EXTREME NETWORKS INC
Form 10-Q
October 30, 2009
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 September 27, 2009

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	**[I.R.S Employer**
of incorporation or organization]	**Identification No.]**
3585 Monroe Street,	
Santa Clara, California	**95051**
[Address of principal executive office]	**[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 has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 229.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes ¨ No ¨

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

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

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

The number of shares of the Registrant s Common Stock, $.001 par value, outstanding at October 15, 2009 was 89,083,408.

Table of Contents

EXTREME NETWORKS, INC.

FORM 10-Q

QUARTERLY PERIOD ENDED SEPTEMBER 27, 2009

INDEX

		PAGE
PART I.	CONDENSED CONSOLIDATED FINANCIAL INFORMATION	
Item 1.	Condensed Consolidated Financial Statements (Unaudited):	
	Condensed Consolidated Balance Sheets as of September 27, 2009 and June 28, 2009	3
	Condensed Consolidated Statements of Operations for the Three months ended September 27, 2009 and September 28, 2008	4
	Condensed Consolidated Statements of Cash Flows for the Three months ended September 27, 2009 and September 28, 2008	5
	Notes to Condensed Consolidated Financial Statements	6
Item 2.	Management s Discussion and Analysis of Financial Condition and Results of Operations	25
Item 3.	Quantitative and Qualitative Disclosures About Market Risk	34
Item 4.	Controls and Procedures	35
PART II.	OTHER INFORMATION	
Item 1.	Legal Proceedings	37
Item 1A.	Risk Factors	37
Item 2.	Unregistered Sales of Equity Securities and Use of Proceeds	37
Item 3.	Defaults Upon Senior Securities	37
Item 4.	Submission of Matters to a Vote of Security Holders	37
Item 5.	Other Information	37
Item 6.	Exhibits	37
Signatures		38

Table of Contents

EXTREME NETWORKS, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS

(In thousands, except share and per share amounts)

	September 27, 2009 (unaudited)	June 28, 2009 (1)
ASSETS		
Current assets:		
Cash and cash equivalents	$ 39,261	$ 46,195
Short-term investments	57,274	8,976
Accounts receivable, net	42,036	44,278
Inventories, net	16,151	12,380
Deferred income taxes	247	244
Prepaid expenses and other current assets, net	4,047	4,368
Total current assets	159,016	116,441
Property and equipment, net	43,810	44,229
Marketable securities	34,126	72,231
Other assets, net	16,514	13,736
Total assets	$ 253,466	$ 246,637
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 16,579	$ 12,771
Accrued compensation and benefits	11,994	12,320
Restructuring liabilities	2,763	3,559
Accrued warranty	3,419	3,170
Deferred revenue, net	30,216	30,058
Deferred revenue, net of cost of sales to distributors	12,364	9,821
Other accrued liabilities	26,985	21,328
Total current liabilities	104,320	93,027
Restructuring liabilities, less current portion	2,463	3,519
Deferred revenue, less current portion	7,025	7,425
Deferred income taxes	586	564
Other long-term liabilities	710	592
Commitments and contingencies (Note 3)		
Stockholders equity:		
Convertible preferred stock, $.001 par value, issuable in series, 2,000,000 shares authorized; none issued		
Common stock, $.001 par value, 750,000,000 shares authorized; 128,584,923 issued at September 27, 2009 and 128,425,140 at June 28, 2009	129	128
Treasury stock, 39,625,305 issued at September 27, 2009 and June 28, 2009	(149,666)	(149,666)
Additional paid-in-capital	950,474	949,113
Accumulated other comprehensive income	2,294	1,323
Accumulated deficit	(664,869)	(659,388)
Total stockholders equity	138,362	141,510

Total liabilities and stockholders equity	$ 253,466	$ 246,637

(1) The information in this column is derived from the Company s consolidated balance sheet included in the Company s Annual Report on Form 10-K for the year ended June 28, 2009.

See accompanying notes to 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	
	September 27, 2009	September 28, 2008
Net revenues:		
Product	$ 50,759	$ 74,349
Service	15,550	15,177
Total net revenues	66,309	89,526
Cost of revenues:		
Product (1)	23,718	30,133
Service (1)	5,821	7,961
Total cost of revenues	29,539	38,094
Gross profit:		
Product	27,041	44,216
Service	9,729	7,216
Total gross profit	36,770	51,432
Operating expenses:		
Sales and marketing (1)	21,602	25,857
Research and development (1)	13,610	16,605
General and administrative (1)	7,241	8,439
Restructuring reversal, net of charge	(513)	
Total operating expenses	41,940	50,901
Operating (loss) income	(5,170)	531
Interest income	322	1,423
Interest expense	(39)	(50)
Other income / (expense), net	(159)	548
(Loss) income before income taxes	(5,046)	2,452
Provision for income taxes	436	813
Net (loss) income	$ (5,482)	$ 1,639
Basic and diluted net income (loss) per share:		
Net (loss) income per share - basic	$ (0.06)	$ 0.01
Net (loss) income per share - diluted	$ (0.06)	$ 0.01
Shares used in per share calculation - basic	88,843	111,323

Shares used in per share calculation - diluted	88,915	111,488

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

Cost of product revenue	$ 72	$ (40)
Cost of service revenue	75	32
Sales and marketing	296	175
Research and development	375	151
General and administrative	322	94
Total stock-based compensation expense	1,140	412
Capitalized in inventory	(4)	(26)
Total stock-based compensation expense, net	$ 1,136	$ 386

See accompanying notes to unaudited condensed consolidated financial statements.

Table of Contents

EXTREME NETWORKS, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)

(unaudited)

	Three Months Ended	
	September 27, 2009	September 28, 2008
Cash flows from operating activities:		
Net (loss) income	$ (5,482)	$ 1,639
Adjustments to reconcile net (loss) income to net cash provided by operating activities:		
Depreciation and amortization	1,647	1,657
Gain on value of UBS option to put securities	(14)	
ARS mark to market, trading loss	14	
Provision for excess and obsolete inventory	785	98
Deferred income taxes	18	15
Loss on retirement of assets		94
Stock-based compensation	1,140	412
Restructuring reversal, net of charge	(513)	
Changes in operating assets and liabilities, net		
Accounts receivable	2,242	11,134
Inventories	(4,559)	(2,520)
Prepaid expenses and other assets	(2,457)	1,262
Accounts payable	3,808	7,433
Accrued compensation and benefits	(325)	(4,087)
Restructuring liabilities	(1,339)	(664)
Accrued warranty	250	(483)
Deferred revenue, net	(243)	2,532
Deferred revenue, net of cost of sales to distributors	2,543	5,698
Other accrued liabilities	6,495	(3,642)
Other long-term liabilities	119	
Net cash provided by operating activities	4,129	20,578
Cash flows (used in) provided by investing activities:		
Capital expenditures	(1,227)	(2,515)
Purchases of investments	(13,697)	
Proceeds from maturities of investments and marketable securities	2,550	20,000
Proceeds from sales of investments and marketable securities	1,086	37,102
Net cash (used in) provided by investing activities	(11,288)	54,587
Cash flows provided by (used in) financing activities:		
Proceeds from issuance of common stock	225	1,355
Repurchase of common stock, including expenses		(101,431)
Net cash provided by (used in) financing activities	225	(100,076)
Net decrease in cash and cash equivalents	(6,934)	(24,911)

Cash and cash equivalents at beginning of period	46,195	70,370
Cash and cash equivalents at end of period	$ 39,261	$ 45,459

See accompanying notes to the unaudited condensed consolidated financial statements.

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 the **Company** or **Extreme Networks**) included herein have been prepared under 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 under such rules and regulations. The condensed consolidated balance sheet at June 28, 2009 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 the Company s audited consolidated financial statements and notes thereto included in the Company s Annual Report on Form 10-K for the fiscal year ended June 28, 2009. The Company has evaluated all subsequent events through October 30, 2009, the date these interim financial statements were filed with the SEC.

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 September 27, 2009. The results of operations for the first quarter of fiscal 2010 are not necessarily indicative of the results that may be expected for fiscal 2010 or any future periods.

Cash, Cash Equivalents, and Investments

The Company considers highly liquid investments with maturities of three months or less at the date of purchase to be cash equivalents. Investments with maturities of greater than three months at the date of purchase are classified as non-cash equivalents. Of these, investments with maturities of less than one year at balance sheet date are classified as short-term investments. Investments with maturities of greater than one year at balance sheet date are classified as marketable securities. Except for direct obligations of the United States government, securities issued by agencies of the United States government, and money market funds, the Company diversifies its investments by limiting its holdings with any individual issuer.

Investments include available-for-sale investment-grade debt securities and trading securities that the Company carries at fair value. The Company accumulates unrealized gains and losses on the Company s available-for-sale debt securities, net of tax, in accumulated other comprehensive income in the stockholders equity section of its balance sheets. Such an unrealized gain or loss does not reduce net income for the applicable accounting period. If the fair value of an available-for-sale debt instrument is less than its amortized cost basis, an other-than-temporary impairment is triggered in circumstances where (1) the Company intends to sell the instrument, (2) it is more likely than not that the Company will be required to sell the instrument before recovery of its amortized cost basis, or (3) the Company does not expect to recover the entire amortized cost basis of the instrument (that is, a credit loss exists). If the Company intends to sell or it is more likely than not that the Company will be required to sell the available-for-sale debt instrument before recovery of its amortized cost basis, the Company recognizes an other-than-temporary impairment in earnings equal to the entire difference between the debt instruments amortized cost basis and its fair value. For available-for-sale debt instruments that are considered other-than-temporarily impaired due to the existence of a credit loss, if the Company does not intend to sell and it is not more likely than not that the Company will be required to sell the instrument before recovery of its remaining amortized cost basis (amortized cost basis less any current-period credit loss), the Company separates the amount of the impairment into the amount that is credit related and the amount due to all other factors. The credit loss component is recognized in earnings and is the difference between the debt instrument s amortized cost basis and the present value of its expected future cash flows. The remaining difference between the debt instrument s fair value and the present value of future expected cash flows is due to factors that are not credit related and is recognized in other comprehensive income (loss).

The Company records unrealized and realized gains and losses on the Company s trading securities, net of tax, in other income (expense), net, in its statements of operations.

Prior to the second quarter of fiscal 2009, the Company classified Auction Rate Securities (**ARS**) as short-term investments available-for-sale. Beginning in the second quarter of fiscal 2009, the Company classified ARS as marketable securities trading. The ARS are held with UBS and the Company accepted a Rights offer on November 7, 2008 (see discussions below). The ARS and Put Option fair value of $40.7 million are reflected in short-term investments trading as of September 27, 2009 while at June 28, 2009 the amount of $40.8 million was reflected in marketable securities trading. The reclassification to short-term investment is a result of the right to exercise the Put Option is less

than one year from balance sheet date.

Table of Contents

EXTREME NETWORKS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) (Continued)

ARS are investments with contractual maturities generally between 0 and 40 years. Examples of the underlying collateral for these securities include municipal bonds, preferred stock, and a pool of student loans or collateralized debt obligations with interest rates resetting every 7 to 49 days through an auction process. At the end of each reset period, investors may sell or continue to hold the securities at par. As of September 27, 2009, the Company held $40.7 million principal amount in ARS, with contractual maturities from 25 to 40 years. All of these ARS are backed by student loans, are over-collateralized, and on an aggregate basis, 93% are guaranteed by the U.S. Department of Education. In addition, all ARS held by the Company are rated as either AA or AAA.

Historically, the Company s ARS were highly liquid, using a Dutch auction process that reset the applicable interest rate at predetermined intervals, typically every 7 to 28 days, which in turn provided liquidity at par value. However, as a result of liquidity issues in the global credit and capital markets, the auctions for all of the Company s ARS failed beginning in February 2008 when sell orders exceeded buy orders. The failures of these auctions do not affect the value of the collateral underlying the ARS, and the Company continues to earn and receive interest on the Company s ARS at contractually set rates.

As of September 27, 2009, there continues to be no auction market for the Company s ARS. In the absence of a liquid market to value these securities, the Company has used a discounted cash flow model to estimate the fair value of its investments in ARS as of September 27, 2009. The valuation model is based on the following key assumptions:

- 17 years to liquidity based on weighted average expected life of a security and its underlying collateral;
- continued receipt of contractual interest; and
- discount rates ranging from 5.0% to 7.0%, which incorporate a spread for both credit and liquidity risk.

Based on the discounted cash flow model described above, the Company determined that, at September 27, 2009, the fair value of the ARS was $36.2 million, which was 89% ($4.5 million unrealized loss) of the principal value of $40.7 million. This represented a decrease in the valuation of the ARS from $36.3 million, which was 89% ($4.5 million unrealized loss) of principal value of $40.8 million as of June 28, 2009. The market conditions related to the availability of liquidity and credit remained stable in the first quarter of fiscal 2010 from the fourth quarter of fiscal 2009. Accordingly, the valuation of the ARS at 89 % of their stated par value remained flat from June 28, 2009 to September 27, 2009.

On November 7, 2008, the Company accepted an offer (the **UBS Rights Offer**) from UBS AG (**UBS**), providing the Company with rights related to its ARS (the **Rights**). The Rights permit the Company to require UBS to purchase its ARS at par value, which is defined as the price equal to the liquidation preference of the ARS plus accrued but unpaid dividends or interest, at any time during the period of June 30, 2010 through July 2, 2012. Conversely, UBS has the right, in its discretion, to purchase or sell the Company s ARS at any time until July 2, 2012, so long as the Company receives payment at par value upon any sale or disposition. The Company expects to sell its ARS under the Rights back to UBS during the period starting in 2010. However, if the Rights are not exercised before July 2, 2012, they will expire and UBS will have no further rights or obligation to buy the Company s ARS. As long as the Company holds its ARS, they will continue to accrue interest under the terms of the ARS.

The Rights represent a firm agreement, which is as an agreement with an unrelated party, binding on both parties and usually legally enforceable, with the following characteristics: a) the agreement specifies all significant terms, including the quantity to be exchanged, the fixed price, and the timing of the transaction, and b) the agreement includes a disincentive for nonperformance that is sufficiently large to make performance probable. The enforceability of the Rights results in the creation of an asset akin to a Put Option (the Company has the right to put the ARS back to UBS at some specified date for a payment equal to the par value of the ARS). The Put Option is a free standing asset separate from the ARS.

In October 2008, the Company entered into a secured line of credit collateralized by the Company s ARS held by UBS. The maximum amount available under this line of credit is $28.8 million. The Company has used a discounted cash flow model to estimate the fair value of the Put Option as of September 27, 2009, assuming that the Company would borrow the entire amount available under this line of credit, therefore the remaining exposure for the Company is the $12.0 million not collateralized by the line of credit. This resulted in an increase in fair value of the Put Option because the risk of counterparty non-performance diminishes. The valuation model is based on the following key assumptions:

- 9 months to recover par value from UBS;
- continued receipt of contractual interest;
- discount rates ranging from 5.0% to 7.0%, which incorporate a spread for both credit and liquidity risk for cashflows related to contractual interest; and
- discount rate equal to the risk-free rate plus a premium associated with the risk for a default by UBS on the UBS Rights Offer.

Using the discounted cash flow model described above, the Company determined the fair value of the Put Option was $4.5 million. The Company recorded the fair value of the Put Option with the corresponding credit in other income (expense) in the condensed consolidated statements of operations for the period ended September 27, 2009. The Put Option does not meet the definition of a derivative instrument under the Company s accounting policy because the terms of the Put Option do not provide for net settlement, i.e., the Company must tender the ARS to receive the settlement and the ARS are not readily convertible to cash.

Table of Contents

EXTREME NETWORKS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) (Continued)

Therefore, the Company has elected to measure the Put Option at fair value. As a result, unrealized gains and losses are included in earnings in the current and future periods. The Company expects that future changes in the fair value of the Put Option will approximate fair value movements in the related ARS. The Put Option fair value of $4.5 million offset the ARS loss of $4.5 million, thereby having no impact to other income (expense), net.

Fair Value Measurements

The Company s financial instruments are measured at fair value and non-financial assets and non-financial liabilities are measured at cost. Fair value is defined as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. Valuation techniques used to measure fair value must maximize the use of observable inputs and minimize the use of unobservable inputs. Fair value is measured based on a fair value hierarchy following three levels of inputs, of which the first two are considered observable and the last unobservable:

Level 1 - Quoted prices in active markets for identical assets or liabilities;

Level 2 - Inputs other than Level 1 that are observable, either directly or indirectly, such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities; and

Level 3 - Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities.

The following table presents the Company s fair value hierarchy for its financial assets measured at fair value on a recurring basis:

September 27, 2009:	**Level 1**	**Level 2**	**Level 3**	**Total**
	(In thousands)			
Assets				
Investments:				
Commercial paper				$
Federal agency notes		13,002		13,002
Money market funds	34,449			34,449
Corporate notes/bonds		36,148		36,148
Auction rate securities			36,202	36,202
Put Option			4,534	4,534
Derivative instruments:				
Foreign currency forward contracts		407		407
Total	$ 34,449	$ 49,557	$ 40,736	$ 124,742

June 28, 2009:	**Level 1**	**Level 2**	**Level 3**	**Total**
	(In thousands)			

Assets				
Investments:				
Commercial paper	$	$ 8,000	$	$ 8,000
Federal agency notes		10,987		10,987
Money market funds	35,367			35,367
Corporate notes/bonds		29,437		29,437
Auction rate securities			36,263	36,263
Put Option			4,520	4,520
Derivative instruments:				
Foreign currency forward contracts		(58)		(58)
Total	$ 35,367	$ 48,366	$ 40,783	$ 124,516

EXTREME NETWORKS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) (Continued)

The following table provides a summary of changes in the fair value of the Company s Level 3 financial assets for the three months ended September 27, 2009 (in thousands):

	Auction Rate Securities
Balance as of June 28, 2009	$ 36,263
Change in interest accrued	(14)
Change in unrealized loss	3
Redemptions at par	(50)
Balance as of September 27, 2009	$ 36,202

	Put Option
Balance as of June 28, 2009	$ 4,520
Gain on Put Option	14
Balance as of September 27, 2009	$ 4,534

Revenue Recognition

The Company allocates revenue to each element of multiple element arrangements that include products containing software that is more-than-incidental using the residual method based on vendor specific objective evidence of fair value of the undelivered elements. The Company determines vendor specific objective evidence of fair value based on the price charged when the item is sold separately.

The Company derives the majority of its revenue from sales of its networking equipment, with the remaining revenue generated from service fees relating to the service contracts, professional services, and training for its products. The Company generally recognizes product revenue from its value-added resellers and end-user customers 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. In instances where the criteria for revenue recognition are not met, revenue is deferred until all criteria have been met. 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 two years.

The Company makes 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. The Company defers 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. The Company grants these distributors the right to return a portion of unsold inventory for the purpose of stock rotation. The Company also grants 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. The Company also provides distributors with credits for changes in selling prices, and allows distributors to participate in cooperative marketing programs. The Company maintains estimated accruals and allowances for these exposures based upon the Company s historical experience. In connection with cooperative advertising programs, the Company does not meet the criteria in its accounting policy for recognizing the expenses as marketing expenses and accordingly, the costs are recorded as a reduction to revenue in the same period that the related revenue is recorded.

The second tier of the distribution channel consists of a large number of third-party value-added resellers that sell directly to end-users. For product sales to value-added resellers, the Company does not grant return privileges, except for defective products during the warranty period, nor does the Company grant pricing credits. Accordingly, the Company recognizes revenue upon transfer of title and risk of loss to the value-added reseller, which is generally upon shipment. The Company reduces product revenue for cooperative marketing activities and certain

price protection rights that may occur under contractual arrangements with its resellers. The Company provides an allowance for sales returns based on its historical returns, analysis of credit memo data and its return policies. The allowance for sales returns was $1.0 million and $0.9 million as of September 27, 2009 and June 28, 2009, respectively, for estimated future returns that were recorded as a reduction of our accounts receivable. The provision for returns is charged to net revenue in the accompanying consolidated statements of operations, and was $0.1 million and $0.9 million in the first quarter of fiscal 2010 and the first quarter of fiscal 2009, respectively. If the historical data that the Company uses to calculate the estimated sales returns and allowances does not properly reflect future levels of product returns, these estimates will be revised, thus resulting in an impact on future net revenues. The Company estimates and adjusts this allowance at each balance sheet date.

Table of Contents

EXTREME NETWORKS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) (Continued)

Inventory, Net

Inventory is stated at the lower of cost or market. Cost is computed using standard cost, which approximates actual cost, on a first-in, first-out basis. The Company provides inventory allowances based on excess and obsolete inventories determined primarily by future demand forecasts. At the point of the loss recognition, a new, lower-cost basis for that inventory is established, and subsequent changes in facts and circumstances do not result in the restoration or increase in that newly established cost basis. Any written down or obsolete inventory subsequently sold has not had a material impact on gross profit for any of the periods disclosed.

Inventories, which are net of write-downs for excess and obsolete inventory of $5.3 million and $4.7 million at September 27, 2009 and June 28, 2009 respectively, consist of (in thousands):

	September 27, 2009	June 28, 2009
Raw materials	$ 35	$ 42
Finished goods	16,116	12,338
Total	$ 16,151	$ 12,380

Deferred Revenue, Net

Deferred revenue, net represents amounts for (i) deferred services revenue (support arrangements, professional services and training), and (ii) deferred product revenue net of the related cost of revenues where the revenue recognition criteria have not been met related to sales by the Company to its resellers or directly to its end-customers. Product revenue includes shipments to end-users and value-add resellers. The following table summarizes deferred revenue, net at September 27, 2009 and June 28, 2009, respectively (in thousands):

	September 27, 2009	June 28, 2009
Deferred services	$ 36,295	$ 36,690
Deferred product		
Deferred revenue	1,907	1,315
Deferred cost of sales	(961)	(522)
Deferred product revenue, net	946	793
Balance at end of period	37,241	37,483
Less: current portion	30,216	30,058
Non-current deferred revenue, net	$ 7,025	$ 7,425

EXTREME NETWORKS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) (Continued)

The Company offers renewable support arrangements, including extended warranty contracts, to its customers that range generally from one to five years. Deferred support revenue is included within deferred revenue, net within the Deferred services category above. The change in the Company s deferred support revenue balance in relation to these arrangements was as follows (in thousands):

	Three Months Ended	
	September 27, 2009	September 28, 2008
Balance beginning of period	$ 36,196	$ 38,778
New support arrangements	14,531	14,549
Recognition of support revenue	(14,785)	(14,270)
Balance end of period	35,942	39,057
Less current portion	28,917	30,188
Non-current deferred revenue	$ 7,025	$ 8,869

Deferred Revenue, Net of Cost of Sales to Distributors

At the time of shipment to distributors, the Company records a trade receivable at the contractual discount to list selling price since there is a legally enforceable obligation from the distributor to pay it currently for product delivered, the Company relieves inventory for the carrying value of goods shipped since legal title has passed to the distributor, and the Company records deferred revenue and deferred cost of sales in Deferred revenue, net of cost of sales to distributors in the liability section of its consolidated balance sheets. Deferred revenue, net of cost of sales to distributors effectively represents the gross margin on the sale to the distributor; however, the amount of gross margin the Company recognizes in future periods will frequently be less than the originally recorded deferred revenue, net of cost of sales to distributors as a result of price concessions negotiated at time of sell-through to end customers. The Company sells each item in its product catalog to all of its distributors worldwide at contractually discounted prices. However, distributors resell the Company s products to end customers at a very broad range of individually negotiated price points based on customer, product, quantity, geography, competitive pricing, and other factors. The majority of the Company s distributors resales are priced at a discount from list price. Often, under these circumstances, the Company remits back to the distributor a portion of their original purchase price after the resale transaction is completed. Thus, a portion of the deferred revenue balance represents a portion of distributors original purchase price that will be remitted back to the distributor in the future. The wide range and variability of negotiated price credits granted to distributors does not allow the Company to accurately estimate the portion of the balance in the deferred revenue that will be remitted to the distributors. Therefore, the Company does not reduce deferred revenue by anticipated future price credits; instead, price credits are typically recorded against deferred revenue, net of cost of sales to distributors when incurred, which is generally at the time the distributor sells the product.

EXTREME NETWORKS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) (Continued)

The following table summarizes deferred revenue, net of cost of sales to distributors at September 27, 2009 and June 28, 2009, respectively (in thousands):

	September 27, 2009	June 28, 2009
Deferred revenue	$ 16,544	$ 13,644
Deferred cost of Sales	(4,180)	(3,823)
Total deferred revenue, net of cost of sales to distributors	$ 12,364	$ 9,821

Guarantees and Product Warranties

The Company has standard product warranty liability. Upon issuance of the warranty, the Company discloses and recognizes a liability for the fair value of the obligation under the warranty. The following table summarizes the activity related to the Company s product warranty liability during the first three months of fiscal 2010 and fiscal 2009, respectively (in thousands):

	Three Months Ended	
	September 27, 2009	September 28, 2008
Balance beginning of period	$ 3,170	$ 4,824
New warranties issued	1,357	1,586
Warranty expenditures	(1,670)	(2,070)
Change in estimates	562	
Balance end of period	$ 3,419	$ 4,340

The Company s standard hardware warranty period is typically 12 months from the date of shipment to end-users. For certain access products, the Company offers 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 the Company s customers, the Company estimates expenses for the cost to repair or replace products that may be returned under warranty and accrues a liability in cost of product revenue for this amount. The determination of the Company s 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. The Company estimates and adjusts these accruals at each balance sheet date in accordance with changes in these factors. For the three months ended September 27, 2009, the Company recorded $0.6 million for a change in estimate resulting from losses identified related to a failure in one of its products.

In the normal course of business to facilitate sales of the Company s products, the Company indemnifies the Company s resellers and end-user customers with respect to certain matters. The Company has 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 the Company under these agreements have not had a material impact on the Company s operating results or financial position.

Recently Issued Accounting Standards

The following standards should be read in conjunction with the standards documented in *Recently Issued Accounting Standards* under Note 2 to Notes to Consolidated Financial Statements included in the Company s Annual Report on Form 10-K for the fiscal year ended June 28, 2009.

In June 2009, the FASB issued a new accounting standard which approved the FASB Accounting Standards Codification (ASC) as the single source of authoritative accounting principles. The codification does not change GAAP, but instead reorganizes the existing authoritative standards into a comprehensive, topically organized online database to simplify user access to all authoritative U.S. GAAP. Companies may elect to disclose the new ASC codes, disclose both new ASC codes and old FASB accounting literature references, or completely remove all references to accounting literature. The Company chose to remove all references to accounting literature and previous references to applicable literature in the Company s disclosures are removed in the Company s Form 10Q effective in the first quarter of fiscal 2010. As the codification did not change GAAP, the adoption of ASC did not have a material impact on the Company s consolidated financial statements.

Table of Contents

EXTREME NETWORKS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) (Continued)

In October 2009, the FASB issued a new accounting standard which excludes from the scope of software revenue guidance the revenue arrangements that include tangible products containing software components and non-software components that function together to deliver the tangible product s essential functionality. At the same time, the FASB also issued a new accounting standard which updates existing guidance pertaining to the separation and allocation of consideration in a multiple element arrangement. This new guidance will be applicable to the Company s multiple element arrangements that include such tangible products. The new standards are effective prospectively for revenue arrangements entered into or materially modified in fiscal years beginning on or after June 15, 2010. The Company is currently evaluating the impact that the adoption of the new accounting standards may have on its consolidated results of operations and financial condition.

2. Employee Benefit Plans (including Share-Based Compensation)

Stock Option Plans

The Company has several stock-based compensation plans (the **Plans**) that are described in the Company s Annual Report on Form 10-K for the fiscal year ended June 28, 2009. The Company, under the various equity plans, grants stock options for shares of common stock to employees and directors. The Plans provide that the options shall be exercisable over a period not to exceed ten years. The majority of options granted under the Plans vest over a period of four years.

A summary of stock option activity under the Plans for the three months ended September 27, 2009 is presented as follows: