EXTREME NETWORKS INC
Form 10-Q
February 13, 2008
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 quarterly period ended December 30, 2007

OR

¨ **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the transition period from ______ to ______

Commission file number 000-25711

EXTREME NETWORKS, INC.

(Exact name of registrant as specified in its charter)

DELAWARE	**77-0430270**
[State or other jurisdiction of	**[I.R.S. Employer**
incorporation or organization]	**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

January 27, 2008 was 115,929,510.

Table of Contents

EXTREME NETWORKS, INC.

FORM 10-Q

QUARTERLY PERIOD ENDED December 30, 2007

INDEX

Table of Contents

Part I. Financial Information

Item 1. Financial Statements

EXTREME NETWORKS, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS

(In thousands)

	December 30, 2007 (unaudited)	July 1, 2007 (1)
ASSETS		
Current assets:		
Cash and cash equivalents	$ 46,042	$ 71,573
Short-term investments	113,575	91,599
Accounts receivable, net	30,042	23,066
Inventories, net	22,287	25,261
Deferred income taxes	979	1,118
Prepaid expenses and other current assets, net	12,720	13,339
Total current assets	225,645	225,956
Property and equipment, net	41,524	43,156
Marketable securities	66,705	52,683
Other assets, net	15,936	20,102
Total assets	$ 349,810	$ 341,897
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 16,377	$ 21,303
Accrued compensation and benefits	18,083	14,841
Restructuring liabilities	2,722	5,532
Accrued warranty	6,708	7,182
Deferred revenue	33,564	32,160
Other accrued liabilities	22,833	23,263
Total current liabilities	100,287	104,281
Restructuring liabilities, less current portion	7,083	8,456
Deferred revenue, less current portion	10,088	10,286
Deferred income taxes	309	688
Other long-term liabilities	1,751	1,961
Commitments and contingencies (Note 3)		
Stockholders equity:		
Common stock and capital in excess of par value	939,694	934,540
Treasury stock	(48,303)	(48,303)
Accumulated other comprehensive income	1,716	572
Accumulated deficit	(662,815)	(670,584)

Total stockholders equity		230,292		216,225
Total liabilities and stockholders equity	$	349,810	$	341,897

(1) Consolidated balance sheet at July 1, 2007 has been derived from audited financial statements.

See accompanying notes to the unaudited condensed consolidated financial statements.

3

Table of Contents

EXTREME NETWORKS, INC.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(In thousands, except per share amounts)

(unaudited)

	Three Months Ended		Six Months Ended	
	December 30, 2007	December 31, 2006	December 30, 2007	December 31, 2006
Net revenues:				
Product	$ 77,427	$ 71,074	$ 151,572	$ 139,056
Service	15,103	15,779	29,920	31,560
Total net revenues	92,530	86,853	181,492	170,616
Cost of revenues:				
Product	31,039	31,968	62,295	63,767
Service	8,511	8,409	17,121	17,222
Total cost of revenues	39,550	40,377	79,416	80,989
Gross profit:				
Product	46,388	39,106	89,277	75,289
Service	6,592	7,370	12,799	14,338
Total gross profit	52,980	46,476	102,076	89,627
Operating expenses:				
Sales and marketing	25,050	25,829	49,588	51,272
Research and development	17,154	15,602	33,645	31,376
General and administrative	8,592	8,790	15,115	16,395
Restructuring charge (reversal)		(231)		1,303
Total operating expenses	50,796	49,990	98,348	100,346
Operating income (loss)	2,184	(3,514)	3,728	(10,719)
Other income, net	2,590	2,227	5,101	5,291
Income (loss) before income taxes	4,774	(1,287)	8,829	(5,428)
Provision for income taxes	638	573	1,060	1,359
Net Income (loss)	$ 4,136	$ (1,860)	$ 7,769	$ (6,787)
Basic and diluted net income (loss) per share:				
Net income (loss) per share - basic	$ 0.04	$ (0.02)	$ 0.07	$ (0.06)
Net income (loss) per share - diluted	$ 0.04	$ (0.02)	$ 0.07	$ (0.06)
Shares used in per share calculation - basic	114,530	113,644	114,217	114,649
Shares used in per share calculation - diluted	115,725	113,644	115,498	114,649

See accompanying notes to unaudited condensed consolidated financial statements.

4

Table of Contents

EXTREME NETWORKS, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)

(unaudited)

	Six Months Ended December 30, 2007	Six Months Ended December 31, 2006
Cash flows from operating activities:		
Net income (loss)	$ 7,769	$ (6,787)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Depreciation and amortization	3,707	4,268
Provision for doubtful accounts	265	2
Provision for excess and obsolete inventory	1,324	2,144
Deferred income taxes	(240)	75
Amortization of warrant	1,349	2,024
Restructuring charge		1,303
(Loss) gain on disposal of assets	(7)	5
Stock-based compensation	2,429	3,658
Changes in operating assets and liabilities, net		
Accounts receivable	(7,242)	(2,629)
Inventories	1,641	(6,042)
Prepaid expenses and other assets	3,436	(5,481)
Accounts payable	(4,925)	(3,400)
Accrued compensation and benefits	3,241	465
Restructuring liabilities	(4,182)	(3,523)
Accrued warranty	(474)	(36)
Deferred revenue	1,207	(1,619)
Other accrued liabilities	(27)	1,893
Net cash provided by (used in) operating activities	9,271	(13,680)
Cash flows (used in) provided by investing activities:		
Capital expenditures	(2,068)	(2,795)
Purchases of investments	(171,393)	(95,059)
Proceeds from maturities of investments and marketable securities	76,247	128,061
Proceeds from sales of investments and marketable securities	59,679	169,542
Net cash (used in) provided by investing activities	(37,535)	199,749
Cash flows provided by (used in) financing activities:		
Proceeds from issuance of common stock, net of repurchases	2,733	602
Repurchase of common stock		(14,602)
Principal payment on convertible debt		(200,000)
Net cash provided by (used in) financing activities	2,733	(214,000)
Net (decrease) in cash and cash equivalents	(25,531)	(27,931)
Cash and cash equivalents at beginning of period	71,573	92,598
Cash and cash equivalents at end of period	$ 46,042	$ 64,667

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 1, 2007 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 1, 2007.

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 December 30, 2007. The results of operations for the second quarter of fiscal 2008 are not necessarily indicative of the results that may be expected for fiscal 2008 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 the delivered deliverables using the residual method. 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 replacement cost. Inventories, which are net of write-downs for excess and obsolete inventory (which we determine primarily based on future demand forecasts) of $3.2 million at December 30, 2007 and $2.9 million at July 1, 2007, consist of (in thousands):

	December 30, 2007	July 1, 2007
Raw materials	$ 258	$

Finished goods	22,029	25,261
Total	$ 22,287	$ 25,261

6

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 $3.5 million and $3.2 million at December 30, 2007 and July 1, 2007, 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):

	December 30, 2007	July 1, 2007
Accounts receivable, net of allowance for doubtful accounts of $217 ($225 at July 1, 2007)	$ 22,682	$ 23,288
Deferred revenue	(15,277)	(15,203)
Net, included in Prepaid expenses and other current assets	$ 7,405	$ 8,085

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 six months ended December 30, 2007 and December 31, 2006, respectively (in thousands):

	Six Months Ended	
	December 30, 2007	December 31, 2006
Balance beginning of period	$ 7,182	$ 7,027
New warranties issued	2,932	4,286
Warranty expenditures	(3,406)	(4,323)
Balance end of period	$ 6,708	$ 6,990

Our standard hardware warranty period is typically 12 months from the date of shipment to end-users. For certain access products, we offer a lifetime hardware warranty commencing on the date of shipment from the Company and ending five (5) years following the Company s announcement of the end of sale of such Product. 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.

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):

	Six Months Ended	
	December 30, 2007	**December 31, 2006**
Balance beginning of period	$ 40,787	$ 41,722
New support arrangements	25,896	28,920
Recognition of support revenue	(27,211)	(28,773)
Balance end of period	39,472	41,869
Less current portion	29,384	31,018
Non-current deferred revenue	$ 10,088	$ 10,851

Recently Issued Accounting Standards

Fair Value Measurements

In September 2006, the FASB issued Statement of Financial Accounting Standards (SFAS) No. 157, *Fair Value Measurements*. SFAS 157 replaces the different definitions of fair value in the accounting literature with a single definition. It defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. SFAS 157 is effective for fair-value measurements already required or permitted by other standards for financial statements issued for fiscal years beginning after November 15, 2007 and interim periods within those fiscal years. We currently are in the process of determining the impact of adopting the provisions of SFAS 157 on our financial position, results of operations and cash flows.

Fair Value Option for Financial Assets and Liabilities

In February 2007, the FASB issued Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities, including an amendment of FASB Statement No. 115* (FAS 159). FAS 159 permits companies to choose to measure many financial instruments and certain other items at fair value that are not currently required to be measured at fair value and establishes presentation and disclosure requirements designed to facilitate comparisons between companies that choose different measurement attributes for similar types of assets and liabilities. The provisions of FAS 159 are optional and adoption may begin for fiscal years beginning after November 15, 2007. We currently are in the process of determining the impact of adopting the provisions of FAS 159 on our financial position, results of operations and cash flows.

Table of Contents

2. Share-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) using the modified-prospective-transition method.

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

	Three Months Ended		Six Months Ended	
	December 30, 2007	December 31, 2006	December 30, 2007	December 31, 2006
Cost of product revenue	$ 118	$ 201	$ 227	$ 398
Cost of service revenue	65	116	117	239
Sales and marketing	410	635	801	1,302
Research and development	398	564	716	1,122
General and administrative	412	292	568	597
Total share-based compensation expense	1,403	1,808	2,429	3,658
Share-based compensation cost capitalized in inventory	4	1	(8)	1
Total share-based compensation cost	$ 1,407	$ 1,809	$ 2,421	$ 3,659

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 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 second quarter of fiscal 2008, based on our historical forfeiture experience, is approximately 9%.

	Stock Option Plans				Employee Stock Purchase Plan			
	Three months ended		Six months ended		Three months ended		Six months ended	
	December 30, 2007	December 31, 2006	December 30, 2007	December 31, 2006	December 30, 2007	December 31, 2006	December 30, 2007	December 31, 2006
Expected life	2.5 yrs	2.5 yrs	2.5 yrs	2.5 yrs	0.25 yrs	N/A	0.25 yrs	0.9 yrs
Risk-free interest rate	3.37%	4.69%	3.58%	4.88%	3.34%	N/A	3.78%	5.03%
Volatility	40%	47%	40%	50%	47%	N/A	43%	37%
Expected dividend yield	0.0%	0.0%	0.0%	0.0%	0.0%	N/A	0.0%	0.0%

The Black-Scholes-Merton option valuation model requires the input of highly subjective assumptions, including the expected life of the share-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 share-based compensation cost could have been materially different from that recorded. 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 second quarter of fiscal 2008 and fiscal 2007 were $1.19 and $1.31, respectively. The weighted-average estimated per share fair value of shares granted under our 1999 Employee Stock Purchase Plan in the second quarter of fiscal 2008 was $1.03. No shares were granted under the ESPP in the second quarter of fiscal 2007.

Table of Contents

3. Commitments, Contingencies and Leases

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 originally was to expire in October 2007. On October 25, 2006 the Board of Directors terminated the share repurchase plan, and as of that date, we had repurchased approximately 11.1 million shares for approximately $48.3 million.

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 December 30, 2007, 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 December 30, 2007, we had letters of credit totaling $0.7 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 December 30, 2007. The line of credit expires on January 24, 2008 and it is our intention to renew the line of credit upon expiration.

Purchase Commitments

We currently have arrangements with two contract manufacturers 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 manufacturers procure in accordance with the forecast, unless we give notice of order cancellation outside of applicable component lead-times. As of December 30, 2007, we had non-cancelable commitments to purchase approximately $25.4 million of such inventory during the third quarter of fiscal 2008.

Legal Proceedings

Government Inquiries Relating to Historical Stock Option Practices

On June 27, 2006, the Company received an informal inquiry letter from the Staff of the SEC Enforcement Division requesting that the Company voluntarily provide documents related to its policies, practices and procedures for granting stock options for the period since its initial public offering on April 9, 1999 (IPO). The Company responded to the request and intends to cooperate fully with the SEC inquiry.

Late SEC Filing and Nasdaq Delisting Proceedings

On September 11, 2006, based on information developed by Company management and at the Audit Committee s recommendation, the Board of Directors appointed a special committee of the Board (the Special Committee) to conduct an independent investigation of our historical practices for granting and accounting for stock options and to present findings and recommendations to the Board. Due to the Special Committee investigation and the resulting restatements, the Company did not timely file its Form 10-K for the fiscal year ending July 2, 2006 or the Quarterly Reports on Forms 10-Q for the quarters ended October 1, 2006, December 31, 2006 and April 1, 2007. The Company initially received Nasdaq Staff Determination notices stating that the Company was not in compliance with Marketplace Rule 4310(c)(14) because it had not timely filed such periodic reports with the SEC. Those filings were made on June 28, 2007. On July 2, 2007, the Company received a written notice from the Nasdaq Stock Market stating that the Nasdaq Listing and Hearing Review Council (the Listing Council), after consultation with the Nasdaq Listing Qualification Staff, had determined that as of that date the Company had demonstrated compliance with all Nasdaq Marketplace Rules. The notice further stated that as of July 2, 2007, the matter was closed and the Company s securities would continue to be listed on The Nasdaq Global Market.

On July 3, 2007, the Company received a further Staff Determination notice from the Nasdaq Stock Market stating that the Company was not in compliance with Nasdaq s Marketplace Rule 4350(e) due to a failure by the Company to hold its annual meeting of shareholders within the time required by Rule 4350(e) and, therefore, that its common stock was again subject to delisting from The Nasdaq Global Market. On July 19, 2007, the Company received a written notice from the Nasdaq Stock Market stating that a Nasdaq Listing Qualifications Panel (the Panel) had determined that the Company s securities would continue to be listed on The Nasdaq Global Market, subject to the condition that on or before August 1, 2007, the Company inform the Panel that it has held its annual meeting of shareholders. On July 31, 2007, the Company notified the Panel that the Company had held the annual meeting of shareholders on July 30, 2007. On August 3, 2007, the Company received a written notice from the Panel confirming that the Company had demonstrated compliance with all Nasdaq Marketplace Rules, and that the Panel determined to continue the listing of the Company s securities on The Nasdaq Stock Market. Accordingly, the Company believes that the Nasdaq delisting proceedings have concluded.

Table of Contents

Shareholder Litigation Relating to Historical Stock Option Practices

On April 25, 2007, an individual identifying herself as a shareholder of the Company filed a derivative action in the United States District Court for the Northern District of California purporting to assert claims on behalf of and in the name of the Company against various of our current and former directors and officers relating to our historical stock option granting and related accounting practices. Two similar derivative actions were filed thereafter in the same court by other individuals. The three cases were consolidated by order of the court on August 2, 2007 and an amended consolidated complaint was filed on October 11, 2007. The amended consolidated complaint alleges that the individual defendants breached their fiduciary duties and other obligations to the Company and violated state and federal securities laws in connection with our historical stock option granting process in connection with options granted from 1999 to 2002 and our accounting for past stock options. The plaintiff has asserted claims for violations of Sections 10(b) (including Rule 10b-5 thereunder), 14(a), and 20(a) of the Securities Exchange Act of 1934, unjust enrichment, breach of fiduciary duty and aiding and abetting such breach, abuse of control, constructive fraud, waste, rescission, insider selling and a claim for an accounting of all stock option grants made to the named defendants. The Company is named as a nominal defendant in these actions. On behalf of the Company, the plaintiff seeks unspecified monetary and other relief against the individual defendants who are Gordon L. Stitt, Herb Schneider, Stephen Haddock, Alexander J. Gray, Frank C. Carlucci, William R. Slakey, Charles Carinalli, Harry Silverglide, Michael West, Kenneth Levy, Robert L. Corey, Peter Wolken, Vito Palermo, Harold Covert, Darrell Scherbarth, Christopher, N. Todd, June Hull, Allan Miller, Promod Haque, Lawrence Orr, Steven Fukuda, Bassam Halabi, Michael Palu, and Alicia Moore. The Company, as nominal defendant, has asked the Court to dismiss the case on the ground that the plaintiff lacks standing to bring a derivative action. Discovery has not yet commenced and the individual defendants are not yet required to respond to the amended consolidated complaint. We cannot at this time predict whether this matter will result in any material recovery by or expense to the Company.

Indemnification Obligations

Subject to certain limitations, we may be obligated to indemnify our current and former directors, officers and employees. These obligations arise under the terms of our certificate of incorporation, our bylaws, applicable contracts, and Delaware and California law. The obligation to indemnify, where applicable, generally means that we are required to pay or reimburse, and in certain circumstances we have paid or reimbursed, the individuals reasonable legal expenses and possibly damages and other liabilities incurred in connection with these matters. It is not possible to estimate the maximum potential amount under these indemnification agreements due to the limited history of these claims. The cost to defend the Company and the named individuals could have a material adverse effect on our consolidated financial position, results of operations and cash flows in the future. Recovery of such costs under our directors and officers insurance coverage is uncertain.

Other Legal Matters

On February 7, 2008, Network-1 Security Solutions filed suit against Extreme Networks, Cisco Systems, Inc., Cisco-Linksys, L.L.C., Adtran, Inc., Enterasys Networks Inc., Foundry Networks Inc., Netgear, Inc. and 3Com Corporation in the United States District Court for the Eastern District of Texas, Civil Action No. 6:08c30. The complaint alleges infringement of U.S. Patent No. 6,218,930 and seeks damages and treble damages, an injunction preventing defendants from infringement, inducement of infringement and contributory infringement, and attorneys fees, costs and interest. We have not yet been served with the complaint, and cannot at this time predict whether this matter will result in any material expense to the Company.

On April 20, 2007, Extreme Networks filed suit against Enterasys in the United States District Court for the Western District of Wisconsin, Civil Action No. 07-C-0229-C. The complaint alleges willful infringement of U.S. patents Nos. 6,104,700, 6,678,248, and 6,859,438, and seeks injunctive relief against Enterasys continuing sale of infringing goods and monetary damages. Enterasys responded to the complaint on May 30, 2007. Enterasys also filed a counterclaim alleging infringement of three U.S. patents owned by Enterasys. A trial date has been set for May 2008.

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 Massachusetts, 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 infringes 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. Foundry brought a claim for reexamination of five of the patents at issue to the Patent and Trademark Office (PTO). The parties stipulated, and the court agreed, to stay the proceeding until the results of the reexamination are released by the PTO. Once the stay is lifted, and should the case remain at that point, we intend vigorously to defend against Enterasys assertions, which we 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. Previously, we executed a settlement agreement presented to all issuer defendants. In that settlement, plaintiffs would 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 would not be required to make any cash payments in the settlement, unless the pro rata amount paid by the insurers in the settlement exceeded the amount of the insurance coverage. The Court gave preliminary approval to the settlement in February 2005 and held a hearing in April 2006 to consider final approval of the settlement. Before the Court issued a final decision on the settlement, on December 5, 2006 the United States Court of Appeals for the Second Circuit vacated the class certification of plaintiffs claims against the underwriters in six cases designated as focus or test cases. Thereafter, on December 14, 2006, the Court ordered a stay of all proceedings in all of the lawsuits pending the outcome of plaintiffs petition to the Second Circuit Court of Appeals for a rehearing en banc and resolution of the class certification issue. On April 6, 2007, the Second Circuit Court of Appeals denied plaintiffs petition for a rehearing, but clarified that the plaintiffs may seek to certify a more limited class. Accordingly, the parties withdrew the prior settlement, which has been terminated, and plaintiffs filed amended complaints in designated focus or test cases with a proposed redefined class in an attempt to comply with the Second Circuit s order. If the prior settlement is not renegotiated and then approved by the Court, there is no assurance 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 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. Litigation in general, and intellectual property and securities litigation in particular, can be expensive and disruptive to normal business operations. Moreover, the results of legal proceedings are difficult to predict.

4. Comprehensive Income (Loss)

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

	Three Months Ended		Six Months Ended	
	December 30, 2007	December 31, 2006	December 30, 2007	December 31, 2006
Net income (loss)	$ 4,136	$ (1,860)	$ 7,769	$ (6,787)
Other comprehensive income:				
Change in unrealized gain on investments:				
Net unrealized gain on investments	158	428	528	1,528
Net unrealized gain on investments	158	428	528	1,528
Net unrealized loss on derivatives	(1)	(28)	(1)	(29)
Foreign currency translation adjustments	87	219	617	297
Total comprehensive income (loss)	$ 4,380	$ (1,241)	$ 8,913	$ (4,991)

5. Income Taxes

We recorded an income tax provision of $0.6 million for both second quarters of fiscal 2008 and fiscal 2007. The income tax provisions for the three months ended December 30, 2007 consisted of US Alternative Minimum tax, taxes on the foreign income and U.S. state income taxes. The income tax provisions for the three months ended December 31, 2006 consisted of taxes on the foreign income and U.S. state income taxes.

12

Table of Contents

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.

The Company implemented FIN 48 in first fiscal quarter 2008. The Company has unrecognized tax benefits of approximately $16.1 million as of July 2, 2007. The future impact of the unrecognized tax benefit of $16.1 million, if recognized, is as follows: approximately $1.8 million would affect the effective tax rate; approximately $14.3 million would result in adjustments to deferred tax assets and corresponding adjustment to the valuation allowance. It is reasonably possible that the amount of unrealized tax benefits could decrease by approximately $0.7 million during the next 12 months due to the expiration of the statue of limitations in certain foreign jurisdictions.

Estimated interest and penalties related to the underpayment of income taxes are classified as a component of tax expense in the Condensed Consolidated Statement of Operations and totaled approximately $46,000 for the quarter ended December 30, 2007. Accrued interest and penalties were approximately $240,099 and $329,000 as of July 1, 2007 and December 30, 2007, respectively.

In general, our income tax returns are subject to examination by U.S. federal, state and local tax authorities for tax years 2004 forward. Our Netherland subsidiary s income tax returns have been properly prepared and filed with the Netherland tax authorities for all the years up through and including 2005/2006 and are subject to examination for tax years 2003 forward.

The income tax provisions for the three months ended December 30, 2007 was comprised of US minimum tax, taxes on foreign income and U.S. state income taxes. Taxes during the three months ended December 31, 2006 are primarily related to foreign taxes on income earned by our foreign operations and U.S. state income taxes.

6. Net Income (Loss) Per Share

Basic net income (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. Diluted net income (loss) per share is calculated by dividing net income (loss) by the weighted average number of common shares used in the basic earnings (loss) 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		Six Months Ended	
	December 30, 2007	December 31, 2006	December 30, 2007	December 31, 2006
Net income (loss)	$ 4,136	$ (1,860)	$ 7,769	$ (6,787)
Weighted-average shares used in per share calculation basic	114,530	113,644	114,217	114,649
Incremental shares using the treasury stock method	1,195		1,281	
Weighted-average shares used in per share calculation diluted	115,725	113,644	115,498	114,649
Net income (loss) per share basic	$ 0.04	$ (0.02)	$ 0.07	$ (0.06)

Net income (loss) per share diluted	$ 0.04	$ (0.02)	$ 0.07	$ (0.06)

Table of Contents

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		Six Months Ended	
	December 30, 2007	December 31, 2006	December 30, 2007	December 31, 2006
Stock options outstanding:				
In-the-money options		640		541
Out-of-the-money options	19,738	21,398	19,106	21,309
Warrants		857		857
Convertible subordinated notes				9,542
Total potential shares of common stock excluded from the computation of earnings per share	19,738	22,895	19,106	32,249

Weighted stock options outstanding representing common stock equivalents under the treasury method with an exercise price lower than the Company s average stock price for the periods presented (In-the-money options) are excluded from the calculation of diluted net loss per share in the three and six months ended December 31, 2006 since the effect would have been anti-dilutive due to the net loss.

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

The computation of diluted loss per share for the three and six months ended December 31, 2006 excludes the impact of certain warrants since the effect would have been anti-dilutive under the treasury stock method due to the net loss.

The computation of diluted earnings (loss) per share for the first six months of fiscal 2007 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 the period presented. The convertible subordinated notes matured and were paid off on December 1, 2006.

7. Restructuring Liabilities

As of December 30, 2007, restructuring liabilities were $9.8 million and consisted of obligations under excess facility operating leases, net of projected future sublease receipts and severance costs associated with a small reduction in force in the fourth quarter of fiscal 2007 impacting several functional areas. During fiscal 2007 and 2006, we recorded restructuring charges of $4.0 million and $3.3 million, respectively. The charges in fiscal 2007 included $1.1 million in the first through third quarter to rationalize our sales force in Japan, and $2.9 million in the fourth quarter to reduce headcount across several functional areas, terminate certain redundant contracts, and to exit an excess facility. The charge in fiscal 2006 was for an excess facilities charge and represented an increase to the charge initially recognized during the third quarter of fiscal 2002. The commercial real estate market continued to deteriorate in fiscal 2006 and we were not able to find suitable tenants to sublease these facilities necessitating an additional charge due to lower projected sublease receipts. At several of the facilities, we have not yet been able to find suitable tenants to sublease the facilities and the commercial real estate market in these areas continues to be weak. The lower projected sublease income necessitated an increase in the liability to take into consideration the unfavorable difference between lease obligation payments and projected sublease receipts. The actual costs could differ from our estimates, and additional adjustments to the restructuring liability could be recorded if we are able to negotiate reasonable termination fees on certain facilities, if facility sub-lease rental rates change, or if other estimates and assumptions change.

Table of Contents

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

	Excess Facilities	Asset Impairment	Contract Termination	Severance	Total
Balance at July 1, 2007	$ 11,395	83	1,098	1,411	$ 13,987
Write-Off		(83)			