnings per share for the quarter and nine months ended April 2, 2006 would have been $0.03 and $0.14, respectively, if we had not adopted FAS123R, compared to reported basic and diluted earnings per share of $0.02 and $0.10, respectively. See Note 2 to Notes to the Condensed Consolidated Financial Statements.

Results of Operations

Our operations and financial performance have been affected by the economic factors described above, and during the third quarter of fiscal 2006 and fiscal 2005, we were able to achieve the following results:

Net revenues of $85.5 million, a decrease of 7.0% from net revenues of $91.9 million in the third quarter of fiscal 2005.

Service revenue of $16.3 million, an increase of 8.2% from service revenue of $15.1 million in the third quarter of fiscal 2005.

Total gross margin of 54.1% of net revenues (54.3% of net revenues, excluding stock-based compensation of $0.2 million), up from 51.4% in the third quarter of fiscal 2005.

Net income of $2.8 million ($4.2 million excluding stock-based compensation of $1.3 million), an increase from net loss of ($1.3) million in the third quarter of fiscal 2005.

Cash flow from operating activities was $26.7 million in the nine months ending April 2, 2006. Cash and cash equivalents, short-term investments and marketable securities increased by $4.3 million in the nine months ending April 2, 2006 to $444.7 million. We continued to buy back shares under our share repurchase program authorized by our board of directors in the first quarter of fiscal 2006 by repurchasing approximately 4.2 million shares for $20.6 million in the second and third quarter of fiscal 2006.

18

Table of Contents

Net Revenues

The following table presents net product and service revenues for the three and nine month periods of fiscal 2006 and fiscal 2005 (dollars in thousands):

	Three months ended April 2, 2006		Three months ended March 27, 2005		Nine months ended April 2, 2006		Nine months ended March 27, 2005	
	$	% of Net Revenues	$	% of Net Revenues	$	% of Net Revenues	$	% of Net Revenues
Net Revenues:								
Product	$ 69,148	80.9%	$ 76,835	83.6%	$ 228,063	82.6%	$ 243,770	84.9%
Service	16,302	19.1%	15,073	16.4%	48,096	17.4%	43,525	15.1%
Total net revenues	$ 85,450	100.0%	$ 91,908	100.0%	$ 276,159	100.0%	$ 287,295	100.0%

Net revenues were $85.5 million in the third quarter of fiscal 2006 and $91.9 million in the third quarter of fiscal 2005, representing a decrease of 7.0% in the third quarter of fiscal 2006 from the third quarter of fiscal 2005. Net revenues were $276.2 million in the nine-month period ended April 2, 2006 and $287.3 million in the nine-month period ended March 27, 2005, representing a decrease of 3.9%.

Product revenue was $69.1 million for the third quarter of fiscal 2006 compared to $76.8 million for the third quarter of fiscal 2005, a decrease of 10.0%. Product revenue was $228.1 million in the nine month period of fiscal 2006 compared to $243.8 million in fiscal 2005, a decrease of 6.4%. The decrease in product revenue in both the third quarter and nine month periods of fiscal 2006 as compared to fiscal 2005 was primarily due to a decrease in the volume of units sold in the third quarter of fiscal 2006, primarily from a decline in sales in the United States and Japan. In the third quarter of fiscal 2006, revenue was negatively impacted by higher than anticipated attrition of sales headcount, particularly in the U.S., reliance on a few large carrier customers in our Japan market, and, in some cases, longer than anticipated purchase decision cycles that impaired our forecasting and predictability.

Service revenue increased to $16.3 million for the third quarter of fiscal 2006 from $15.1 million for the third quarter of fiscal 2005, an increase of $1.2 million, or 8.2%. Service revenue increased to $48.1 million for the nine month period ended April 2, 2006 from $43.5 million for the nine month period ended March 27, 2005, an increase of 10.5%. These increases were primarily due to an increase in the number of service contracts outstanding which resulted from a focused sales and marketing effort to increase the number of contracts sold with equipment, obtaining contract renewals, and increases in our installed base of equipment.

The following table presents the total net revenue geographically for the three and nine-month periods ending April 2, 2006 and March 27, 2005 (dollars in thousands):

	Three months ended April 2, 2006		Three months ended March 27, 2005		Nine months ended April 2, 2006		Nine months ended March 27, 2005	
	$	% of Net Revenues	$	% of Net Revenues	$	% of Net Revenues	$	% of Net Revenues
Net Revenues:								
United States	$ 33,882	39.7%	$ 40,689	44.3%	$ 110,906	40.2%	$ 123,967	43.1%
Europe, Middle East and Africa	33,513	39.2%	27,400	29.8%	94,990	34.4%	82,500	28.7%
Japan	7,712	9.0%	13,200	14.4%	29,414	10.6%	48,400	16.9%
Other	10,343	12.1%	10,619	11.5%	40,848	14.8%	32,428	11.3%
Total net revenues	$ 85,450	100.0%	$ 91,908	100.0%	$ 276,158	100.0%	$ 287,295	100.0%

Sales of products and services outside the United States accounted for approximately 60% of our business in both the three and nine month periods ending April 2, 2006, compared to 56% and 57% in the three and nine month periods ending March 27, 2005. Revenue in the U.S. decreased by $6.8 million, or 8% of total net revenue, compared to the prior year quarter due to lower than expected demand from our customers in the enterprise networking market. In the third quarter of

19

Table of Contents

fiscal 2006, revenue outside the U.S., as a percentage of total net revenue, increased by 4% compared to the year-ago quarter. Net revenue in Europe, Middle East and Africa increased in the current quarter over the prior year quarter following the recent trend of improved demand in that geographic region. Japan s net revenue decreased in the current period as a result of lower demand for networking products within the service provider segment. Net revenue outside the United States, increased by 3% as a percentage to total net revenue in the nine-month period ended April 2, 2006 as compared to the same prior year period due to the same trends noted above for the third quarter. We expect that export sales will continue to represent a significant portion of net revenue, although export sales may fluctuate as a percentage of net revenue. Substantially all sales transactions are denominated in United States dollars.

We rely upon multiple channels of distribution, including two-tiered distribution in which large distributors purchase our product and make it available to resellers. Revenue through the distributor channel as a percentage of total product revenue was 45% in the third quarter of fiscal 2006 and 34% in the third quarter of fiscal 2005. Revenue through the distributor channel as a percentage of total product revenue was 38% in the first nine months of fiscal 2006 and 2005. The level of sales to any one customer may vary from period to period; however, we expect that significant customer concentration will continue for the foreseeable future. One distributor accounted for 10% of our net revenues for the third quarter of fiscal 2006 and 2005, as well as for the first nine months of fiscal 2006 and 2005

Cost of Revenues and Gross Margin

The following table presents the gross margin on product and service revenues and the gross margin percentage of product and service revenues for the third quarter and nine month periods ending April 2, 2006 and March 27, 2005 (dollars in thousands):

	Three months ended April 2, 2006		Three months ended March 27, 2005		Nine months ended April 2, 2006		Nine months ended March 27, 2005	
	$	Gross Margin %	$	Gross Margin %	$	Gross Margin %	$	Gross Margin %
Gross margin:								
Product	$ 38,716	56.0%	$ 41,143	53.5%	$ 128,188	56.2%	$ 133,819	54.9%
Service	7,496	46.0%	6,119	40.6%	22,094	45.9%	17,957	41.3%
Total gross margin	$ 46,212	54.1%	$ 47,262	51.4%	$ 150,282	54.4%	$ 151,776	52.8%

Gross margin was $46.2 million in the third quarter of fiscal 2006 and $47.3 million in the third quarter of fiscal 2005, representing a decrease of 2.2%. Gross margin was $150.3 million in the first nine months of fiscal 2006 compared to $151.8 million in the first nine months of fiscal 2005. Gross margin as a percentage of net revenues was 54.1% and 51.4% in the third quarter of fiscal 2006 and the third quarter of fiscal 2005, respectively. Gross margin included a $0.2 million charge for stock-based compensation in the third fiscal quarter of 2006, and excluding this charge, gross margin was $46.4 million, or 54.3% of net revenue. Gross margin included a $0.8 million charge for stock-based compensation in the fiscal 2006 year to date period, and excluding this charge, gross margin was $151.1 million, or 54.7% of net revenue.

Cost of product revenue includes costs of raw materials, amounts paid to third-party contract manufacturers, costs related to warranty obligations, charges for excess and obsolete inventory, royalties under technology license agreements, and internal costs associated with manufacturing overhead, including management, manufacturing engineering, quality assurance, development of test plans and document control. Product gross margin in the third quarter of fiscal 2006 was $38.7 million, representing 56.0% of product revenues as compared to $41.1 million in the third quarter of fiscal 2005, or 53.5% of product revenue. The decrease in gross margin in the three and nine month periods of fiscal 2006 as compared to the prior year is directly attributable to the decline in product revenues, offset partially by reductions in the cost of product revenue. The increase in product gross margin as a percentage of product revenues was primarily due to lower per-unit product costs, and a decrease in manufacturing overhead and lower warranty costs. Product gross margin in the nine months of fiscal 2006 was $128.2 million, representing 56.2% of product revenues as compared to $133.8 million in the same nine month period of fiscal 2005, or 54.9% of product revenue. The increase in product gross margin as a percentage of product revenues was primarily due to lower per-unit product costs, a decrease in manufacturing overhead and lower warranty costs. Stock-based compensation cost included in cost of product revenue was approximately $0.1 million in the third quarter of 2006, and approximately $0.5 million in the nine month period ended April 2, 2006.

Cost of product revenue in all periods includes the cost of our manufacturing overhead. We outsource substantially all of our manufacturing and supply chain management operations, and we conduct quality assurance, manufacturing engineering, document control and repairs at our facility in Santa Clara, California. Accordingly, a significant portion of our cost of product revenue consists of payments to our contract manufacturer, Flextronics International, Ltd. located in San Jose, California, and Guadalajara, Mexico.

Our cost of service consists primarily of labor, overhead, repair and freight costs and the cost of spares used in providing support under customer service contracts. Service gross margin in the third quarter of fiscal 2006 was $7.5 million, representing 46.0% of service revenues as compared to $6.1 million in the third quarter of fiscal 2005, or 40.6% of service revenue. Service gross margin in the nine months of fiscal 2006 was $22.1 million, representing 45.9% of service revenue as compared to $18.0 million in the same nine month period of fiscal 2005, or 41.3% of service revenue. The increase in service gross margin in the third quarter and year to date periods of fiscal 2006, compared to the prior year periods, was primarily due to an increase in service revenue as well as a slight decrease in the cost of service revenue. The decrease in the cost of service in the third quarter of fiscal 2006 is due to lower product replacement costs. The increase in the cost of service in the nine months of fiscal 2006 is due to an increase in service operations overhead and costs associated with processing repairs and replacements. Stock-based compensation expense included in the cost of service revenue was approximately $0.1 million, and $0.3 million in the three and nine month periods ending April 2, 2006, respectively.

Our product and service gross margins are variable and dependent on many factors, some of which are outside of our control. Some of the primary factors affecting gross margin include demand for our products, changes in our pricing policies and those of our competitors, and the mix of products sold. Our gross margin may be adversely affected by increases in material or labor costs, increases in warranty expense, the cost of providing services under extended service contracts, heightened price competition, obsolescence charges and higher inventory balances. In addition, our gross margin may fluctuate due to changes in our product mix, our geographic mix of sales and the mix of distribution channels through which our products are sold, including the effects of our two-tier distribution model. Any significant decline in sales to our resellers, distributors or end-user customers, or the loss of any of our key resellers, distributors or end-user customers could have a material adverse effect on our business, operating results and financial condition. In addition, an increase in distribution channels generally makes it more difficult to forecast the mix of products sold and the timing of orders from our customers. New product introductions may result in excess or obsolete inventories, which may also reduce our gross margin.

Sales and Marketing Expenses

Sales and marketing expenses consist of salaries, commissions and related expenses for personnel engaged in sales and marketing functions, as well as trade shows and promotional expenses. Sales and marketing expenses were $23.1 million for the third quarter of fiscal 2006 compared to $23.9 million for the third quarter of fiscal 2005, a decrease of $0.8 million. The decrease in the current quarterly period is due to lower compensation costs due to sales force attrition, lower commissions on lower revenue, offset by an increase from stock-based compensation of $0.5 million. Sales and marketing expenses were $73.0 million for the nine month period of fiscal 2006 compared to $70.9 million for the nine month period of fiscal 2005, an increase of $2.1 million. The increase in the nine month period was primarily due to stock-based compensation of $1.9 million, increased expenses of $0.6 million from the inclusion of an additional department to better align costs with functional activities, which in fiscal 2005 was included under General & Administrative expenses,, offset by lower compensation costs due to lower headcount and lower revenue. The level of our sales and marketing spending in the future, in dollars and as a percentage of net revenues will depend on many factors, including most importantly the rate at which we expand our sales force and the rate at which our net revenues increase.

Research and Development Expenses

Research and development expenses consist principally of salaries and related personnel expenses, consultant fees and prototype expenses related to the design, development and testing of our products. Research and development expenses decreased to $14.5 million for the third quarter of fiscal 2006 from $15.3 million for the third quarter of fiscal 2005, a decrease of $0.9 million. This decrease was due to a reduction in the amortization of the warrant issued to Avaya of $0.7 million due to the extension of the development agreement with Avaya, lower information technology costs and decreased engineering project expenses offset by increased expenses of $0.5 million from the inclusion of an additional department to better align costs with functional activities, which in fiscal 2005 was included under cost of product revenue, and stock compensation expense of $0.4 million. Research and development expenses increased to $46.4 million for the nine months of fiscal 2006 from $45.6 million for the nine months of fiscal 2005, an increase of $0.8 million. This increase was due to an increase in engineering project expenses due to the recovery of $1.1 million of costs under a third party development agreement in the second quarter of fiscal 2005, increased expenses of $0.7 million from the inclusion of an additional department as described above, and stock compensation expense of $1.3 million, offset by lower information technology costs and a reduction in the amortization of the warrant issued to Avaya of $1.2 million due to the extension of the agreement with Avaya. We expense all research and development costs as incurred. We believe that continued investment in research and development is critical to attaining our strategic objectives and as a result, we expect research and development expenses to increase in absolute dollars.

General and Administrative Expenses

General and administrative expenses consist primarily of salaries and related expenses for executive, finance and administrative personnel, legal fees, professional fees and other general corporate expenses. General and administrative expenses decreased to $6.5 million for the third quarter of fiscal 2006 from $7.3 million for the third quarter of fiscal 2005, a decrease of $0.7 million. This decrease was primarily due to a decrease in legal fees of $1.0 million due to higher legal costs associated with litigation in fiscal 2005, decreases in payroll and related personnel expenses due to decreased headcount, and decreased expenses of $0.4 million from the transfer of a department to Sales and Marketing in fiscal 2006, offset by increased stock compensation expense of $0.2 million. General and administrative expenses decreased to $19.7 million for the first nine months of fiscal 2006 from $21.9 million for the first nine months of fiscal 2005, a decrease of $2.2 million. This decrease was primarily due to decreased legal fees of $3.0 million associated with litigation in fiscal 2005, and decreased expenses of $0.6 million from the transfer of a department to Sales and Marketing in fiscal 2006, offset by stock compensation expense of $0.8 million and increased provision for doubtful accounts of $1.2 million. Legal expenses related to intellectual property litigation are expected to increase in our fourth fiscal quarter but at lower levels than in fiscal 2005. Expenses as a result of compliance with the Sarbanes-Oxley Act of 2002, and Section 404 thereof, are expected to continue at similar or slightly lower levels than fiscal 2005.

Amortization of Deferred Stock Compensation

Amortization of deferred stock compensation was zero in the third quarter and nine months of fiscal 2006. Deferred stock compensation was fully amortized by the end of the third quarter of fiscal 2005. Amortization of deferred stock compensation was attributable to unvested stock options subject to forfeiture issued to employees that we assumed in conjunction with acquisitions during fiscal 2001. Deferred stock compensation was amortized as charges to operations, using the graded method, over the vesting periods of the individual stock options, generally four years. Upon termination of an employee, the amount of expense recognized under the graded vesting method that was in excess of the amount actually earned was reversed. For the nine month period of fiscal 2005, there were no reversals of excess compensation expense related to terminated employees.

Technology Agreement

In the third quarter of fiscal 2005, we entered into a Patent and Cross License Agreement (Technology Agreement) with IBM. The agreement provided for a release of prior claims and a cross license of patents extending into the future from the effective date of the agreement. We charged the estimated value of the release of prior claims of $2 million to operating expenses in the quarter ended March 27, 2005 under the caption Technology agreement . The remaining costs payable under this agreement are charged to cost of product revenue over the license term. We expect these costs to have a small impact on the total product cost of revenue.

Other Income, Net

Other income, net was $1.4 million for the third quarter of fiscal 2006 compared to $0.8 million in the third quarter of fiscal 2005, an increase of $0.6 million. The third quarter of fiscal 2006 includes $1.1 million higher interest income due to higher interest rates, offset by higher other expense, primarily foreign exchange losses, of $0.6 million. Other income, net was $3.7 million for the nine month period of fiscal 2006 compared to $4.6 million in the nine month period of fiscal 2005, a decrease of $0.8 million. This decrease is attributed to the $3.9 million relief of a foreign consumption tax obligation recognized in fiscal 2005, offset by higher interest income in the current period of approximately $3.1 million resulting from an increase in interest rates.

Provision for Income Taxes

The provisions for income taxes of $0.6 million and $0.8 million for the third quarter of fiscal 2006 and the third quarter of fiscal 2005, respectively, were recorded for estimated taxes due on income generated in certain state and foreign tax jurisdictions. The estimated effective tax rates were 19% and (186%) in the third fiscal quarters of 2006 and 2005, respectively, which differs from the statutory tax rate due to benefits to U.S. taxes from net operating loss carryforwards and tax credit carryforwards, offset by the tax impact on income from foreign operations. The provisions for income taxes were $2.0 million and $3.0 million for the nine months ended April 2, 2006 and March 27, 2005, respectively. The estimated effective tax rates were 14% and 19% in the nine month periods of fiscal 2006 and 2005, respectively, The change in the effective tax rate from 13% in the second quarter of fiscal 2006 to 19% in the third quarter of fiscal 2006 is due to changes in estimates for both the full year earnings and full year taxes. Our tax provision is based primarily on taxes on income in foreign jurisdictions, as our U.S. income before tax benefits from net operating loss carryforwards and tax credit carryforwards. Our effective tax rate will be subject to revision during fiscal 2006 based on changes in estimated full year earnings.

We have provided a full valuation allowance for our net deferred tax assets. We initially recorded this charge during fiscal 2003 in accordance with SFAS No. 109, *Accounting for Income Taxes* (SFAS 109), which places greater weight on previous cumulative losses than the outlook for future profitability when determining whether deferred tax assets can be realized. Based upon our most recent three-year history of losses, as of the date of determining the charge, and relying on other guidance specified in SFAS 109, we determined that it was appropriate to establish a full valuation allowance against our deferred tax assets. This valuation allowance will be evaluated periodically and can be reversed partially or totally if business results have sufficiently improved to support realization of our deferred tax assets.

Critical Accounting Policies and Estimates

Our significant accounting policies are more fully described in Note 2 of Notes to Consolidated Financial Statements included in our Form 10-K for the year ended July 3, 2005. The preparation of consolidated financial statements in accordance with generally accepted accounting principles requires management to make estimates, assumptions and judgments that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the consolidated financial statements, and the reported amounts of revenue and expenses during the period reported. By their nature, these estimates, assumptions and judgments are subject to an inherent degree of uncertainty. We base our estimates, assumptions and judgments on historical experience, market trends and other factors that are believed to be reasonable under the circumstances. Estimates, assumptions and judgments are reviewed on an ongoing basis and the effects of revisions are reflected in the consolidated financial statements in the period they are determined to be necessary. Actual results may differ from these estimates under different assumptions or conditions. Our significant accounting policies have been discussed with the audit committee of the Board of Directors. We believe there have been no material changes to our critical accounting policies and estimates during the nine months ended April 2, 2006 compared to those discussed in our Annual Report of Form 10-K for the year ended July 3, 2005, except for the adoption of Financial Accounting Standards Board Statement No. 123(R), *Share-based Payment*.

Share-based Payments

On July 4, 2005, we adopted the fair value recognition provisions of Financial Accounting Standards Board (FASB) Statement No. 123(R), *Share-Based Payment*, (FAS 123R). Prior to July 4, 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 method. Under that transition method, compensation cost recognized in the nine months ended April 2, 2006 includes: a) compensation cost for all share-based payments granted prior to, but not yet vested as of July 4, 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 4, 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.

We have provided certain pro forma information excluding the effect of stock-based compensation expenses because such information may facilitate the comparison by investors of our results with companies that have not adopted FAS 123R, and of our current results with our results in prior periods. We use these pro forma comparisons in measuring and evaluating the results of our business, particularly in making comparisons to the performance of competitors and to our performance in

23

prior periods. We believe that choices of valuation methodologies and the application of judgment required in applying any model will lead to disparities between companies in the effect of applying FAS 123R and that pro forma comparisons may provide an additional useful method of evaluating our results without such variability. We believe the use of GAAP measures as well as pro forma measures avoids these limitations.

As a result of adopting Statement 123R in the three and nine month periods ended April 2, 2006, our net income for the third quarter and the nine months of fiscal 2006 is $1.3 million and $4.8 million, respectively, lower than if we had continued to account for share-based compensation under APB 25 as we did in the comparable prior year period. Basic and diluted earnings per share for the quarter ended April 2, 2006 would have been $0.03 and $0.03, respectively, if we had not adopted FAS 123R, compared to reported basic and diluted earnings per share of $0.02 and $0.02, respectively. Basic and diluted earnings per share for the nine months ended April 2, 2006 would have been $0.14 and $0.14, respectively, if we had not adopted FAS 123R, compared to reported basic and diluted earnings per share of $0.11 and $0.10, respectively. We have not recognized, and do not expect to recognize in the near future, any tax benefit related to employee stock based compensation cost as a result of the full valuation allowance on our net deferred tax assets and our net operating loss carryforwards. Total compensation cost capitalized in inventory was less than $0.1 million in the third quarter of fiscal 2006. Stock-based compensation cost of less than $0.1 million and approximately $0.2 million was recognized in the Statement of Operations for the three and nine month periods ended March 27, 2005.

Share-based compensation recognized in the financial statements by line item caption is as follows (dollars in thousands):

	Three months ended		Nine months ended	
	April 2, 2006	March 27, 2005	April 2, 2006	March 27, 2005
Cost of product revenue	$ 147	$	$ 513	$
Cost of service revenue	77		277	
Sales and marketing	500	14	1,876	39
Research and development	363	4	1,330	98
General and administrative	228		763	
Amortization of deferred stock compensation		2		69
Total share-based compensation expense	1,315	20	4,759	206
Share-based compensation cost capitalized in inventory	(8)		17	
Total share-based compensation cost	$ 1,307	$ 20	$ 4,776	$ 206

The fair value of each option award is estimated on the date of grant using the Black-Scholes-Merton option valuation model with the weighted average assumptions noted in the table in Note 2 of Notes to Condensed Consolidated Financial Statements. The expected term of options granted is derived from historical data on employee exercise and post-vesting employment termination behavior. The risk-free rate for periods within the contractual life of the option is based on the U.S. Treasury yield curve in effect at the time of grant. Expected volatility is based on both the implied volatilities from traded options on our stock and historical volatility on our stock.

For options granted prior to July 4, 2005, and valued in accordance with FAS 123, the expected volatility used to estimate the fair value of the options was based solely on the historical volatility on our stock; we used the graded vested method for expense attribution, and we recognized option forfeitures as they occurred as allowed by FAS 123.

For options granted after July 3, 2005, and valued in accordance with FAS 123R, we used the straight-line method for expense attribution and, we estimate forfeitures and only recognize expense for those shares expected to vest. Our estimated forfeiture rate in the first quarter of fiscal 2006, based on our historical forfeiture experience, is approximately 20%.

The Black-Scholes-Merton option valuation model requires the input of highly subjective assumptions, including the expected life of the stock-based award and stock price volatility. The assumptions used in calculating the fair value of share-based compensation represent management s best estimates, but these estimates involve inherent uncertainties and the application of management judgment. As a result, if other assumptions had been used, our stock-based compensation expense could have been materially different. In addition, we are required to estimate the expected forfeiture rate and only recognize expense for those shares expected to vest. If our actual forfeiture rate is materially different from our estimate, the share-based compensation expense could be materially different.

In the fourth quarter of fiscal 2005, the compensation committee of the Board of Directors approved the acceleration of vesting of certain unvested stock options with exercise prices equal to or greater than $7.00 per share previously awarded to employees, including executive officers, and directors. Options to purchase approximately 4,544,000 shares of common stock were subject to acceleration. In accordance with APB 25, no compensation expense was required to be recorded in our consolidated statement of operations in fiscal 2005 in connection with the acceleration of the vesting of these options, as the exercise price of the employee stock options was higher than the market price of our stock on the date of the modification of the options. We believe that such options had limited economic value and were not offering sufficient incentive to the employees when compared to the potential future expense of approximately $11.4 million that would have been required to be recorded in future periods under FAS 123R had the options not been accelerated.

Recently Issued Accounting Standards

Identification of Impaired Investments

In November 2005, the FASB issued FASB Staff Position Paper (FSP) 115-1, *The Meaning of Other-Than-Temporary Impairment and its Application to Certain Investments* (FSP 115-1). FSP 115-1 provides new guidance for evaluating impairment losses on debt and equity investments, as well as new disclosure requirements for investments that are determined to be other-than-temporarily impaired. FSP 115-1 is effective for other-than-temporary impairment analyses conducted in periods beginning after December 15, 2005.

As substantially all of our investments are investment grade government and corporate debt securities that have maturities of less than 3 years, and we have both the ability and intent to hold the investments until maturity, we do not expect FSP 115-1 to have a material impact on our financial position and results of operations.

Liquidity and Capital Resources

Cash and cash equivalents, short-term investments and marketable securities increased to $444.7 million at April 2, 2006 from $440.4 million at July 3, 2005, an increase of $4.3 million. This increase was primarily due to cash provided by operating activities of $26.6 million and proceeds from issuance of common stock of $4.1 million, partially offset by cash used to repurchase treasury stock of $20.6 million, and capital expenditures of $6.5 million.

We generated $26.7 million in cash from operations in the first nine months of fiscal 2006. Net income was $12.8 million and included significant non-cash charges including depreciation of $9.1 million, $4.7 million in stock-based compensation expense and warrant amortization expense of $3.7 million. Accounts receivable, net decreased to $27.5 million at April 2, 2006 from $30.8 million at July 3, 2005. Days sales outstanding (DSO) in receivables increased to 30 days at April 2, 2006 from 29 days at July 3, 2005. The decrease in our accounts receivable was primarily due to a decrease in shipments during the third quarter of fiscal 2006. Net inventory levels decreased to $20.6 million at April 2, 2006 from $25.9 million at July 3, 2005. Inventory management remains an area of focus as we balance the need to maintain strategic inventory levels to ensure competitive lead times and avoid stock-outs with the risk of inventory excess or obsolescence because of declining demand, rapidly changing technology and customer requirements. Other assets increased by $2.5 million due to additional EMEA service spare parts inventory to comply with implementing legislation under the RoHS Directive. Deferred revenue decreased to $43.1 million at April 2, 2006 from $50.5 million at July 3, 2005, primarily due to a change in fiscal 2005 in the structure and pricing of our service contracts in our international locations that reduced the standard duration to 12 months.

We have a revolving line of credit for $10.0 million with a major lending institution. As of April 2, 2006, there were no outstanding borrowings under this facility. The line of credit contains a provision for the issuance of letters of credit not to exceed the unused balance of the line. As of April 2, 2006, we had letters of credit totaling $0.8 million. These letters of credit were primarily issued to satisfy requirements of certain of our customers for performance bonds. The line of credit requires us to maintain specified financial covenants related to tangible net worth and liquidity with which we were in compliance as of April 2, 2006. The line of credit expires on January 25, 2007.

In December 2001, we completed a private placement of $200.0 million of convertible subordinated notes. The notes mature on December 1, 2006. Interest is payable semi-annually at 3.5% per annum. The notes are convertible at the option of the holders into our common stock at an initial conversion price of $20.96 per share, subject to adjustment. The notes are redeemable in cash at our option at a redemption price of 100.7% of the principal amount between December 2005 and November 2006; and 100% thereafter. Each holder of the notes has the right to cause us to repurchase all of such holder s convertible notes at 100% of the principal amount plus accrued interest upon a change of control of ownership of Extreme Networks, as defined in the offering circular. Instead of paying the repurchase price in cash, we may, if we satisfy certain conditions, elect to pay the repurchase price in common stock valued at 95% of the average of the closing prices of our common stock for the five trading days immediately preceding and including the third trading day prior to the repurchase date.

On October 20, 2005, our Board of Directors authorized the repurchase of up to $50 million of our common stock. This authorization will expire in October 2007. In the nine months ended April 2, 2006, we repurchased approximately 4.2 million shares for approximately $20.6 million. We expect to repurchase stock over the next twelve months, primarily through open market purchases. The repurchases will be made in compliance with the Securities and Exchange Commission s Rule 10b-18, and are subject to market conditions as well as applicable legal and other considerations.

We own our corporate headquarters in Santa Clara, California. The campus is located on approximately 16 acres of property in an area that may ultimately be suitable for residential development. We recently entered into a contract for the sale of our corporate headquarters campus in Santa Clara, California at a price of $70 million. Completion of the transaction is contingent upon successful rezoning of the property for residential development, and is expected to close in 15 to 21 months. When we are certain that a sale transaction will close, we intend to relocate our corporate headquarters to a separate campus in the Santa Clara area.

The following summarizes our contractual obligations (including interest payments) at April 2, 2006, and the effect such obligations are expected to have on our liquidity and cash flow in future periods (in thousands):

	Total	Less Than 1 Year	1 3 Years	3 5 Years	After Five Years
Contractual Obligations:					
Convertible subordinated notes	$ 207,000	$ 207,000	$	$	$
Non-cancelable inventory					
Purchase commitments	22,667	22,667			
Non-cancelable operating lease obligations	19,923	5,743	8,381	4,724	1,075
Other non-cancelable purchase commitments	6,000	3,500	2,000	500	
Total contractual cash obligations	$ 255,590	$ 238,910	$ 10,381	$ 5,224	$ 1,075

We did not have any material commitments for capital expenditures as of April 2, 2006. Other non-cancelable purchase commitments represent OEM and technology agreements. We did not have any off-balance sheet arrangements as of April 2, 2006.

We require substantial capital to fund our business, particularly to finance inventories and accounts receivable and for capital expenditures. As a result, we could be required to raise substantial additional capital at any time. To the extent that we raise additional capital through the sale of equity or convertible debt securities, the issuance of such securities could result in dilution to existing stockholders. If additional funds are raised through the issuance of debt securities, these securities may have rights, preferences and privileges senior to holders of common stock and the terms of such debt could impose restrictions on our operations. If we are unable to obtain such additional capital, we may be required to reduce the scope of our planned product development and marketing efforts, which would materially adversely affect our business, financial condition and operating results.

We believe that our current cash and cash equivalents, short-term investments, marketable securities and cash available from credit facilities and future operations will enable us to meet our working capital requirements for at least the next 12 months.

Table of Contents

Risk Factors

We Cannot Assure You That We Will Be Profitable in the Future

While we have reported a profit in fiscal 2005, we were not profitable in each quarter. In addition, we reported losses for fiscal 2004, fiscal 2003, and fiscal 2002. Fiscal 2000 was the only other year in which we have achieved profitability for the full year. We anticipate continuing to incur significant sales and marketing, product development and general and administrative expenses and, as a result, we will continue to need to rationalize expense levels and increase revenue levels to maintain profitability in future fiscal quarters.

A Number of Factors Could Cause Our Quarterly Financial Results to Be Worse Than Expected, Resulting in a Decline in Our Stock Price

Our ability to control our operating expenses at a level that is consistent with anticipated revenue is significant to our financial results. A high percentage of our expenses are fixed in the short term, so any delay in generating or recognizing revenue could cause our quarterly operating results to fall below the expectations of public market analysts or investors, which could cause the price of our stock to fall.

Orders in our backlog at the beginning of each quarter do not equal expected revenue for that quarter and are generally cancelable at any time. Accordingly, we are dependent upon obtaining orders during a quarter and shipping those orders in the same quarter to achieve our revenue objectives. In addition, the timing of product releases and purchase orders, and product availability, often results in a majority of our product shipments being scheduled near the end of a quarter. Failure to ship these products by the end of a quarter may adversely affect our operating results. Our customer agreements generally allow customers to delay scheduled delivery dates or to cancel orders within specified timeframes without significant charges to the customers. Furthermore, some of our customers require that we provide installation or inspection services that may delay the recognition of revenue for both products and services, and some of our customer agreements include acceptance provisions that prevent our ability to recognize revenue upon shipment.

We may experience a delay in generating or recognizing revenue for a number of reasons and our quarterly revenue and operating results have varied significantly in the past and may vary significantly in the future due to a number of factors, including, but not limited to, the following:

- changes in general and/or specific economic conditions in the networking industry;
- seasonal fluctuations in demand for our products and services, particularly in Asia-Pacific and Europe;
- the level of attrition of our employees, and of our sales force in particular;
- a disproportionate percentage of our sales occurring in the last month of the quarter;
- reduced visibility into the implementation cycles for our products and our customers spending plans;
- our ability to forecast demand for our products, which in the case of lower-than-expected sales, may result in excess or obsolete inventory in addition to non-cancelable purchase commitments for component parts;
- product returns or the cancellation or rescheduling of orders;
- our ability to develop, introduce, ship and support new products and product enhancements and manage product transitions;

announcements and new product introductions by our competitors;

our ability to develop and support relationships with enterprise customers, service providers and other potential large customers;

our ability to achieve targeted cost reductions;

fluctuations in warranty or other service expenses actually incurred;

our ability to obtain sufficient supplies of sole- or limited-source components for our products on a timely basis;

increases in the prices of the components that we purchase;

decreases in the prices of the products that we sell;

our ability to achieve and maintain desired production volumes and quality levels for our products;

the mix of products sold and the mix of distribution channels through which products are sold;

impairment charges associated with long-lived assets;

restructuring costs associated with adjustments to the size of our operations;

costs relating to possible acquisitions and the integration of technologies or businesses; and

the effect of amortization of deferred compensation and purchased intangibles resulting from existing or new transactions.

Table of Contents

In the third quarter of fiscal 2006 and in the third quarter of fiscal 2005, we reported revenues below expectations. Our results were particularly impacted by lower sales in the United States in the third quarter of fiscal 2006, offset in part by increased service revenue and increased product revenue in Asia Pacific. We believe that revenues will increase in coming quarters; however, our future results could be adversely affected if longer term economic or industry trends are unfavorable.

Due to the foregoing factors, we believe that period-to-period comparisons of our operating results should not be relied upon as an indicator of our future performance.

Intense Competition in the Market for Networking Equipment Could Prevent Us from Increasing Revenue and Returning to Profitability

The market for networking equipment is intensely competitive. Our principal competitors include Cisco Systems, Enterasys Networks, Foundry Networks, Inc., Nortel Networks and 3Com Corporation. In addition, a number of private companies and foreign competitors have announced plans for new products, or have introduced products, that may compete with our own products. Some of our current and potential competitors have superior market leverage, longer operating histories and substantially greater financial, technical, sales and marketing resources, in addition to wider name recognition and larger installed customer bases. Foreign competitors may have competitive advantages due to significantly lower costs or strong ties to customers in their home countries. These competitors may have developed, or may in the future develop, new competing products based on technologies that compete with our own products or render our products obsolete. Furthermore, a number of these competitors may merge or form strategic partnerships that enable them to offer or bring to market competitive products. Consolidation within our industry could lead to increased competition and could harm our operating results.

The pricing policies of our competitors impact the overall demand for our products and services. Some of our competitors are capable of operating at significant losses for extended periods of time, increasing pricing pressure on our products and services. If we do not maintain competitive pricing, the demand for our products and services, as well as our market share, may decline. From time to time, we may lower the prices of our products and services. When this happens, if we are unable to reduce our component costs or improve operating efficiencies, our revenues and margins will be adversely affected.

To remain competitive, we believe that we must, among other things, invest significant resources in developing new products, improve our current products and maintain customer satisfaction. Such investment will increase our expenses and affect our profitability. In addition, if we fail to make this investment, we may not be able to compete successfully with our competitors, which could have a material adverse effect on our revenue and future profitability.

When Our Products Contain Undetected Software or Hardware Errors, We Incur Significant Unexpected Expenses and Could Lose Sales

Network products frequently contain undetected software or hardware errors when new products or new versions or updates of existing products are released to the marketplace. In the past, we have experienced such errors in connection with new products and product upgrades. We have experienced component problems in prior years that caused us to incur higher than expected warranty and service costs and expenses, and to record an accrual for related anticipated expenses. In the future, we expect that, from time to time, such errors or component failures will be found in new or existing products after the commencement of commercial shipments. These problems may have a material adverse effect on our business by causing us to incur significant warranty and repair costs, diverting the attention of our engineering personnel from new product development efforts, delaying the recognition of revenue and causing significant customer relations problems. Further, if products are not accepted by customers due to such defects, and such returns exceed the amount we accrued for defect returns based on our historical experience, our operating results would be adversely affected.

Our products must successfully interoperate with products from other vendors. As a result, when problems occur in a network, it may be difficult to identify the sources of these problems. The occurrence of hardware and software errors, whether or not caused by our products, could result in the delay or loss of market acceptance of our products and any necessary revisions may cause us to incur significant expenses. The occurrence of any such problems would likely have a material adverse effect on our business, operating results and financial condition.

Table of Contents

Our Future Success Will Depend in Part Upon Increasing Our Revenue in the U.S. Market

Our recent revenues in the U.S. have not met our expectations. We believe a number of factors have contributed to a decline in our revenues in the U.S., including attrition in our sales and marketing personnel, intense competition, as well as the timing of customer purchase decisions. Our success will depend upon increasing our revenue in the United States. We are initiating a number of programs to improve retention and to compete more effectively in the U.S. market. If these efforts are not successful, our ability to sustain and grow our revenue and to achieve increased profitability would be adversely affected.

We Depend Upon International Sales for a Significant Portion of Our Revenue and Our Ability to Grow Our International Sales Depends on Successfully Expanding Our International Operations

International sales constitute a significant portion of our net revenues. Our ability to grow will depend in part on the continued expansion of international sales. Sales to customers outside of the United States accounted for approximately 60% and 56% of our net revenues for the third quarter of fiscal 2006 and 2005, respectively. Our international sales primarily depend on the success of our resellers and distributors. The failure of these resellers and distributors to sell our products internationally would limit our ability to sustain and grow our revenue. There are a number of risks arising from our international business, including:

- longer accounts receivable collection cycles;
- difficulties in managing operations across disparate geographic areas;
- difficulties associated with enforcing agreements through foreign legal systems;
- the payment of operating expenses in local currencies, which exposes us to risks of currency fluctuations;
- higher credit risks requiring cash in advance or letters of credit;
- difficulty in safeguarding intellectual property;
- political and economic turbulence;
- potential adverse tax consequences; and
- unexpected changes in regulatory requirements, including compliance with U.S. and foreign export laws and regulations.

In addition, conducting our business on a global basis subjects us to a number of frequently changing and complex trade protection measures and import or export regulatory requirements. Our failure to comply with these measures and regulatory requirements may result in the imposition of financial penalties and restrictions on our ability to conduct business in and with certain countries, which may harm our business and damage our reputation. Pursuant to regulations of the U.S. Department of Commerce providing for voluntary disclosure, in the fourth quarter of fiscal 2002, we disclosed information regarding a possible violation of certain export regulations. The Department of Commerce has completed an investigation of these transactions, but has not yet advised us of the action, if any, that it proposes to take in this matter. We intend to work with the Department to resolve the matter. While it is possible that the Department will seek civil penalties and/or other administrative sanctions, we believe that these matters will be resolved without a material adverse effect on our business. We have also implemented procedures to reduce the risk of violations in the future.

Our international sales currently are U.S. dollar-denominated. Future increases in the value of the U.S. dollar relative to foreign currencies could make our products less competitive in international markets. In the future, we may elect to invoice some of our international customers in local currency, which will expose us to fluctuations in exchange rates between the U.S. dollar and the particular local currency. If we do so, we may decide to engage in hedging transactions to minimize the risk of such fluctuations.

We have entered into foreign exchange forward contracts to offset the impact of payment of operating expenses in local currencies to some of our operating foreign subsidiaries. However, if we are not successful in managing these hedging transactions, we could incur losses from hedging activities.

Table of Contents

We Expect the Average Selling Prices of Our Products to Decrease, Which May Reduce Gross Margin and/or Revenue

The network equipment industry has traditionally experienced a rapid erosion of average selling prices due to a number of factors, including competitive pricing pressures, promotional pricing and technological progress. We anticipate that the average selling prices of our products will decrease in the future in response to competitive pricing pressures, excess inventories, increased sales discounts and new product introductions by us or our competitors, including, for example, competitive products manufactured with low-cost merchant silicon. We may experience substantial decreases in future operating results due to the erosion of our average selling prices. To maintain our gross margin, we must develop and introduce on a timely basis new products and product enhancements and continually reduce our product costs. Our failure to do so would likely cause our revenue and gross margins to decline, which could have a material adverse effect on our operating results and cause the price of our common stock to decline.

Some of Our Customers May Not Have the Resources to Pay for Our Products as a Result of the Current Economic Environment

At April 2, 2006, three customers accounted for more than 10% of our accounts receivable balance. Some of our customers are likely to experience serious cash flow problems and, as a result, may find it difficult to obtain financing, if financing is available at all. If our customers are not successful in generating sufficient revenue or securing alternate financing arrangements, they may not be able to pay, or may delay payment of, the amounts that they owe us. In the fourth quarter of fiscal 2005, one large distributor in Europe became delinquent in its payments to us due to cash flow problems and difficulty in obtaining financing. We increased our receivable allowance to fully cover this customer s outstanding balance.

In addition, sales to the service provider market are especially volatile and continued declines or delays in sale orders from this market may harm our financial condition. Furthermore, they may not order as many products from us as originally forecast, or cancel orders with us entirely. The inability of some of our potential customers to pay us for our products may adversely affect our cash flow, the timing of our revenue recognition and the amount of revenue, which may cause our stock price to decline.

If We Lose Key Personnel or are Unable to Hire Additional Qualified Personnel as Necessary, We May Not Be Able to Successfully Manage Our Business or Achieve Our Goals

Our success depends to a significant degree upon the continued contributions of our key management, engineering, sales and marketing, service and operations personnel, many of whom would be difficult to replace. We do not have employment contracts with these individuals nor do we carry life insurance on any of our key personnel.

We believe our future success will also depend in large part upon our ability to attract and retain highly skilled managerial, engineering, sales and marketing, service, finance and operations personnel. The market for these personnel is competitive, especially in the San Francisco Bay Area, and we have had difficulty in hiring employees, particularly engineers, in the timeframe we desire. In addition, retention has become more difficult for us and other public technology companies as a result of the stock market decline, which caused the price of many of our employees stock options to be above the current market price of our stock and we are experiencing a high level of attrition. There can be no assurance that we will be successful in attracting and retaining our key personnel. We have and are initiating a number of employee retention programs, but we can not assure you that these will be successful. The loss of the services of any of our key personnel, the inability to attract or retain qualified personnel in the future or delays in hiring desired personnel, particularly engineers and sales personnel, could make it difficult for us to manage our business and meet key objectives, such as new product introductions. In addition, companies in the networking industry whose employees accept positions with competitors frequently claim that competitors have engaged in unfair hiring practices. We have from time to time been involved in claims like this with other companies and, although to date they have not resulted in material litigation, we do not know whether we will be involved in additional claims in the future as we seek to hire and retain qualified personnel or that such claims will not result in material litigation. We could incur substantial costs in litigating any such claims, regardless of the merits.

The Market in Which We Compete is Subject to Rapid Technological Progress and to Compete We Must Continually Introduce New Products that Achieve Broad Market Acceptance

The network equipment market is characterized by rapid technological progress, frequent new product introductions, changes in customer requirements and evolving industry standards. If we do not regularly introduce new products in this dynamic environment, our product lines will become obsolete. Developments in routers and routing software could also significantly reduce demand for our products. Alternative technologies could achieve widespread market acceptance and displace the Ethernet technology on which we have based our product architecture. We cannot assure you that our technological approach will achieve broad market acceptance or that other technologies or devices will not supplant our own products and technology.

When we announce new products or product enhancements that have the potential to replace or shorten the life cycle of our existing products, customers may defer or cancel orders for our existing products. These actions could have a material adverse effect on our operating results by unexpectedly decreasing sales, increasing inventory levels of older products and exposing us to greater risk of product obsolescence. The market for switching products is evolving and we believe our ability to compete successfully in this market is dependent upon the continued compatibility and interoperability of our products with products and architectures offered by other vendors.

In particular, the networking industry has been characterized by the successive introduction of new technologies or standards that have dramatically reduced the price and increased the performance of switching equipment. To remain competitive, we need to introduce products in a timely manner that incorporate, or are compatible with, these emerging technologies. We are particularly dependent upon the successful introduction of new products. We cannot ensure that any new products we introduce will be commercially successful. We have experienced delays in releasing new products and product enhancements in the past that resulted in lower quarterly revenue than anticipated. We may experience similar delays in product development and releases in the future, and any delay in product introduction could adversely affect our ability to compete, causing our operating results to be below our expectations or the expectations of public market analysts or investors.

Our Limited Ability to Protect Our Intellectual Property May Adversely Affect Our Ability to Compete

We rely on a combination of patent, copyright, trademark and trade secret laws and restrictions on disclosure to protect our intellectual property rights. However, we cannot ensure that the actions we have taken will adequately protect our intellectual property rights or that other parties will not independently develop similar or competing products that do not infringe on our patents. We generally enter into confidentiality or license agreements with our employees, consultants and corporate partners, and control access to and distribution of our software, documentation and other proprietary information. Despite our efforts to protect our proprietary rights, unauthorized parties may attempt to copy or otherwise misappropriate or use our products or technology, which would adversely affect our ability to compete.

Claims of Infringement by Others May Increase and the Resolution of such Claims May Adversely Affect our Ability to Compete and Our Operating Results

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. Because of the existence of a large number of patents in the networking field, the secrecy of some pending patents and the issuance of new patents as a rapid pace, it is not possible to determine in advance if a product or component might infringe the patent rights of others. Because of the potential for courts awarding substantial damages and the lack of predictability of such awards, it is not uncommon for companies in our and similar industries to settle even potentially unmeritorious claims for very substantial amounts. We expect to increasingly be subject to infringement claims asserted by third parties as the numbers of products and competitors in the market for network switches grow and product functionality overlaps.

We are actively involved in disputes and licensing discussions with, and have received notices from, others regarding their claimed proprietary rights. As the functionality and features of our products expands, these disputes and discussions could increase or become harder to resolve. The corporations with whom we have or could have disputes or discussions include corporations with extensive patent portfolios and substantial financial assets who are actively engaged in programs to generate substantial revenues from their patent portfolios, and who are seeking or may seek significant payments or royalties from us and others in our industry. We cannot ensure that we will always be able successfully to defend ourselves against such claims or conclude licensing discussions on favorable terms. If we are found to infringe the proprietary rights of others, or if we otherwise settle such claims or enter into licensing arrangement to resolve potential disputes, we could be compelled to pay damages, royalties or other payments 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. Litigation resulting from claims that we are infringing the proprietary rights of others has resulted and could in the future result in substantial costs and a diversion of resources, and could have a material adverse effect on our business, financial condition and results of operations. Due to the number of companies with extensive patent portfolios in our industry who are or may be actively involved in licensing programs, we believe that even if we do not infringe any patents, we will incur significant expenses in the future due to disputes or licensing negotiations, though the amounts can not be determined. We cannot assure you that any such expenses will not be material or otherwise adversely affect our operating results.

We Are Engaged in Litigation Regarding Intellectual Property Rights, and an Adverse Outcome Could Harm Our Business and Require Us to Incur Significant Costs

We have received notice from several companies alleging that we may be infringing their patents. One of these companies, Lucent Technologies, Inc., filed a claim against us alleging patent infringement, and although we received a favorable verdict in the first phase of the trial, the judge granted Lucent s post-trial motion for a new trial, and we continue in litigation. Another company, Enterasys Networks, Inc., also recently filed a claim against us alleging patent infringement. We are evaluating the merits of the claim and potential counter claims. Without regard to the merits of this or any other claim, if judgments by a court of law on this or any other claim received in the future were to be upheld, or if we were otherwise to agree to the settlement of such claims, the consequences to us may be severe and could require us, among other actions to:

- stop selling our products that incorporate the challenged intellectual property;
- obtain a royalty bearing license to sell or use the relevant technology, which license may not be available on reasonable terms or available at all;
- pay damages; or
- redesign those products that use the disputed technology.

If we are compelled to take any of the foregoing actions, our business could be severely harmed.

Adjustments to the Size of Our Operations May Require Us to Incur Unanticipated Costs

Prior to the quarter ended April 1, 2001, we experienced rapid growth and expansion that placed a significant strain on our resources. Subsequent to that period, we have from time to time incurred unanticipated costs to downsize our operations to a level consistent with lower forecasted sales. We may make mistakes in structuring or operating our business, such as inaccurate sales forecasting or incorrect material planning. Any of these mistakes may lead to unanticipated fluctuations in our operating results. We cannot assure you that we will be able to size our operations in accordance with fluctuations of our business in the future.

We Must Continue to Develop and Increase the Productivity of Our Indirect Distribution Channels to Increase Net Revenues and Improve Our Operating Results

Our distribution strategy focuses primarily on developing and increasing the productivity of our indirect distribution channels. If we fail to develop and cultivate relationships with significant resellers, or if these resellers are not successful in their sales efforts, sales of our products may decrease and our operating results could suffer. Many of our resellers also sell products from other vendors that compete with our products. We cannot assure you that we will be able to enter into additional reseller and/or distribution agreements or that we will be able to successfully manage our product sales channels. Our failure to do any of these could limit our ability to grow or sustain revenue. In addition, our operating results will likely fluctuate significantly depending on the timing and amount of orders from our resellers. We cannot assure you that our resellers and/or distributors will continue to market or sell our products effectively or continue to devote the resources necessary to provide us with effective sales, marketing and technical support.

Most of Our Revenue is Derived From Sales of Three Product Families, So We are Dependent on Widespread Market Acceptance of These Products

We derive substantially all of our revenue from sales of our Summit, BlackDiamond and Alpine products and related services. We expect that revenue from these product families will account for a substantial portion of our revenue for the foreseeable future. Accordingly, widespread market acceptance of our product families is vital to our future success. Factors that may affect the sales of our products, some of which are beyond our control, include:

the demand for switching products (Gigabit Ethernet and Layer 3 switching technologies in particular) in the enterprise and service provider markets;

32

Table of Contents

- the performance, price and total cost of ownership of our products;
- the availability and price of competing products and technologies;
- our ability to match supply with demand for certain products; and
- the success and development of our resellers, distributors and field sales channels.

We may not be able to achieve widespread market acceptance of our product families, which could reduce our revenue.

Future Performance Will Depend on the Introduction and Acceptance of New Products

Our future performance will also depend on the successful development, introduction, and market acceptance of new and enhanced products that address customer requirements in a timely and cost-effective manner. In particular, we are dependent upon the successful introduction of new products. In the past, we have experienced delays in product development and such delays may occur in the future. We have recently announced a number of new or enhanced products. The introduction of new and enhanced products may cause our customers to defer or cancel orders for existing products. Therefore, to the extent customers defer or cancel orders in the expectation of new product releases, any delay in the development or introduction of new products could cause our operating results to suffer. The inability to achieve and maintain widespread levels of market acceptance for our current and future products may significantly impair our revenue growth.

Our Reliance on Industry Standards, Technological Change in the Marketplace and New Product Initiatives May Cause our Sales to Fluctuate or Decline

The network equipment industry in which we compete is characterized by rapid changes in technology and customers requirements and evolving industry standards. As a result, our success depends on

- the timely adoption and market acceptance of industry standards, and timely resolution of conflicting U.S. and international industry standards; and
- our ability to influence the development of emerging industry standards and to introduce new and enhanced products that are compatible with such standards.

Slow market acceptance of new technologies, products or industry standards could adversely affect our sales or overall results of operations. In addition, if our technology is not included in an industry standard on a timely basis or if we fail to achieve timely certification of compliance to industry standards for our products, our sales of such products or our results of operations could be adversely affected.

If a Key Reseller, Distributor, or Other Significant Customer Cancels or Delays a Large Purchase, Our Net Revenues May Decline and the Price of Our Stock May Fall

To date, a limited number of resellers, distributors and other customers have accounted for a significant portion of our revenue. One customer accounted for greater than 10% of our net revenue in the third quarter of both fiscal 2006 and 2005. In addition, while no other distributor or customer has accounted for 10% or more of revenue in the recent fiscal years, sales to several distributors represent a high percentage of our sales. If any of our large customers stop or delay purchases, our revenue and profitability would be adversely affected.

Our expense levels are based on our expectations as to future revenue and to a large extent are fixed in the short term, so a substantial reduction or delay in sales of our products to a significant reseller, distributor or other customer could harm our business, operating results and financial condition. Although our largest customers may differ from period-to-period, we anticipate that our operating results for any given period will continue to depend to a significant extent on large orders from a relatively small number of customers.

While our financial performance depends on large orders from a limited number of key resellers, distributors and other significant customers, we do not have binding purchase commitments from any of them. For example:

- our service providers and enterprise customers can stop purchasing, and our resellers and distributors can stop marketing, our products at any time;

Table of Contents

- our reseller agreements are non-exclusive and are for one-year terms, with no obligation upon the resellers to renew the agreements; and
- our reseller, distributor and end-user customer agreements generally do not require minimum purchases.

Under specified conditions, some third-party distributors are allowed to return products to us. We do not recognize revenue on sales to distributors until the distributors sell the product to their customers.

The Sales Cycle for Our Products is Long and We May Incur Substantial Non-Recoverable Expenses or Devote Significant Resources to Sales that Do Not Occur When Anticipated

The use of indirect sales channels may contribute to the length and variability of our sales cycle. Our products represent a significant strategic decision by a customer regarding its communications infrastructure. The decision by customers to purchase our products is often based on the results of a variety of internal procedures associated with the evaluation, testing, implementation and acceptance of new technologies. Accordingly, the product evaluation process frequently results in a lengthy sales cycle, typically ranging from three months to longer than a year, and as a result, our ability to sell products is subject to a number of significant risks, including:

- the risk that budgetary constraints and internal acceptance reviews by customers will result in the loss of potential sales;
- the risk of substantial variation in the length of the sales cycle from customer to customer, making decisions on the expenditure of resources difficult to assess;
- the risk that we may incur substantial sales and marketing expenses and expend significant management time in an attempt to initiate or increase the sale of products to customers, but not succeed;
- the risk that, if a sales forecast from a specific customer for a particular quarter is not achieved in that quarter, we may be unable to compensate for the shortfall, which could harm our operating results; and
- the risk that downward pricing pressures could occur during this lengthy sales cycle.

We Purchase Several Key Components for Products From Single or Limited Sources and Could Lose Sales if These Suppliers Fail to Meet Our Needs

We currently purchase several key components used in the manufacture of our products from single or limited sources and are dependent upon supply from these sources to meet our needs. Certain components such as tantalum capacitors, static random access memory, or SRAM, dynamic random access memory, or DRAM, and printed circuit boards, have been in the past, and may in the future be, in short supply. We have encountered, and are likely in the future to encounter, shortages and delays in obtaining these or other components, and this could have a material adverse effect on our ability to meet customer orders. Our principal sole-source components include:

- ASICs;
- microprocessors;
- programmable integrated circuits;

- selected other integrated circuits;
- custom power supplies; and
- custom-tooled sheet metal.

Our principal limited-source components include:

- flash memories;
- DRAMs and SRAMs; and
- printed circuit boards.

We use our forecast of expected demand to determine our material requirements. Lead times for materials and components we order vary significantly, and depend on factors such as the specific supplier, contract terms and demand for a component at a given time. If forecasts exceed orders, we may have excess and/or obsolete inventory on hand or under non-cancelable purchase commitments that could have a material adverse effect on our operating results and financial condition. If orders exceed forecasts, we may have inadequate supplies of certain materials and components, which could have a material adverse effect on our operating results and financial condition. We do not have agreements fixing long-term prices or minimum volume requirements from suppliers. From time to time we have experienced shortages and allocations of certain components, resulting in delays in filling orders. Qualifying new suppliers to compensate for such shortages may be time-consuming and costly, and may increase the likelihood of errors in design or production. In addition, during the development of our products, we have experienced delays in the prototyping of our chipsets, which in turn has led to delays in product introductions. We cannot ensure that similar delays will not occur in the future. Furthermore, we cannot ensure that the performance of the components as incorporated in our products will meet the quality requirements of our customers.

Our Dependence on One Contract Manufacturer for All of Our Manufacturing Requirements Could Harm Our Operating Results

If the demand for our products grows, we will need to increase our material purchases, contract manufacturing capacity, and internal test and quality functions. Any disruptions in product flow could limit our revenue, adversely affect our competitive position and reputation, and result in additional costs or cancellation of orders under agreements with our customers.

We rely on one independent contractor, Flextronics International, Ltd., to manufacture our products. This company s facilities are located in San Jose, California and Guadalajara, Mexico. Our commitment with Flextronics is formalized through a one-year contract. We have experienced delays in product shipments from contract manufacturers in the past, which in turn delayed product shipments to our customers. These or similar problems may arise in the future, such as products of inferior quality, insufficient quantity of products, or the interruption or discontinuance of operations of a manufacturer, any of which could have a material adverse effect on our business and operating results.

We do not know whether we will effectively manage our contract manufacturer or that this manufacturer will meet our future requirements for timely delivery of products of sufficient quality and quantity. We intend to introduce new products and product enhancements, which will require that we rapidly achieve volume production by coordinating our efforts with those of our suppliers and contract manufacturer. The inability of our contract manufacturer to provide us with adequate supplies of high-quality products may cause a delay in our ability to fulfill orders and may have a material adverse effect on our business, operating results and financial condition. Moreover, our current dependence on a single manufacturer makes us particularly vulnerable to these risks.

As part of our cost-reduction efforts, we will need to realize lower per unit product costs from our contract manufacturer by means of volume efficiencies and the utilization of manufacturing sites in lower-cost geographies. However, we cannot be certain when or if such price reductions will occur. The failure to obtain such price reductions would adversely affect our gross margins and operating results.

If We Do Not Adequately Manage and Evolve Our Financial Reporting and Managerial Systems and Processes, Our Ability to Manage and Grow Our Business May Be Harmed

Our ability to successfully implement our business plan and comply with regulations requires an effective planning and management process. We need to continue improving our existing, and implement new, operational and financial systems, procedures and controls. Any delay in the implementation of, or disruption in the transition to, new or enhanced systems, procedures or controls, could harm our ability to record and report financial and management information on a timely and accurate basis, or to forecast future results.

We May Be Unable to Reasonably Anticipate Whether a Change in Our Process Will Have a Material Affect on Our Internal Control Over Financial Reporting

As we improve our controls and procedures in our ongoing effort to improve our business systems, we may be required to make changes to our internal control over financial reporting. We may be unable to reasonably anticipate, both during the period in which such changes are made and at the time we file the periodic reports covering such period, that such changes will have a material affect on our internal control over financial reporting. If we are unable to reasonably anticipate such material affect, it will have an adverse effect on our ability to accurately report our changes in internal control over financial reporting.

Table of Contents

If In the Future We Are Unable To Favorably Assess The Effectiveness Of Our Internal Control Over Financial Reporting, or If Our Independent Registered Accounting Firm Is Unable To Provide An Unqualified Attestation Report On Our Assessment, Our Stock Price Could Be Adversely Affected

Section 404 of the Sarbanes-Oxley Act of 2002 requires our management to report on, and our independent registered public accounting firm to attest to, the effectiveness of our internal control over financial reporting. We have an ongoing program to perform the system and process evaluation and testing necessary to comply with these requirements. We expect to incur significant expenses and dedicate significant management resources towards Section 404 compliance on an ongoing basis.

We have identified significant deficiencies in our internal controls over financial reporting. We are addressing such deficiencies by enhancing the controls and procedures in relation to these deficiencies. It is possible that additional significant deficiencies may be identified and, or the existing deficiencies may not be fully remediated, resulting in a material weakness in our internal control over financial reporting. In the event that our executive officers or independent registered public accounting firm determine in the future that our internal controls over financial reporting are not effective as defined under Section 404, investor confidence and our stock price could be adversely affected.

Changes in Financial Accounting Standards May Cause Adverse Unexpected Revenue Fluctuations and Affect Our Reported Results of Operations

A change in accounting policies can have a significant effect on our reported results and may even affect our reporting of transactions completed before the change is effective. New pronouncements and varying interpretations of pronouncements have occurred with frequency and may occur in the future. Changes to existing rules or the questioning of current practices may adversely affect our reported financial results or the way we conduct our business.

In particular, in December 2004 the Financial Accounting Standards Board issued a statement requiring companies to record stock option grants as compensation expense in their income statements. This statement was effective beginning with the first quarter of fiscal 2006. The methodology for expensing such stock options is based on, among other things, the historical volatility of the underlying stock and the expected life of our stock options. Our stock price has been historically volatile. Therefore, the adoption of this accounting standard has, and will continue to, negatively impact our profitability and may adversely impact our stock price. In addition, our adoption of this standard could limit our ability to continue to use stock options as an incentive and retention tool, which could, in turn, hurt our ability to recruit employees and retain existing employees.

In addition, various accounting rules and regulations have been established over the recent past relating to revenue recognition. These regulations frequently require judgments in their application, and are subject to numerous subsequent clarifications and interpretations, some of which may require changes in the way we recognize revenue and may require restatement of prior period revenue and results, either of which could adversely affect our reported results.

Our Business Substantially Depends Upon the Continued Growth of the Internet and Internet-Based Systems

A substantial portion of our business and revenue depends on growth of the Internet and on the deployment of our products by customers that depend on the continued growth of the Internet. As a result of the recent economic slowdown and reduction in capital spending, which have particularly affected telecommunications service providers, spending on Internet infrastructure has declined, which has materially harmed our business. To the extent that the recent economic slowdown and reduction in capital spending continue to adversely affect spending on Internet infrastructure, we could continue to experience material harm to our business, operating results, and financial condition.

Because of the rapid introduction of new products, and changing customer requirements related to matters such as cost-effectiveness and security, we believe that there could be certain performance problems with Internet communications in the future, which could receive a high degree of publicity and visibility. As we are a large supplier of networking products, our business, operating results, and financial condition may be materially adversely affected, regardless of whether or not these problems are due to the performance of our own products. Such an event could also result in a material adverse effect on the market price of our common stock independent of direct effects on our business.

Table of Contents

Compliance with Changing Regulation of Corporate Governance and Public Disclosure May Result in Additional Expenses

Changing laws, regulations and standards relating to corporate governance and public disclosure, including the Sarbanes-Oxley Act of 2002, new SEC regulations and NASDAQ Stock Market rules, are creating uncertainty for companies such as ours. We are committed to maintaining high standards of corporate governance and public disclosure. As a result, we are investing all reasonably necessary resources to comply with evolving standards, and this investment may result in increased general and administrative expenses and a diversion of management time and attention from revenue-generating activities to compliance activities.

We Have Been Named as a Defendant in a Shareholder Class Action Lawsuit Arising Out of Our Public Offerings of Securities in 1999

Beginning on July 6, 2001, purported securities fraud class action complaints were filed in the United States District Court for the Southern District of New York. The cases were consolidated and the litigation is now captioned as In re Extreme Networks, Inc. Initial Public Offering Securities Litigation, Civ. No. 01-6143 (SAS) (S.D.N.Y.), related to In re Initial Public Offering Securities Litigation, 21 MC 92 (SAS) (S.D.N.Y.).

The operative amended complaint is brought purportedly on behalf of all persons who purchased Extreme Networks common stock from April 8, 1999 through December 6, 2000. It names as defendants Extreme Networks; six of our present and former officers and/or directors, including our CEO (the Extreme Networks Defendants); and several investment banking firms that served as underwriters of our initial public offering and October 1999 secondary offering. Subsequently, plaintiffs and one of the individual defendants stipulated to a dismissal of that defendant without prejudice. The complaint alleges liability under Sections 11 and 15 of the Securities Act of 1933 and Sections 10(b) and 20(a) of the Securities Exchange Act of 1934, on the grounds that the registration statement for the offerings did not disclose that: (1) the underwriters had agreed to allow certain customers to purchase shares in the offerings in exchange for excess commissions paid to the underwriters; and (2) the underwriters had arranged for certain customers to purchase additional shares in the aftermarket at predetermined prices. The Securities Act allegations against the Extreme Networks Defendants are made as to the secondary offering only. The amended complaint also alleges that false analyst reports were issued. No specific damages are claimed.

Similar allegations were made in other lawsuits challenging over 300 other initial public offerings and follow-on offerings conducted in 1999 and 2000. The cases were consolidated for pretrial purposes. On February 19, 2003, the Court ruled on all defendants motions to dismiss. The Court denied the motions to dismiss the claims in our case under the Securities Act of 1933. The Court denied the motion to dismiss the claim under Section 10(a) of the Securities Exchange Act of 1934 against Extreme Networks and 184 other issuer defendants, on the basis that the complaints alleged that the respective issuers had acquired companies or conducted follow-on offerings after their initial public offerings. The Court denied the motion to dismiss the claims under Section 10(a) and 20(a) of the Securities Exchange Act of 1934 against the remaining Extreme Networks Defendants and 59 other individual defendants, on the basis that the respective amended complaints alleged that the individuals sold stock.

We have executed a settlement agreement presented to all issuer defendants. In this settlement, plaintiffs will dismiss and release all claims against the Extreme Network Defendants, in exchange for a contingent payment by the insurance companies collectively responsible for insuring the issuers in all of the IPO cases, and for the assignment or surrender of control of certain claims we may have against the underwriters. The Extreme Networks Defendants will not be required to make any cash payments in the settlement, unless the pro rata amount paid by the insurers in the settlement exceeds the amount of the insurance coverage, a circumstance which we do not believe will occur. The settlement will require approval of the Court, which cannot be assured. If the settlement is not approved, we cannot assure you that we will prevail in the lawsuit. Failure to prevail could have a material adverse effect on our consolidated financial position, results of operations and cash flows in the future.

In addition, in the past, we have, and may in the future, become subject to other types of litigation, and may in the future become subject to other types of litigation. Litigation is often expensive and diverts management s attention and resources, which could materially and adversely affect our business.

Our Headquarters and Some Significant Supporting Businesses Are Located in Northern California and Other Areas Subject to Natural Disasters That Could Disrupt Our Operations and Harm Our Business

Our corporate headquarters are located in Silicon Valley in Northern California. Historically, this region has been vulnerable to natural disasters and other risks, such as earthquakes, fires and floods, which at times have disrupted the local economy and posed physical risks to our property. We have a contract manufacturer located in Northern California and in Mexico where similar natural disasters and other risks may disrupt the local economy and pose physical risks to our property and the property of our contract manufacturer.

In addition, the continued threat of terrorism and heightened security and military action in response to this threat, or any future acts of terrorism, may cause further disruptions to the economies of the U.S. and other countries. If such disruptions result in delays or cancellations of customer orders for our products, our business and operating results will suffer.

We currently do not have redundant, multiple site capacity in the event of a natural disaster, terrorist act or other catastrophic event. In the event of such an occurrence, our business would suffer.

Failure of Our Products to Comply With Evolving Industry Standards and Complex Government Regulations May Cause Our Products to Not Be Widely Accepted, Which May Prevent Us From Growing Our Net Revenues or Achieving Profitability on a Fiscal Year Basis

The market for network equipment products is characterized by the need to support industry standards as different standards emerge, evolve and achieve acceptance. We will not be competitive unless we continually introduce new products and product enhancements that meet these emerging standards. In the past, we have introduced new products that were not compatible with certain technological standards, and in the future we may not be able to effectively address the compatibility and interoperability issues that arise as a result of technological changes and evolving industry standards. Our products must comply with various United States federal government regulations and standards defined by agencies such as the Federal Communications Commission, in addition to standards established by governmental authorities in various foreign countries and recommendations of the International Telecommunication Union. If we do not comply with existing or evolving industry standards or if we fail to obtain timely domestic or foreign regulatory approvals or certificates we will not be able to sell our products where these standards or regulations apply, which may prevent us from sustaining our net revenue or achieving profitability on a fiscal year basis.

Production and marketing of products in certain states and countries may subject us to environmental and other regulations including, in some instances, the requirement to provide customers the ability to return product at the end of its useful life, and place the responsibility for environmentally safe disposal or recycling with us. Additionally, certain states and countries may pass regulations requiring our products to meet certain requirements to use environmentally friendly components. Such laws and regulations have recently been passed in several jurisdictions in which we operate, including the European Union which issued a Directive 2002/96/EC Waste Electrical and Electronic Equipment (WEEE) to mandate funding, collection, treatment, recycling and recovery of WEEE by producers of electrical or electronic equipment into Europe. China is in the final approval stage of compliance programs which will harmonize with the European Union WEEE. In the future, Japan and other countries are expected to adopt environmental compliance programs. If we fail to comply with these regulations, we may not be able to sell our products in jurisdictions where these regulations apply, which would have a material adverse affect on our results of operations.

In addition, the EU also adopted Directive 2002/95/EC on Restriction on the Certain Hazardous Substances in Electrical and Electronic Equipment (the RoHS Directive). The RoHS Directive bans in the EU the use of certain hazardous materials in electrical and electronic equipment. The RoHS Directive goes into effect on July 1, 2006, the date by which each EU-member country is required to adopt legislation implementing the RoHS Directive in that country. Certain EU-member countries where we import products have adopted such implementing legislation to be effective on July 1, 2006, while other EU-member countries have either not yet adopted implementing legislation or have not yet adopted rules under their implementing legislation. It is therefore not yet possible for us to fully determine or estimate the impact on us of complying with the RoHS Directive, although we have a program underway to ensure compliance with the RoHS Directive. We have incurred higher manufacturing costs and increased our European service spare parts inventory by approximately $2.5 million in the third quarter of fiscal 2006 as a result of complying with the RoHS Directive. We might incur further increased manufacturing costs, production delays and/or increased finished goods inventory and service spare parts inventory in complying with implementing legislation under the RoHS Directive, but we cannot currently estimate those costs because of uncertainty on how the RoHS Directive will be implemented in each EU-member country where we manufacture or import electrical or electronic equipment. We may experience RoHS compliant product shortages during the initial implementation period that may cause product shipments and revenue to be below expectations. To the extent those costs or delays are substantial, our financial condition or results of operations could be materially adversely affected. In addition, similar legislation has been or could be enacted in other countries outside the EU, the cumulative impact of which could similarly impact our financial condition or results of operations.

38

Table of Contents

Failure to Successfully Expand Our Sales and Support Teams or Educate Them In Regard to Technologies and Our Product Families May Harm Our Operating Results

The sale of our products and services requires a concerted effort that is frequently targeted at several levels within a prospective customer s organization. We may not be able to increase net revenues unless we expand our sales and support teams in order to address all of the customer requirements necessary to sell our products.

We cannot assure you that we will be able to successfully integrate employees into our company or to educate current and future employees in regard to rapidly evolving technologies and our product families. A failure to do so may hurt our revenue growth and operating results.

We May Engage in Future Acquisitions that Dilute the Ownership Interests of Our Stockholders, Cause Us to Incur Debt and Assume Contingent Liabilities

As part of our business strategy, we review acquisition and strategic investment prospects that we believe would complement our current product offerings, augment our market coverage or enhance our technical capabilities, or otherwise offer growth opportunities. From time to time we review investments in new businesses and we expect to make investments in, and to acquire, businesses, products, or technologies in the future. In the event of any future acquisitions, we could:

- issue equity securities which would dilute current stockholders percentage ownership;
- incur substantial debt;
- assume contingent liabilities; or
- expend significant cash.

These actions could have a material adverse effect on our operating results or the price of our common stock. Moreover, even if we do obtain benefits in the form of increased sales and earnings, there may be a lag between the time when the expenses associated with an acquisition are incurred and the time when we recognize such benefits. This is particularly relevant in cases where it is necessary to integrate new types of technology into our existing portfolio and new types of products may be targeted for potential customers with which we do not have pre-existing relationships. Acquisitions and investment activities also entail numerous risks, including:

- difficulties in the assimilation of acquired operations, technologies and/or products;
- unanticipated costs associated with the acquisition or investment transaction;
- the diversion of management s attention from other business concerns;
- adverse effects on existing business relationships with suppliers and customers;
- risks associated with entering markets in which we have no or limited prior experience;

the potential loss of key employees of acquired organizations; and

substantial charges for the amortization of certain purchased intangible assets, deferred stock compensation or similar items.

We cannot ensure that we will be able to successfully integrate any businesses, products, technologies, or personnel that we might acquire in the future, and our failure to do so could have a material adverse effect on our business, operating results and financial condition.

We May Need Additional Capital to Fund Our Future Operations and, If It Is Not Available When Needed, We May Need to Reduce Our Planned Development and Marketing Efforts, Which May Reduce Our Net Revenues and Prevent Us From Achieving Profitability on a Fiscal Year Basis

We believe that our existing working capital and cash available from credit facilities and future operations, will enable us to meet our working capital requirements for at least the next 12 months. However, if cash from future operations is insufficient, or if cash is used for acquisitions or other currently unanticipated uses, we may need additional capital. The development and marketing of new products and the expansion of reseller and distribution channels and associated support personnel requires a significant commitment of resources. In addition, if the markets for our products develop more slowly than anticipated, or if we fail to establish significant market share and achieve sufficient net revenues, we may continue to consume significant amounts of capital. As a result, we could be required to raise additional capital. To the extent that we raise additional capital through the sale of equity or convertible debt securities, the issuance of such securities could result in dilution of the shares held by existing stockholders. If additional funds are raised through the issuance of debt securities, such securities may provide the holders certain rights, preferences, and privileges senior to those of common stockholders, and the terms of such debt could impose restrictions on our operations. We cannot assure you that additional capital, if required, will be available on acceptable terms, or at all. If we are unable to obtain sufficient amounts of additional capital, we may be required to reduce the scope of our planned product development and marketing efforts, which could harm our business, financial condition and operating results.

We Have Substantial Debt Obligations

In connection with the sale of convertible subordinated notes in December 2001, we incurred $200 million of indebtedness. The convertible subordinated notes are scheduled for repayment in December 2006. We will require substantial amounts of cash to fund repayment of the principal amount of the convertible notes at that time. If we are unable to repay the notes at maturity, or if management determines repayment is not the Company s best financial alternative, we may attempt to refinance the notes; however, no assurance can be given that such a refinancing would be available on terms acceptable to us, if at all. Any failure by us to satisfy our obligations with respect to the notes at maturity would constitute a default under the indenture and could cause a default under agreements governing our other indebtedness.

We Have Entered into Long-Term Lease Agreements for Several Facilities that are Currently Vacant and May be Difficult to Sublease due to Current Real Estate Market Conditions

We have certain long-term real estate lease commitments carrying future obligations for non-cancelable lease payments. Reductions in our workforce and the restructuring of operations since fiscal 2002 have resulted in the need to consolidate certain of these leased facilities, located primarily in Northern California, for which we recorded excess facilities charges of approximately $6.5 million in fiscal 2004, and $9.6 million in fiscal 2003. For more information, see Note 7 of Notes to Condensed Consolidated Financial Statements. We continue to attempt to sublease certain of these facilities and have estimated the amount of sublease income to offset the carrying costs of these facilities when establishing our excess facilities charges. However, we may not be able to sublease these facilities at the times or on the terms we anticipated when we took the excess facilities charge and therefore if the market does not improve, we may incur additional charges in the future. In addition, we may incur additional charges for excess facilities as a result of additional reductions in our workforce or future restructuring of operations. We will continue to be responsible for all carrying costs of these facilities until such time as we can sublease these facilities or terminate the applicable leases based on the contractual terms of the lease agreements, and these costs may have an adverse effect on our business, operating results and financial condition.

Our Stock Price Has Been Volatile In the Past and Our Stock Price and the Price of the Notes May Significantly Fluctuate in the Future

In the past, our common stock price has fluctuated significantly. This could continue as we or our competitors announce new products, our results or those of our customers or competition fluctuate, conditions in the networking or semiconductor industry change, or when investors, change their sentiment toward stocks in the networking technology sector.

In addition, fluctuations in our stock price and our price-to-earnings multiple may make our stock attractive to momentum, hedge or day-trading investors who often shift funds into and out of stock rapidly, exacerbating price fluctuations in either direction, particularly when viewed on a quarterly basis.

Securities We Issue to Fund Our Operations Could Dilute Your Ownership

We may decide to raise additional funds through public or private debt or equity financing to fund our operations. If we raise funds by issuing equity securities, the percentage ownership of current stockholders will be reduced and the new equity securities may have rights prior to those of our common stock, including the common stock issuable upon conversion of the notes. We may not obtain sufficient financing on terms that are favorable to you or us. We may delay, limit or eliminate some or all of our proposed operations if adequate funds are not available.

Table of Contents

Provisions in Our Charter Documents and Delaware Law and Our Adoption of a Stockholder Rights Plan May Delay or Prevent Acquisition Of Extreme, Which Could Decrease the Value of Our Common Stock and the Notes

Our certificate of incorporation and bylaws and Delaware law contain provisions that could make it more difficult for a third party to acquire us without the consent of our Board of Directors. Delaware law also imposes some restrictions on mergers and other business combinations between us and any holder of 15% or more of our outstanding common stock. In addition, our Board of Directors has the right to issue preferred stock without stockholder approval, which could be used to dilute the stock ownership of a potential hostile acquirer. Although we believe these provisions of our certificate of incorporation and bylaws and Delaware law and our stockholder rights plan, which is described below, will provide for an opportunity to receive a higher bid by requiring potential acquirers to negotiate with our Board of Directors, these provisions apply even if the offer may be considered beneficial by some of our stockholders.

Our Board of Directors adopted a stockholder rights plan, pursuant to which we declared and paid a dividend of one right for each share of common stock held by stockholders of record as of May 14, 2001. Under the plan, each right will entitle stockholders to purchase a fractional share of our preferred stock for $150.00. Each such fractional share of the new preferred stock has terms designed to make it substantially the economic equivalent of one share of common stock. Initially the rights will not be exercisable and will trade with our common stock. Generally, the rights may become exercisable if a person or group acquires beneficial ownership of 15% or more of our common stock or commences a tender or exchange offer upon consummation of which such person or group would beneficially own 15% or more of our common stock. When the rights become exercisable, our Board of Directors has the right to authorize the issuance of one share of our common stock in exchange for each right that is then exercisable.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

Interest Rate Sensitivity

The primary objective of our investment activities is to preserve principal while at the same time maximize the income we receive from our investments without significantly increasing risk. Some of the securities that we have invested in may be subject to market risk. This means that a change in prevailing interest rates may cause the principal amount of the investment to fluctuate. For example, if we hold a security that was issued with a fixed interest rate at the then-prevailing rate and the prevailing interest rate later rises, the principal amount of our investment will probably decline. To minimize this risk, we maintain our portfolio of cash equivalents and short-term investments in a variety of securities, including commercial paper, other non-government debt securities and money market funds. In general, money market funds are not subject to market risk because the interest paid on such funds fluctuates with the prevailing interest rate. The following table presents the amounts of our cash equivalents, short-term investments, marketable securities and long-term debt that are subject to market risk by range of expected maturity and weighted-average interest rates as of January 1, 2006. This table does not include money market funds because those funds are generally not subject to market risk.

		Maturing in			
	Three months or less	Three months to one year	Greater than one year	Total	Fair Value
Included in cash and cash equivalents	$ 17,048			$ 17,048	$ 17,048
Weighted average interest rate	4.61%				
Included in short-term investments	$ 155,339	$ 156,656		$ 311,995	$ 311,995
Weighted average interest rate	4.05%	3.07%			
Included in marketable securities			$ 49,965	$ 49,965	$ 49,965
Weighted average interest rate			3.91%		
Convertible subordinated notes		$ 200,000		$ 200,000	$ 196,750
Weighted-average interest rate		3.50%			

Exchange Rate Sensitivity

Currently, substantially all of our sales and the majority of our expenses are denominated in United States dollars and, as a result, we have experienced no significant foreign exchange gains and losses to date. While we conduct some sales transactions and incur certain operating expenses in foreign currencies and expect to continue to do so, we do not anticipate that foreign exchange gains or losses will be significant, in part because of our foreign exchange risk management process discussed below.

Table of Contents

Foreign Exchange Forward Contracts

We enter into foreign exchange forward contracts to hedge foreign currency forecasted transactions related to certain operating expenses, denominated in Japanese Yen, the Euro, the Swedish Krona and the British Pound. These derivatives are designated as cash flow hedges under SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities, as amended and interpreted* (SFAS 133). At April 2, 2006, these forward foreign currency contracts had a notional principal amount of $5.6 million (fair value of zero). These contracts have maturities of less than 60 days.

Additionally, we enter into foreign exchange forward contracts to mitigate the effect of gains and losses generated by the remeasurement of certain assets and liabilities denominated in Japanese Yen, the Euro, the Swedish Krona and the British Pound. These derivatives are not designated as hedges under SFAS 133. At April 2, 2006, we held foreign currency forward contracts with a notional principal amount of $10.0 million (fair value of $39,000). These contracts have maturities of less than 45 days. Changes in the fair value of these foreign exchange forward contracts are offset largely by remeasurement of the underlying assets and liabilities.

We do not enter into foreign exchange forward contracts for speculative or trading purposes. Foreign currency transaction losses from operations, including the impact of hedging, were ($0.4) million for the third quarter of fiscal 2006 and ($0.9) million for the first nine months of fiscal 2006. Foreign currency transaction losses from operations, including the impact of hedging, were $0.1 million for the third quarter of fiscal 2005 and a loss of ($0.7) million for the first nine months of fiscal 2005.

Item 4. Controls and Procedures

Disclosure Controls and Procedures. Our management, with the participation of our principal executive officer and principal financial officer, has evaluated the effectiveness of our disclosure controls and procedures (as such term is defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the Exchange Act)) as of the end of the period covered by this report. Based on that evaluation, these officers have concluded that our disclosure controls and procedures are effective for the purpose of ensuring that material information required to be in this quarterly report is made known to them by others on a timely basis, and 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 principal executive and principal financial officer, in order to allow timely decisions regarding required disclosure and that such information is recorded, processed, summarized and reported by us within the time periods specified in the Securities and Exchange Commission rules and forms.

Changes in Internal Controls. We are continuously seeking to improve the efficiency and effectiveness of our operations and of our internal controls. This results in refinements to processes throughout our organization. However, there has been no change in our internal control over financial reporting that occurred during the most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

Table of Contents

PART II. Other Information

Item 1. Legal Proceedings

On December 27, 2006, Broadband Office Inc. (Broadband) served an amended complaint, adding Extreme Networks as a defendant in its lawsuit against Technology Credit Corporation (TCC) and Key Equipment Finance, Inc., seeking recovery of an alleged preferential payment in the amount of $0.8 million plus interest, purportedly paid by Broadband to TCC within ninety days prior to Broadband s petition for bankruptcy protection. Extreme disputes that it owes any money to Broadband, and intends vigorously to defend against the claims.

On June 21, 2005, Enterasys filed suit against Extreme Networks and Foundry Networks, Inc. (Foundry) in the United States District Court for the District of Delaware, Civil Action No.05-11298 DPW. The complaint alleges willful infringement of U. S. Patent Nos. 5,251,205; 5,390,173; 6,128,665; 6,147,995; 6,539,022; and 6,560, 236, and seeks: a) a judgment thatExtreme willfully infringed each of the patents; (b) a permanent injunction from infringement, inducement of infringement and contributory infringement of each of the six patents; (c) damages and a reasonable royalty to be determined at trial; (d) trebled damages; (e) attorneys fees, costs and interest; and (f) equitable relief at the court s discretion. The Markman hearing has been scheduled for January 2007. We intend to vigorously defend against Enterasys assertions, which we believe to be without merit.

On May 27, 2003, Lucent filed suit against Extreme Networks and Foundry in the United States District Court for the District of Delaware, Civil Action No. 03-508. The complaint alleged willful infringement of U.S. Patent Nos. 4,769,810, 4,769,811, 4,914,650, 4,922,486 and 5,245,607. The judge split the case into three parts to be tried separately: phase 1 to cover infringement, willfulness and damages; phase 2 to cover invalidity; and phase 3 to cover equitable defenses and our counterclaims. On May 9, 2005, a jury in Delaware awarded a verdict to Extreme in the phase 1 trial of non-infringement on 18 out of the 19 claims asserted. The jury did award Lucent damages of approximately $275,000 on the remaining claim; which covers a feature that is not offered in our current product line. The parties each filed post-trial motions; and on August 16, 2005, the judge granted Lucent s motion for a new trial, ruling that Extreme impermissibly introduced to the jury evidence of its prior relationship with Lucent. Extreme s motion for reconsideration was denied. The new trial on phase 1 has been scheduled for September 18, 2006 and the remaining phases of the trial have not yet been scheduled. We intend to vigorously defend against Lucent s claims, which we continue to believe to be without merit.

Beginning on July 6, 2001, purported securities fraud class action complaints were filed in the United States District Court for the Southern District of New York. The cases were consolidated and the litigation is now captioned as In re Extreme Networks, Inc. Initial Public Offering Securities Litigation, Civ. No. 01-6143 (SAS) (S.D.N.Y.), related to In re Initial Public Offering Securities Litigation, 21 MC 92 (SAS) (S.D.N.Y.).The operative amended complaint names as defendants Extreme Networks; six of our present and former officers and/or directors, including our CEO (the Extreme Networks Defendants); and several investment banking firms that served as underwriters of our initial public offering and October 1999 secondary offering. The complaint alleges liability under Sections 11 and 15 of the Securities Act of 1933 and Sections 10(b) and 20(a) of the Securities Exchange Act of 1934, on the grounds that the registration statement for the offerings did not disclose that: (1) the underwriters had agreed to allow certain customers to purchase shares in the offerings in exchange for excess commissions paid to the underwriters; and (2) the underwriters had arranged for certain customers to purchase additional shares in the aftermarket at predetermined prices.

Similar allegations were made in other lawsuits challenging over 300 other initial public offerings and follow-on offerings conducted in 1999 and 2000. The cases were consolidated for pretrial purposes. We have executed a settlement agreement in which plaintiffs will dismiss and release all claims against the Extreme Network Defendants, in exchange for a contingent payment by the insurance companies collectively responsible for insuring the issuers in all of the IPO cases, and for the assignment or surrender of control of certain claims we may have against the underwriters. The Extreme Networks Defendants will not be required to make any cash payments in the settlement, unless the pro rata amount paid by the insurers in the settlement exceeds the amount of the insurance coverage, a circumstance which we do not believe will occur. The settlement will require approval of the Court, which cannot be assured. If the settlement is not approved, we cannot assure you that we will prevail in the lawsuit. Failure to prevail could have a material adverse effect on our consolidated financial position, results of operations and cash flows in the future.

Other than the proceedings stated above, we are not aware of any pending legal proceedings against us that, individually or in the aggregate, would have a material adverse effect on our business, operating results or financial condition. We may from time to time be party to litigation arising in the course of our business, including, without limitation, allegations relating to commercial transactions or business relationships or intellectual property rights. Such claims, even if not meritorious, could result in the expenditure of significant financial and managerial resources.

Table of Contents

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

Period	Total Number of Shares Purchased	Average Price Paid per Share		Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Approximate Dollar Value of Shares that May Yet Be Purchased Under the Plans or Programs (1)	
January 2, 2006 through January 29, 2006	887,606(2)	$	4.78	887,606(2)	$	38,951,069
January 30, 2006 through February 26, 2006	853,105(2)	$	4.92	853,105(2)	$	34,754,656
February 27, 2006 through April 2, 2006	1,101,500(2)	$	4.87	1,101,500(2)	$	29,393,834
Total	2,842,211	$	4.85(3)	2,842,211		

(1) We announced on October 26, 2005 that we have an ongoing authorization from the Board of Directors, subject to certain specifications, to repurchase shares of our common stock up to an aggregate maximum amount of $50 million on the open market or in negotiated transactions through October 2007.

(2) As part of our share repurchase program, we have entered into and we may continue to enter into structured share repurchase transactions with financial institutions. During the third quarter of fiscal 2006, we repurchased 2.8 million shares of our common stock for $13.8 million under structured share repurchase transactions. These transactions required that we make up-front payments.

(3) Represents average price paid per share during the third quarter of fiscal 2006.

Item 3. Defaults Upon Senior Securities None

Item 4. Submission of Matters to a Vote of Security Holders None

Item 5. Other Information None

Item 6. Exhibits

a) Exhibits:

10.11	Extreme Networks, Inc. Executive Change in Control Severance Plan
31.1	Section 302 Certification of Chief Executive Officer
31.2	Section 302 Certification of Chief Financial Officer
32.1	Section 906 Certification of Chief Executive Officer
32.2	Section 906 Certification of Chief Financial Officer

Table of Contents

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.

EXTREME NETWORKS, INC.
(Registrant)

/S/ WILLIAM R. SLAKEY

WILLIAM R. SLAKEY
Senior Vice President and Chief Financial Officer

May 9, 2006