

EXTREME NETWORKS INC
Form 10-Q
May 06, 2009
Table of Contents

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D. C. 20549

Form 10-Q

(Mark One)

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended March 29, 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
[State or other jurisdiction]

77-0430270
[I.R.S Employer Identification No.]

of incorporation or organization]

3585 Monroe Street,

Santa Clara, California
[Address of principal executive office]

95051
[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.

Edgar Filing: EXTREME NETWORKS INC - Form 10-Q

Yes 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

Non-accelerated filer
(Do not check if a smaller

Smaller reporting company

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

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

April 30, 2009 was 88,795,565.

Table of Contents

EXTREME NETWORKS, INC.

FORM 10-Q

QUARTERLY PERIOD ENDED MARCH 29, 2009

INDEX

	PAGE
PART I. CONDENSED CONSOLIDATED FINANCIAL INFORMATION	
Item 1. Condensed Consolidated Financial Statements (Unaudited):	
<u>Condensed Consolidated Balance Sheets as of March 29, 2009 and June 29, 2008</u>	3
<u>Condensed Consolidated Statements of Operations for the Three and Nine months ended March 29, 2009 and March 30, 2008</u>	4
<u>Condensed Consolidated Statements of Cash Flows for the Nine months ended March 29, 2009 and March 30, 2008</u>	5
<u>Notes to Condensed Consolidated Financial Statements</u>	6
Item 2. <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	26
Item 3. <u>Quantitative and Qualitative Disclosures About Market Risk</u>	39
Item 4. <u>Controls and Procedures</u>	41
PART II. OTHER INFORMATION	
Item 1. <u>Legal Proceedings</u>	43
Item 1A. <u>Risk Factors</u>	43
Item 2. <u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	43
Item 3. <u>Defaults Upon Senior Securities</u>	43
Item 4. <u>Submission of Matters to a Vote of Security Holders</u>	43
Item 5. <u>Other Information</u>	43
Item 6. <u>Exhibits</u>	43
<u>Signatures</u>	44

Table of Contents**EXTREME NETWORKS, INC.****CONDENSED CONSOLIDATED BALANCE SHEETS**

(In thousands, except share and per share amounts)

	March 29, 2009 (unaudited)	June 29, 2008 (1)
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 38,595	\$ 70,370
Short-term investments	4,510	42,922
Accounts receivable, net	43,588	64,417
Inventories, net	22,752	13,942
Deferred income taxes	289	254
Prepaid expenses and other current assets, net	4,823	4,654
Total current assets	114,557	196,559
Property and equipment, net	43,204	43,348
Marketable securities	77,708	112,380
Other assets, net	13,388	13,474
Total assets	\$ 248,857	\$ 365,761
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	\$ 15,414	\$ 16,921
Accrued compensation and benefits	11,633	18,956
Restructuring liabilities	4,459	2,612
Accrued warranty	3,193	4,824
Deferred revenue, net	32,171	31,284
Deferred revenue, net of cost of sales to distributors	12,445	14,138
Other accrued liabilities	18,254	27,728
Total current liabilities	97,569	116,463
Restructuring liabilities, less current portion	4,329	6,777
Deferred revenue, less current portion	7,604	9,006
Deferred income taxes	562	403
Other long-term liabilities	693	1,058
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; 128,261,067 issued at March 29, 2009 (127,358,570 June 29, 2008) and capital in excess of par value	128	127
Treasury stock, 39,625,305 shares at March 29, 2009 (11,053,877 June 29, 2008)	(149,665)	(48,303)
Additional paid-in-capital	947,644	943,156
Accumulated other comprehensive income (loss)	264	(723)
Accumulated deficit	(660,271)	(662,203)
Total stockholders' equity	138,100	232,054
Total liabilities and stockholders' equity	\$ 248,857	\$ 365,761

Edgar Filing: EXTREME NETWORKS INC - Form 10-Q

- (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 29, 2008.

Table of Contents**EXTREME NETWORKS, INC.****CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS****(In thousands, except per share amounts)****(unaudited)**

	Three Months Ended		Nine Months Ended	
	March 29, 2009	March 30, 2008	March 29, 2009	March 30, 2008
Net revenues:				
Product	\$ 62,017	\$ 67,388	\$ 208,946	\$ 218,960
Service	15,185	14,642	45,330	44,562
Total net revenues	77,202	82,030	254,276	263,522
Cost of revenues:				
Product	26,142	27,126	87,686	89,421
Service	6,642	7,801	22,049	24,923
Total cost of revenues	32,784	34,927	109,735	114,344
Gross profit:				
Product	35,875	40,262	121,260	129,539
Service	8,543	6,841	23,281	19,639
Total gross profit	44,418	47,103	144,541	149,178
Operating expenses:				
Sales and marketing	24,293	25,232	75,926	74,820
Research and development	13,928	15,579	44,457	49,223
General and administrative	6,967	8,610	22,818	23,725
Restructuring charge, net of reversal	2,092		2,092	
Total operating expenses	47,280	49,421	145,293	147,768
Operating (loss) income	(2,862)	(2,318)	(752)	1,410
Interest income	672	2,693	2,965	8,326
Interest expense	(23)	(28)	(92)	(69)
Other income / (expense), net	411	(152)	1,727	(643)
(Loss) income before income taxes	(1,802)	195	3,848	9,024
Provision for income taxes	371	355	1,917	1,415
Net (loss) income	\$ (2,173)	\$ (160)	\$ 1,931	\$ 7,609
Basic and diluted net (loss) income per share:				
Net (loss) income per share - basic	\$ (0.02)	\$ (0.00)	\$ 0.02	\$ 0.07
Net (loss) income per share - diluted	\$ (0.02)	\$ (0.00)	\$ 0.02	\$ 0.07
Shares used in per share calculation - basic	88,553	115,629	96,066	114,688
Shares used in per share calculation - diluted	88,553	115,629	96,139	115,685

See accompanying notes to unaudited condensed consolidated financial statements.

Table of Contents**EXTREME NETWORKS, INC.****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS****(In thousands)****(unaudited)**

	Nine Months Ended	
	March 29, 2009	March 30, 2008
Cash flows from operating activities:		
Net income	\$ 1,931	\$ 7,609
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	4,200	5,616
Gain on value of option to put securities	(4,616)	
Mark to market, trading loss	4,616	
Provision for doubtful accounts	(232)	207
Provision for excess and obsolete inventory	838	2,111
Deferred income taxes	124	420
Amortization of warrant		1,349
Gain (loss) on retirement of assets	94	(7)
Stock-based compensation	2,630	3,732
Restructuring charge, net of reversal	2,092	
Changes in operating assets and liabilities, net		
Accounts receivable	21,060	(2,477)
Inventories	(9,651)	5,114
Prepaid expenses and other assets	(83)	3,274
Accounts payable	(1,506)	(9,508)
Accrued compensation and benefits	(7,323)	3,233
Restructuring liabilities	(2,693)	(4,826)
Accrued warranty	(1,630)	(2,130)
Deferred revenue, net	(515)	(22,836)
Deferred revenue, net of cost of sales to distributors	(1,693)	23,546
Other accrued liabilities	(11,642)	596
Net cash (used in) provided by operating activities	(3,999)	15,023
Cash flows provided by (used in) investing activities:		
Capital expenditures	(4,150)	(4,032)
Purchases of investments	(33,645)	(250,504)
Proceeds from maturities of investments and marketable securities	28,164	93,625
Proceeds from sales of investments and marketable securities	81,354	142,944
Net cash provided by (used in) investing activities	71,723	(17,967)
Cash flows (used in) provided by financing activities:		
Proceeds from issuance of common stock	1,864	3,248
Proceeds from exercise of warrants		9
Repurchase of common stock, including expenses	(101,363)	
Net cash (used in) provided by financing activities	(99,499)	3,257
Net decrease in cash and cash equivalents	(31,775)	313

Edgar Filing: EXTREME NETWORKS INC - Form 10-Q

Cash and cash equivalents at beginning of period	70,370	71,573
Cash and cash equivalents at end of period	\$ 38,595	\$ 71,886

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 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 29, 2008 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 29, 2008.

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 March 29, 2009. The results of operations for the third quarter of fiscal 2009 are not necessarily indicative of the results that may be expected for fiscal 2009 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. 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 fiscal second quarter of 2009, the Company classified Auction Rate Securities (**ARS**) as non-current investments available-for-sale. Beginning in the fiscal second quarter of 2009, the Company classified ARS as trading securities and as non-current investments.

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 March 29, 2009, the Company held \$40.8 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.

Edgar Filing: EXTREME NETWORKS INC - Form 10-Q

As of March 29, 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 March 29, 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 4.0% to 6.0%, which incorporate a spread for both credit and liquidity risk.

Table of Contents

Based on the discounted cash flow model described above, the Company determined that, at March 29, 2009, the fair value of the ARS was \$36.2 million, which was 89% (\$4.6 million unrealized loss) of the principal value of \$40.8 million. This represented a decrease in the valuation of the ARS from 94% (\$2.5 million unrealized loss) of principal value as of June 28, 2008. The market conditions related to the availability of liquidity and credit continued to worsen in the third quarter of fiscal 2009 from the fourth quarter of fiscal 2008, thereby increasing the discount rates in the valuation model. Accordingly, the increase in discount rate decreased the valuation of the ARS from 94% to 89% of their stated par value as of June 29, 2008 as compared to March 29, 2009, respectively.

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 in accordance with SFAS 133, which defines a firm agreement 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 March 29, 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:

1.25 years to recover par value from UBS;

continued receipt of contractual interest;

discount rates ranging from 4.0% to 6.0%, 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 \$4.6 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 March 29, 2009. The Put Option does not meet the definition of a derivative instrument under SFAS 133 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. Therefore, the Company has elected to measure the Put Option at fair value under SFAS 159, which permits an entity to elect the fair value option for recognized financial assets, in order to match the changes in the fair value of the ARS. 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.

Prior to accepting the UBS Rights Offer, the Company recorded \$3.5 million of unrealized losses on its ARS, net of a tax benefit, in accumulated other comprehensive income in the shareholders' equity section of the Company's balance sheets. In connection with the Company's acceptance of the UBS Rights Offer in November 2008, the Company transferred its ARS from investments available-for-sale to trading securities in accordance with SFAS 115. Upon transfer to trading securities, the Company immediately transferred \$3.5 million of unrealized losses previously recorded in accumulated other comprehensive income in the consolidated balance sheet to other income (expense). The

Edgar Filing: EXTREME NETWORKS INC - Form 10-Q

Company recognized a loss of \$3.3 million and a gain of \$2.2 million in the second and third quarters of fiscal 2009, respectively, in other income (expense) in the condensed consolidated statements of operations.

The transfer to trading securities reflects management's intent to exercise its Put Option during the period June 30, 2010 to July 3, 2012. Prior to the Company's agreement with UBS, the Company's intent was to hold the ARS until the market recovered. Accordingly, the Company continues to classify the ARS under long term assets in the Company's Consolidated Balance Sheet for the period ended March 29, 2009.

Table of Contents

Fair Value Measurements

Effective June 30, 2008, the Company adopted SFAS No. 157, Fair Value Measurements (**SFAS No. 157**). In February 2008, the Financial Accounting Standards Board (**FASB**) issued Staff Position No. FAS 157-2, Effective Date of FASB Statement No. 157, which provides a one-year deferral of the effective date of SFAS No. 157 for non-financial assets and non-financial liabilities, except those that are recognized or disclosed in the financial statements at fair value at least annually. Therefore, the Company has adopted the provisions of SFAS No. 157 with respect to its financial assets and liabilities only. SFAS No. 157 defines fair value, establishes a framework for measuring fair value under generally accepted accounting principles and enhances disclosures about fair value measurements. Fair value is defined under SFAS No. 157 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 under SFAS No. 157 must maximize the use of observable inputs and minimize the use of unobservable inputs. The standard describes a fair value hierarchy based on the following three levels of inputs, of which the first two are considered observable and the last unobservable, that may be used to measure fair value:

- 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.

Table of Contents

The following table presents the Company's fair value hierarchy for its financial assets measured at fair value on a recurring basis as of March 29, 2009:

	Level 1	Level 2	Level 3	Total
	(In thousands)			
Assets				
Investments:				
Commercial paper	\$	\$	\$	\$
Federal agency notes		16,659		16,659
Money market funds	35,410			35,410
Corporate notes/bonds		24,676		24,676
Auction rate securities			36,266	36,266
Put Option			4,616	4,616
Derivative instruments:				
Foreign currency forward contracts		684		684
Total	\$ 35,410	\$ 42,019	\$ 40,882	\$ 118,311

The following table provides a summary of changes in the fair value of the Company's Level 3 financial assets as of March 29, 2009 (in thousands):

	Auction Rate Securities
Amortized Cost as of June 29, 2008	\$ 40,836
Unrealized loss	(2,517)
Balance as of June 29, 2008	\$ 38,319
Change in interest accrued	27
Purchases	
Change in unrealized loss	(1,030)
Balance as of September 28, 2008	\$ 37,316
Change in interest accrued	(4)
Purchases	
Change in unrealized loss	(3,231)
Balance as of December 28, 2008	\$ 34,081
Change in interest accrued	21
Purchases	
Change in unrealized gain	2,164
Balance as of March 29, 2009	\$ 36,266

During the quarter ended December 28, 2008, the Company designated these securities as trading securities. Accordingly, the cumulative unrealized loss of \$3.5 million as of the end of first quarter of fiscal 2009 was reclassified and recorded in the Statement of Operations during the second quarter of fiscal 2009. The Company recognized a loss of \$3.3 million and a gain of \$2.2 million in the second and third quarters of fiscal 2009, respectively, in other income (expense) in the condensed consolidated statements of operations.

Table of Contents

Revenue Recognition

Historically, the Company's products have been hardware-focused and the Company has recognized revenue in accordance with the principles of SAB 104 and EITF 00-21. The Company has been monitoring a variety of factors with respect to its product evolution, including whether the software component of its products is becoming more-than-incidental to the hardware product. As noted in the Company's Annual Report in Form 10-K for the year ended June 29, 2008, the Company anticipated a transition to the American Institute of Certified Public Accountants Statement of Position 97-2 *Software Revenue Recognition* (**SOP 97-2**) and related interpretations with respect to the sale of products with a significant software component.

During the first quarter of fiscal 2009, the Company concluded that software had become more-than-incidental to the product shipped. Effective beginning the first quarter of fiscal 2009, the Company adopted SOP 97-2 for products shipped during the quarter containing software that is more-than-incidental. Such shipments grew during the second quarter of fiscal 2009 to represent of a majority of the Company's shipped products. For arrangements with multiple software elements, the Company allocates revenue to each element of the arrangement 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 adoption of SOP 97-2 did not have a significant impact on our results of operations for the first three quarters of fiscal 2009.

The Company applies the provisions of Staff Accounting Bulletin No. 104, *Revenue Recognition*, and Emerging Issues Task Force No. 00-21, *Revenue Arrangements with Multiple Deliverables* to the sales of products and services for which software is incidental to the Company's equipment. When sales arrangements contain multiple deliverables, such as hardware, service contracts and other services, the Company determines whether the deliverables represent separate units of accounting and then allocates revenue to the delivered elements using the residual method.

The Company derives the majority of its revenue from sales of its modular and stackable 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 EITF 01-09 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 \$1.1 million and \$1.2 million as of March 29, 2009 and June 29, 2008, respectively, for estimated future returns that were recorded as a reduction of our accounts receivable. The provision for returns is charged to net revenues in the accompanying consolidated statements of operations, and was \$0 and \$0.3 million in the third quarter of fiscal 2009 and the third quarter of fiscal 2008, respectively. If the historical data that we use 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***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 (which the Company determines primarily based on future demand forecasts) of \$3.4 million and \$3.2 million at March 29, 2009 and June 29, 2008, respectively, consist of (in thousands):

	March 29, 2009	June 29, 2008
Raw materials	\$ 33	\$ 59
Finished goods	22,719	13,883
Total	\$ 22,752	\$ 13,942

Table of Contents**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 March 29, 2009 and June 29, 2008, respectively (in thousands):

	March 29, 2009	June 29, 2008
Deferred services	\$ 38,153	\$ 39,522
Deferred product		
Deferred revenue	2,612	1,249
Deferred cost of sales	(990)	(481)
Deferred product revenue, net	1,622	768
Balance at end of period	39,775	40,290
Less: current portion	32,171	31,284
Non-current deferred revenue, net	\$ 7,604	\$ 9,006

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 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		Nine Months Ended	
	March 29, 2009	March 30, 2008	March 29, 2009	March 30, 2008
Balance beginning of period	\$ 37,931	\$ 39,472	\$ 38,778	\$ 40,787
New support arrangements	13,496	11,950	40,969	37,845
Recognition of support revenue	(13,709)	(13,157)	(42,029)	(40,367)
Balance end of period	37,718	38,265	37,718	38,265
Less current portion	30,114	28,800	30,114	28,800
Non-current deferred revenue	\$ 7,604	\$ 9,465	\$ 7,604	\$ 9,465

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 price since there is a legally enforceable right to current payment from the distributor. 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 profit on the sale to the distributor; however, the amount of gross profit 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.

Table of Contents

The following table summarizes deferred revenue, net of cost of sales to distributors at March 29, 2009 and June 29, 2008, respectively (in thousands):

	March 29, 2009	June 29, 2008
Deferred revenue	\$ 16,908	\$ 19,232
Deferred cost of Sales	(4,463)	(5,094)
Total deferred revenue, net of cost of sales to distributors	\$ 12,445	\$ 14,138

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.

The Company has determined that the requirements of FIN 45 apply to the Company's standard product warranty liability. The following table summarizes the activity related to the Company's product warranty liability during the first nine months of fiscal 2009 and fiscal 2008, respectively (in thousands):

	Nine months ended	
	March 29, 2009	March 30, 2008
Balance beginning of period	\$ 4,824	\$ 7,182
New warranties issued	5,486	4,290
Warranty expenditures	(5,027)	(5,004)
Change in estimates	(2,090)	(1,415)
Balance end of period	\$ 3,193	\$ 5,053

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 accrue 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 nine months ended March 29, 2009, the Company recorded \$2.1 million for a change in estimates in warranty reserve resulting from reduction in actual returns and associated warranty cost.

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

On October 10, 2008, the FASB issued FSP No. 157-3, Determining the Fair Value of a Financial Asset When the Market for That Asset is Not Active, (**FSP 157-3**) that clarifies the application of SFAS 157 in a market that is not active and provides an example to illustrate key

Edgar Filing: EXTREME NETWORKS INC - Form 10-Q

considerations in determining the fair value of a financial asset when the market for that financial assets is not active. FSP 157-3 is applicable to the valuation of auction-rate securities held by the Company for which there was no active market as of March 29, 2009. FSP 157-3 is effective upon issuance, including prior periods for which the financial statements have not been issued. The adoption of FSP 157-3 during the nine month period ended March 29, 2009 did not have a material impact on the Company's consolidated results of operations or financial condition.

Table of Contents

In April 2009, the FASB issued FSP No. FAS 157-4, *Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly*, which provides guidance on determining fair value when there is no active market or where the price inputs being used represent distressed sales. FSP No. 157-4 is effective for interim and annual periods ending after June 15, 2009. The Company is currently evaluating the impact that the adoption of FSP No. 157-4 may have on its consolidated results of operations and financial condition.

In April 2009, the FASB issued FSP No. FAS 115-2 and FAS 124-2, *Recognition and Presentation of Other-Than-Temporary Impairments*, which provides operational guidance for determining other-than-temporary impairments (OTTI) for debt securities. FSP No. 115-2 and 124-2 is effective for interim and annual periods ending after June 15, 2009. The Company is currently evaluating the impact that the adoption of FSP No. 115-2 and 124-2 may have on its consolidated results of operations and financial condition.

In April 2009, the FASB issued FSP FAS 107-1 and APB 28-1, *Interim Disclosures About Fair Value of Financial Instruments* (**FSP FAS 107-1**). FSP FAS 107 extends the disclosure requirements of FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments* (**Statement 107**), to interim financial statements of publicly traded companies as defined in APB Opinion No. 28, *Interim Financial Reporting*. Statement 107 requires disclosures of the fair value of all financial instruments (recognized or unrecognized), except for those specifically listed in paragraph 8 of Statement 107, when practicable to do so. These fair value disclosures must be presented together with the carrying amount of the financial instruments in a manner that clearly distinguishes between assets and liabilities and indicates how the carrying amounts relate to amounts reported on the balance sheet. An entity must also disclose the method(s) and significant assumptions used to estimate the fair value of financial instruments. FSP FAS 107 is effective for interim reporting periods ending after June 15, 2009. The Company is currently evaluating the impact that the adoption of FSP FAS 107 may have on its consolidated results of operations and financial condition.

Effective June 30, 2008, the Company adopted SFAS No. 159 *The Fair Value Option for Financial Assets and Financial Liabilities* (**SFAS 159**). SFAS 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 SFAS 159 are optional and adoption began for fiscal years beginning after November 15, 2007. The Company adopted the fair value option as it relates to ARS Put Option under this Statement and the adoption did not have a material impact on the Company's consolidated results of operations or financial condition.

In May 2008, the FASB issued SFAS No. 162, *The Hierarchy of Generally Accepted Accounting Principles* (**SFAS 162**). SFAS No. 162 defines the order in which accounting principles that are generally accepted should be followed. SFAS No. 162 was effective during the first quarter of fiscal 2009. The adoption of SFAS No. 162 did not have an impact on the Company's consolidated results of operations or financial condition.

In December 2007, the FASB issued SFAS No. 141 (Revised 2007), *Business Combinations* (**SFAS 141R**). SFAS 141R will significantly change the accounting for business combinations. Under SFAS 141R, an acquiring entity will be required to recognize all the assets acquired and liabilities assumed in a transaction at the acquisition-date fair value with limited exceptions. It also amends the accounting treatment for certain specific items including acquisition costs and non controlling minority interests and includes a substantial number of new disclosure requirements. SFAS 141R applies prospectively to the Company for business combinations for which the acquisition date is on or after June 29, 2009. The Company is currently evaluating the impact that the adoption of SFAS 141R may have on its consolidated results of operations and financial condition.

In December 2007, the FASB issued SFAS No. 160, *Noncontrolling Interests in Consolidated Financial Statements – an amendment of Accounting Research Bulletin No. 51* (**SFAS 160**). SFAS 160 clarifies the classification in a company's consolidated balance sheet and the accounting for and disclosure of transactions between the company and holders of noncontrolling interests. SFAS 160 is effective for the Company on January 1, 2009. Early adoption is not permitted. The Company does not expect the adoption of SFAS 160 will have a material impact on its consolidated financial statements.

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 29, 2008. 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.

Table of Contents

A summary of stock option activity under the Plans for the three months ended March 29, 2009 is presented as follows:

	Number of Shares (000 s)	Weighted Average Exercise Price Per Share
Balance at June 29, 2008 (10,459 options exercisable at a weighted-average exercise price of \$5.87 per share)	18,969	\$ 5.05
Options exercised	(394)	\$ 2.84
Options canceled/expired	(1,237)	\$ 5.22
Balance at September 28, 2008 (10,322 options exercisable at a weighted-average exercise price of \$5.82 per share)	17,338	\$ 5.09
Options granted	2,449	\$ 2.04
Options canceled/expired	(789)	\$ 4.61
Balance at December 28, 2008 (10,580 options exercisable at a weighted-average exercise price of \$5.72 per share)	18,998	\$ 4.72
Options granted	247	\$ 1.77
Options canceled/expired	(879)	\$ 4.27
Balance at March 29, 2009 (10,982 options exercisable at a weighted-average exercise price of \$5.60 per share)	18,366	\$ 4.70

The weighted-average grant-date per share fair value of options granted in the third quarter of fiscal 2009 and 2008 were \$0.53 and \$0.94, respectively.

Employee Stock Purchase Plan (ESPP)

Under the Company's 1999 Employee Stock Purchase Plan, employees purchased 174,838 shares for \$0.3 million with a weighted-average estimated per share fair value of \$0.63 during the third quarter of fiscal 2009. Employees purchased 161,900 shares for \$0.5 million with a weighted-average estimated per share fair value of \$0.83 in the third quarter of fiscal 2008.

Table of Contents***Stock Awards***

Stock awards may be granted under the 2005 Plan on terms approved by the Board of Directors. Stock awards generally provide for the issuance of restricted stock which vests over a fixed period. A summary of the status of the Company's non-vested stock awards as of March 29, 2009 and changes during the first nine months of fiscal 2009 is presented below:

	Number of Shares (000 s)	Weighted- Average Grant- Date Fair Value
Non-vested stock outstanding at June 29, 2008	361	\$ 3.76
Vested	(182)	3.52
Canceled	(10)	3.53
Non-vested stock outstanding at September 28, 2008	169	\$ 4.59
Granted	742	\$ 2.04
Vested	(50)	3.98
Non-vested stock outstanding at December 28, 2008	861	\$ 2.90
Vested	(18)	1.84
Canceled	(47)	3.34
Non-vested stock outstanding at March 29, 2009	796	\$ 3.37

Table of Contents**Share Based Compensation**

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

	Three Months Ended		Nine Months Ended	
	March 29, 2009	March 30, 2008	March 29, 2009	March 30, 2008
Cost of product revenue	\$ 93	\$ 125	\$ 109	\$ 351
Cost of service revenue	79	65	173	182
Sales and marketing	420	424	923	1,225
Research and development	387	415	848	1,131
General and administrative	255	275	578	843
Total share-based compensation expense	\$ 1,234	1,304	\$ 2,631	3,732
Share-based compensation cost capitalized in inventory	3	1	(4)	(7)
Total share-based compensation cost	\$ 1,237	\$ 1,305	\$ 2,627	\$ 3,725

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 the Company's stock and historical volatility on the Company's stock.

For options granted prior to the first quarter of fiscal 2006, and valued in accordance with FAS 123, the Company uses a graded vesting method for expense attribution. For options granted after the first quarter of fiscal 2006, and valued in accordance with FAS 123R, the Company uses the straight-line method for expense attribution, and the Company estimates forfeitures and only recognize expense for those shares expected to vest. The Company's estimated forfeiture rate in the third quarter of fiscal 2009, based on the Company's historical forfeiture experience, is approximately 9%.

	Stock Option Plans				Employee Stock Purchase Plans			
	Three Months Ended March 29, 2009	Three Months Ended March 30, 2008	Nine Months Ended March 29, 2009	Nine Months Ended March 30, 2008	Three Months Ended March 29, 2009	Three Months Ended March 30, 2008	Nine Months Ended March 29, 2009	Nine Months Ended March 30, 2008
Expected life	2.5 yrs	2.5 yrs	2.5 yrs	2.5 yrs	0.25 yrs	0.25 yrs	0.25 yrs	0.25 yrs
Risk-free interest rate	1.7%	2.3%	1.4%	3.5%	0.3%	2.2%	0.9%	3.3%
Volatility	46%	41%	41%	40%	95%	48%	74%	45%
Expected dividend yield	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%

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, the Company's share-based compensation cost could have been materially different from that recorded. In addition, the Company is required to estimate the expected forfeiture rate and only recognize expense for those shares expected to vest. If the Company's actual forfeiture rate is materially different from the Company's estimate, the share-based compensation expense could be materially different.

3. Commitments, Contingencies and Leases**Line of Credit**

Edgar Filing: EXTREME NETWORKS INC - Form 10-Q

The Company has a revolving line of credit for \$10.0 million with a major lending institution which was renewed on January 22, 2009, and is contractually available to the Company until January 22, 2010. Borrowings under this line of credit bear interest at the bank's prime rate. As of March 29, 2009, 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 March 29, 2009, the

Table of Contents

Company had outstanding letters of credit totaling \$0.2 million. These letters of credit were primarily issued to satisfy requirements of certain of the Company's customers for performance bonds. The line of credit requires the Company to maintain specified financial covenants related to tangible net worth and liquidity with which the Company was in compliance as of March 29, 2009.

In October 2008, UBS and the Company entered into a secured line of credit collateralized by the Company's ARS held by UBS. The maximum amount of credit available under this line of credit is \$28.8 million. On November 7, 2008 the Company accepted the UBS Rights Offer from UBS and hence the terms of the "no net cost" loan program apply to this line of credit. Under this program, the interest rate on this secured credit facility will be equivalent to the interest rate earned by the Company on the ARS at UBS, resulting in no net interest cost to the Company. There are currently no outstanding borrowings under this line of credit.

Table of Contents

Purchase Commitments

The Company currently has arrangements with three contract manufacturers and other suppliers for the manufacture of the Company's products. The Company's arrangements allow it to procure long lead-time component inventory on the Company's behalf based upon a rolling production forecast provided by us. The Company is obligated for the purchase of long lead-time component inventory that the Company's contract manufacturers procure in accordance with the forecast, unless the Company gives notice of order cancellation outside of applicable component lead-times. As of March 29, 2009, the Company had non-cancelable commitments to purchase approximately \$20.5 million of such inventory.

Table of Contents***Legal Proceedings***

The Company may from time to time be party to litigation arising in the course of its business, including, without limitation, allegations relating to commercial transactions, 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.

Intellectual Property Litigation

On April 20, 2007, the Company filed suit against Enterasys Networks in the United States District Court for the Western District of Wisconsin, Civil Action No. 07-C-0229-C. The complaint alleged willful infringement of U.S. Patents Nos. 6,104,700, 6,678,248, and 6,859,438, and sought injunctive relief against Enterasys' continuing sale of infringing goods and monetary damages. Enterasys responded to the complaint on May 30, 2007, and also filed counterclaims alleging infringement of three U.S. patents owned by Enterasys. On April 9, 2008, the Court dismissed Enterasys' counterclaims on one of its patents with prejudice. On May 5, 2008, the Court granted the Company's motion for summary judgment, finding that the Company does not infringe Enterasys' two remaining patents and dismissing all of Enterasys' remaining counterclaims with prejudice. On May 30, 2008, a jury found that Enterasys infringed all three of the Company's patents and awarded the Company damages in the amount of \$0.2 million. The Court also ruled in the Company's favor on Enterasys' challenge to the validity of the Company's patents. On October 29, 2008, the Court denied Enterasys' post-trial motion for judgment as a matter of law, and granted Extreme Network's motion for a permanent injunction against Enterasys. The injunction order permanently enjoins Enterasys from manufacturing, using, offering to sell, selling in the U.S. and importing into the U.S. the Enterasys products accused of infringing Extreme Network's three patents. The injunction will run until the expiration of the Company's patents the last of which is not set to expire until March of 2020. On March 16, 2009, the Court also denied Enterasys' motion for a new trial, but granted Enterasys' motion for a stay of the injunction pending appeal. On April 17, 2009, Enterasys filed its notice of appeal and on May 1, 2009, the Company filed its cross appeal.

On June 21, 2005, Enterasys filed suit against the Company 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 the Company 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) treble 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 U.S. Patent and Trademark Office (**PTO**). The parties stipulated, and the Court agreed, to stay the Massachusetts action until the results of the reexamination are released by the PTO. Once the stay is lifted, the Company intends to defend the lawsuit vigorously, but, due to the inherent uncertainties of litigation, the Company cannot predict the ultimate outcome of the matter at this time.

Table of Contents**Other Legal Matters**

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 the Company; six of the Company's present and former officers and/or directors, including the Company's former CEO and current Chairman of the Board (the **Extreme Networks Defendants**); and several investment banking firms that served as underwriters of the Company's 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.

The parties to the lawsuits have reached a settlement, subject to Court approval. Under the settlement, the Extreme Networks Defendants would not be required to make cash payments in the settlement. There is no guarantee that this new settlement will be approved by the Court. If the settlement agreement is not approved by the Court, the Company intends to defend the lawsuit vigorously, but, due to the inherent uncertainties of litigation, the Company cannot predict the ultimate outcome of the matter at this time.

Indemnification Obligations

Subject to certain limitations, the Company may be obligated to indemnify its current and former directors, officers and employees. These obligations arise under the terms of its certificate of incorporation, its bylaws, applicable contracts, and Delaware and California law. The obligation to indemnify, where applicable, generally means that the Company is required to pay or reimburse, and in certain circumstances the Company has 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 its consolidated financial position, results of operations and cash flows in the future. Recovery of such costs under its directors and officers insurance coverage is uncertain.

4. Comprehensive Income (Loss)

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

	Three Months Ended		Nine Months Ended	
	March 29, 2009	March 30, 2008	March 29, 2009	March 30, 2008
Net (loss) income	\$ (2,173)	\$ (160)	\$ 1,931	\$ 7,609
Other comprehensive (loss) income:				
Change in unrealized (loss) gain on investments:				
Net unrealized (loss) gain on ARS recorded to other income	(1)		2,517	
Net unrealized (loss) gain on other investments	(333)	422	272	950
Net unrealized (loss) gain on investments	(334)	422	2,789	950
Net unrealized gain (loss) on derivatives	4	2	(3)	2
Foreign currency translation adjustments	(773)	908	(1,799)	1,525
Total comprehensive (loss) income	\$ (3,276)	\$ 1,172	\$ 2,918	\$ 10,086

5. Income Taxes

The Company recorded an income tax provision of \$0.4 million for the third quarter of both fiscal 2009 and fiscal 2008. The income tax provision for the three months ended March 29, 2009 and March 30, 2008 consisted of U.S. alternative minimum tax, taxes on foreign income and U.S state income taxes. The income tax provisions for both quarters were calculated based on the results of operations for the three months ended March 29, 2009 and March 30, 2008, and may not reflect the annual effective rate. Since the Company has net operating loss carryforwards to offset U.S. taxable income, the Company is not using an annual effective tax rate to apply to the taxable income for the quarter.

Table of Contents

The Company recognizes 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 the Company's deferred tax assets and liabilities and any valuation allowance recorded against the Company's net deferred tax assets. The Company makes an assessment of the likelihood that the Company's 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, the Company established a full valuation allowance for the Company's US 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 the Company's expectations of future profitability, which are inherently uncertain. The Company's 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 the Company's US 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 the Company's US deferred tax assets.

The Company had FIN 48 unrecognized tax benefits of approximately \$15.6 million as of March 29, 2009. The future impact of the unrecognized tax benefit of \$15.6 million, if recognized, is as follows: approximately \$2.0 million would affect the effective tax rate, and approximately \$13.6 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 \$0.8 million during the next 12 months due to the expiration of the statute 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 \$8,000 for the quarter ended March 29, 2009. Accrued interest and penalties were approximately \$0.5 million and \$0.4 million as of March 29, 2009 and March 30, 2008, respectively.

In general, the Company's U.S. federal income tax returns are subject to examination by tax authorities for fiscal years 2006 forward and the Company's state income tax returns are subject to examination for fiscal years 2005 forward. The Company's Netherlands income tax returns are subject to examination for fiscal years 2003 forward and are currently under audit for fiscal year 2006. The Company's German income tax returns are subject to examination for fiscal years 2003 forward and are currently under audit for fiscal years 2003 through 2007.

Table of Contents**6. Net Income Per Share**

Basic net income per share is calculated by dividing net income by the weighted average number of common shares outstanding during the period, less shares subject to repurchase, and excludes any dilutive effects of options and warrants. Diluted net income per share is calculated by dividing net income 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, and warrants.

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

	Three Months Ended		Nine Months Ended	
	March 29, 2009	March 30, 2008	March 29, 2009	March 30, 2008
Net (loss) income	(\$ 2,173)	\$ (160)	\$ 1,931	\$ 7,609
Weighted-average shares used in per share calculation basic	88,553	115,629	96,066	114,688
Incremental shares using the treasury stock method:				
Stock options			18	228
Unvested restricted awards			55	138
Warrants issuable to Avaya				631
Weighted -average share used in per share calculation diluted	88,553	115,629	96,139	115,685
Net (loss) income per share basic	(\$ 0.02)	\$ (0.00)	\$ 0.02	\$ 0.07
Net (loss) income per share diluted	(\$ 0.02)	\$ (0.00)	\$ 0.02	\$ 0.07

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

	Three Months Ended		Nine Months Ended	
	March 29, 2009	March 30, 2008	March 29, 2009	March 30, 2008
Stock options outstanding:				
In-the-money options		13		201
Out-of-the-money options	18,766	20,517	18,363	19,528
Warrants				179
Total potential shares of common stock excluded from the computation of earnings per share	18,779	20,897	18,363	19,528

The computation of diluted loss per share for the three months ended March 30, 2008 excludes the impact of the Avaya warrants since the effect of including the potential shares would have been anti-dilutive under the treasury stock method due to the net loss.

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 months ended March 30, 2008 since the effect of including them would have been anti-dilutive due to the net loss position of the Company during the periods presented.

Table of Contents

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 per share since the effect would have been anti-dilutive under the treasury stock method.

7. Restructuring Liabilities

The Company's restructuring costs consist of termination benefits, excess facilities and asset impairments. Termination benefits generally include severance, stay-put or one-time bonuses, outplacement services, health insurance coverage, and legal costs. Excess facilities costs generally include rent expense less expected sublease income, lease termination costs and asset abandonment costs. Asset impairments include adjustments to basis of assets as a result of restructuring activities.

As of March 29, 2009, restructuring liabilities were \$8.8 million and consisted of obligations under excess facilities operating leases incurred in the current quarter and prior years from fiscal 2004 through 2008, and termination benefits incurred in the current quarter. During the fiscal third quarter of 2009 and fiscal year 2008 the Company recorded restructuring charges, net of reversal, of \$2.1 million and \$0.9 million, respectively.

The charges in the third fiscal quarter of 2009 were:

\$0.8 million related to the Company's termination of 1% of the Company's workforce, exiting a facility where the terminated employees worked, and the write-off of impaired assets as part of its strategic plan. This restructuring was completed by the end of the third quarter of fiscal 2009.

\$1.8 million related a reduction-in-force of a further 5% of the Company's workforce to reduce operating costs and realign its organization in the current competitive operating environment. The reduction-in-force was executed in the third quarter of fiscal 2009 and is expected to be completed by the end of the fourth quarter of fiscal 2009.

These charges were offset by a reversal of \$0.5 million of restructuring expense due to higher projected sublease receipt from a sublease renewal arrangement.

The charges in fiscal 2008 were for excess facilities charges and represented increases to the charges initially recognized during the fourth and third quarter of fiscal 2002 due to changes in original estimates. The commercial real estate market continued to deteriorate through fiscal 2008, and the Company was not able to find suitable tenants to sublease these excess facilities necessitating additional charges due to lower projected sublease receipts.

Table of Contents

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

	Excess Facilities	Asset Impairment	Termination Benefits	Total
Balance at June 29, 2008	\$ 9,389	\$	\$	\$ 9,389
Period charges	96	415	2,068	2,579
Period reversals	(487)			(487)
Period impairments		(415)		(415)
Period payments	(2,035)		(243)	(2,278)
Restructuring Liabilities at March 29, 2009	6,963		1,825	8,788
Less current portion	2,634		1,825	4,459
Restructuring liabilities at March 29, 2009, less current portion	\$ 4,329	\$	\$	\$ 4,329

8. Disclosure about Segments of an Enterprise and Geographic Areas

Operating segments are defined as components of an enterprise about which separate financial information is available that is evaluated regularly by the chief operating decision makers with respect to the allocation of resources and performance.

The Company operates in one segment, the development and marketing of network infrastructure equipment. The Company conducts business globally and is managed geographically. Revenue is attributed to a geographical area based on the location of the customers. The Company operates in three geographical areas: North America, which includes the United States, Canada and Central America; EMEA, which includes Europe, Middle East, Africa and South America; and APAC which includes Asia Pacific and Japan.

Information regarding geographic areas is as follows (in thousands):

	Three months ended March 29, 2009		Three months ended March 30, 2008		Nine months ended March 29, 2009		Nine months ended March 30, 2008	
	\$	% of Net Revenues	\$	% of Net Revenues	\$	% of Net Revenues	\$	% of Net Revenues
Net Revenues:								
North America	\$ 26,938	34.89%	\$ 31,015	37.81%	\$ 96,039	37.77%	\$ 113,129	42.93%
EMEA	38,464	49.82%	38,187	46.55%	122,235	48.07%	104,752	39.75%
APAC	11,800	15.29%	12,828	15.64%	36,002	14.16%	45,641	17.32%
Total net revenues	\$ 77,202	100.00%	\$ 82,030	100.00%	\$ 254,276	100.00%	\$ 263,522	100.00%

Tech Data accounted and Westcon EMEA accounted for 11.0% and 10.3% of the Company's revenue in the third quarter of fiscal 2009, respectively. Tech Data and Ericsson AB accounted for 10.3% and 10.0%, respectively, of the Company's revenue in the first nine months of fiscal 2009. Tech Data accounted for 10.8% of the Company's revenue in the first nine months of fiscal 2008. No customer accounted for greater than 10% of the Company's revenue in the three month period ended March 30, 2008.

Table of Contents

Substantially all of the Company's assets were attributable to North America operations at March 29, 2009 and March 30, 2008.

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, our expectations regarding results of operations, the general economic environment, 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 profits, our expectations to continue to develop new products and enhance existing products, our expectations regarding the amount of our research and development expenses, our expectations relating to our selling, general and administrative expenses, 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 expectations that we have sufficient capital to meet our requirements for at least the next twelve months, our expectations regarding the rationalization of our workforce and facilities, and our expectations regarding materials and inventory management. These forward-looking statements involve risks and uncertainties. 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 the section entitled "Risk Factors" in this Report, our Quarterly Reports on Form 10-Q for the first and second quarters of fiscal 2009, our Annual Report on Form 10-K for the fiscal year ended June 29, 2008 and other filings we have made with the Securities and Exchange Commission. These risk factors, include, but are not limited to: fluctuations in demand for our products and services; a highly competitive business environment for network switching equipment; our effectiveness in controlling expenses; the possibility that we might experience delays in the development of new technology and products; customer response to our new technology and products; the timing of any recovery in the global economy; risks related to pending or future litigation; and a dependency on third parties for certain components and for the manufacturing of our products.

Table of Contents

Business Overview

We develop and sell a family of modular and stackable secure network infrastructure equipment and offer related service contracts for extended warranty and maintenance agreements to Enterprise and Carrier customers. Substantially all of our revenue is derived from the sale of our networking equipment and related service contracts. In the third quarter of fiscal 2009, our revenues decreased \$4.8 million, gross profit decreased \$2.7 million, operating profit decreased \$0.5 million and net loss increased \$2.0 million as compared to the third quarter of fiscal 2008. In the nine months ended March 29, 2009, our revenues decreased \$9.2 million, gross profit decreased \$4.6 million, operating profit decreased \$2.2 million and net income decreased \$5.7 million as compared to the nine months ended March 30, 2008.

We believe that considering the following key developments will assist investors in understanding our operating results for the three and nine months ended March 29, 2009.

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 fiscal 2008, we delivered to the market a new and expanded portfolio of stackable products, upgrades to our modular chassis products and enhancements to both our security and wireless portfolio, all targeted at the enterprise market. We also initiated the development of our next generation products for the metro service provider market.

Convergence of Voice, Video and Data

We have a vision of providing customers with cost effective solutions to build highly available and high performance converged communications infrastructure that can easily accommodate voice, video and data on a seamless wired and wireless network. We believe that demand for availability and performance; the continued acceleration in the convergence of voice, video and data; and the combination of both wired and wireless access are important underlying demand creators in the Enterprise market.

Business Environment

The credit market crisis and other challenges affecting economic conditions in the United States and other parts of the world has and will negatively impact demand for networking solutions long term, including Ethernet equipment, as Enterprises and Carriers decrease expenses, conserve capital and delay or cancel IT infrastructure plans.

However, we believe that increasing demand for bandwidth resulting from deployment of converged networks and adoption of electronic communications in all aspects of our lives will continue to drive demand for networking solutions. In addition, we believe that the Ethernet segment of the networking equipment market will continue to grow as Enterprises and Carriers continue to recognize the performance and operating cost benefits of Ethernet technology.

The market for network infrastructure equipment is highly competitive and dominated by a few large companies. Consolidation of vendors within the Ethernet networking market and with vendors from adjacent markets, including storage, security, wireless and voice applications, continues to gain in momentum. We believe that the underpinning technology for all of these adjacent markets is Ethernet. As a result, independent Ethernet switch vendors are being acquired or merged with larger, adjacent market vendors to enable them to deliver complete and broad solutions.

During the quarter, we reduced employee headcount by approximately 6%. As a result of these actions, we have recorded a restructuring charge of \$2.6 million for severance, asset and facility charges partially offset by a \$0.5 million adjustment resulting from additional sublease income related to prior restructuring charges, netting \$2.1 million of restructuring charges for the quarter.

We have taken and plan to continue to take other steps to manage our business in the current economic environment. For example, we have managed our contingent work force, scheduled shutdown weeks, reduced travel and other discretionary spending, and restricted all hiring activities.

Stock Repurchase

We repurchased 28,571,428 shares of our common stock on September 19, 2008 at \$3.50 per share. Total cash expenditures were \$101.4 million for the shares repurchased, including direct costs associated with the repurchase. Primarily as a result of the share repurchase, our outstanding

Edgar Filing: EXTREME NETWORKS INC - Form 10-Q

shares of common stock decreased from 116,867,768 as of August 29, 2008 to 88,635,762 as of March 29, 2009.

Results of Operations

During the third quarter of fiscal 2009, we experienced the following results:

Net revenues of \$77.2 million, compared to net revenues of \$82.0 million in the third quarter of fiscal 2008.

Total gross profit of 57.5% of net revenues, compared to 57.4% in the third quarter of fiscal 2008.

Table of Contents

Operating loss of \$2.9 million compared to operating loss of \$2.3 million in the third quarter of fiscal 2008.

Net loss of \$2.2 million, compared to net loss of \$0.2 million in the third quarter of fiscal 2008.

During the nine months ended March 29, 2009, we experienced the following results:

Net revenues of \$254.3 million, compared to net revenues of \$263.5 million for the nine months ended March 30, 2008.

Total gross profit of 56.8% of net revenues, compared to total gross profit of 56.6% of net revenues for the nine months ended March 30, 2008.

Operating loss of \$0.8 million compared to operating income of \$1.4 million for the nine months ended March 30, 2008.

Net income of \$1.9 million compared to net income of \$7.6 million for the nine months ended March 30, 2008.

Cash used in operating activities was \$4.0 million for the nine months ending March 29, 2009. Cash and cash equivalents, short-term investments and marketable securities decreased by \$104.9 million in the nine months ended March 29, 2009 to \$120.8 million, primarily as a result of \$101.4 million used to repurchase 28,571,428 shares of common stock, cash used in operations of \$4.0 million, capital expenditures of \$4.2 million, offset by \$1.9 million received for common stock purchases.

Net Revenues

The following table presents net product and service revenues for the three and nine months period ended March 29, 2009 and March 30, 2008, respectively (dollars in thousands):

	Three months ended March 29, 2009		Three months ended March 30, 2008		Nine months ended March 29, 2009		Nine months ended March 30, 2008	
	\$	% of Net Revenues	\$	% of Net Revenues	\$	% of Net Revenues	\$	% of Net Revenues
Net Revenues:								
Product	\$ 62,017	80.33%	\$ 67,388	82.10%	\$ 208,946	82.17%	\$ 218,960	83.10%
Service	15,185	19.67%	14,642	17.90%	45,330	17.83%	44,562	16.90%
Total net revenues	\$ 77,202	100.00%	\$ 82,030	100.00%	\$ 254,276	100.00%	\$ 263,522	100.00%

Net revenues were \$77.2 million in the third quarter of fiscal 2009 and \$82.0 million in the third quarter of fiscal 2008, representing a decrease of \$4.8 million or 5.9% in the third quarter of fiscal 2009 from the third quarter of fiscal 2008. Net revenues for the first nine months of fiscal 2009 were \$254.3 million, which is a decrease of \$9.2 million or 3.5% from net revenues of \$263.5 million in the first nine months of fiscal 2008.

Product revenue was \$62.0 million for the third quarter of fiscal 2009 compared to \$67.4 million for the third quarter of fiscal 2008, a decline of \$5.4 million, or 8.0%. Product revenue was \$208.9 million for the first nine months of fiscal 2009 a decrease of \$10.0 million or 4.6%. The decrease in product revenue in the three and nine months ended March 29, 2009 compared to the three and nine months ended March 30, 2008 was primarily driven by lower sales in all geographies due to the global macroeconomic issues.

Service revenue was \$15.2 million for the third quarter of fiscal 2009 compared to \$14.6 million for the third quarter of fiscal 2008, an increase of \$0.6 million, or 3.7%. Service revenue was \$45.3 million for the first nine months of fiscal 2009 compared to \$44.6 million for the first nine

Edgar Filing: EXTREME NETWORKS INC - Form 10-Q

months of fiscal 2008, an increase of \$0.8 million or 1.7%. The increases in service revenue for the third quarter of fiscal 2009 and for the first nine months of fiscal 2009 were primarily driven by higher maintenance revenue as a result of stronger maintenance revenue renewals in EMEA.

Table of Contents

We operate in three regions: North America, which includes the United States, Canada and Central America; EMEA, which includes Europe, Middle East, Africa and South America; and APAC which includes Asia Pacific and Japan. The following table presents the total net revenue geographically for the three and nine month period ended March 29, 2009 and March 30, 2008 (dollars in thousands):

	Three months ended March 29, 2009		Three months ended March 30, 2008		Nine months ended March 29, 2009		Nine months ended March 30, 2008	
	\$	% of Net Revenues	\$	% of Net Revenues	\$	% of Net Revenues	\$	% of Net Revenues
Net Revenues:								
North America	\$ 26,938	34.89%	\$ 31,015	37.81%	\$ 96,039	37.77%	\$ 113,129	42.93%
EMEA	38,464	49.82%	38,187	46.55%	122,235	48.07%	104,752	39.75%
APAC	11,800	15.29%	12,828	15.64%	36,002	14.16%	45,641	17.32%
Total net revenues	\$ 77,202	100.00%	\$ 82,030	100.00%	\$ 254,276	100.00%	\$ 263,522	100.00%

In the third quarter of fiscal 2009, North America revenues were \$26.9 million, a decrease of \$4.1 million, or 13.1% from the third quarter of fiscal 2008. Product revenues decreased \$3.8 million or 17.8% and service revenues decreased \$0.2 million or 2.5% compared to the year ago quarter. In the first nine months of fiscal 2009, North America revenues were \$96.0 million which represented a decrease of \$17.1 million or 15.1% from the first nine months of fiscal 2008. Product revenues decreased \$15.5 million or 18.4% and service revenues decreased \$1.6 million or 5.6% from the first nine months of fiscal 2008. The decreases in the North America revenues compared to the third quarter of fiscal 2008 and the first nine months of fiscal 2008 is primarily the result of the economic downturn in the United States.

In the third quarter of fiscal 2009, EMEA revenues were \$38.5 million, an increase of \$0.3 million, or 0.7%, from the third quarter of fiscal 2008. Product revenues decreased \$0.9 million or 2.7% and service revenues increased \$1.2 million or 34.5% compared to a year ago quarter. In the first nine months of fiscal 2009, EMEA revenues were \$122.2 million which represented an increase of \$17.5 million or 16.7% from the first nine months of fiscal 2008. Product revenues increased \$14.1 million or 14.9% and service revenues increased \$3.4 million or 32.6% compared to the first nine months of fiscal 2008. The increases in EMEA revenues compared to the third quarter of fiscal 2008 and the first nine months of fiscal 2008 were primarily driven by an increase in service provider sales in Europe. The increases in service revenues for both periods were due to increased maintenance revenue as a result of increased focus on renewals.

In the third quarter of fiscal 2009, APAC revenues were \$11.8 million, a decrease of \$1.0 million or 8.0% from third quarter of fiscal 2008. Product revenues decreased \$0.6 million or 5.5% and service revenues decreased \$0.4 million or 24.3% compared to a year ago quarter. In the first nine months of fiscal 2009, APAC revenues were \$36.0 million which represented a decrease of \$9.7 million or 21.1% from the first nine months of fiscal 2008. Product revenues decreased \$8.7 million or 21.5% and service revenues decreased \$1.0 million or 18.2%. We believe the decreases in APAC revenues compared to the third quarter of fiscal 2008 and the first nine months of fiscal 2008 were primarily due to our execution challenges and the broader economic climate.

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. Tech Data and Westcon EMEA accounted for 11.0% and 10.3%, respectively of the Company's revenue in the third quarter of fiscal 2009. Tech Data and Ericsson AB accounted for 10.3% and 10.0%, respectively, of the Company's revenue in the first nine months of fiscal 2009. Tech Data accounted for 10.8% of the Company's revenue in the first nine months of fiscal 2008. No customer accounted for greater than 10% of the Company's revenue in the three month period ended March 30, 2008.

Table of Contents**Cost of Revenues and Gross Profit**

The following table presents the gross profit on product and service revenues and the gross profit percentage of product and service revenues for the three and nine-month periods ended March 29, 2009 and March 30, 2008, respectively (dollars in thousands):

	Three months ended March 29, 2009		Three months ended March 30, 2008		Nine months ended March 29, 2009		Nine months ended March 30, 2008	
	\$	Gross Margin %	\$	Gross Margin %	\$	Gross Margin %	\$	Gross Margin %
Gross profit:								
Product	\$ 35,875	57.85%	\$ 40,262	59.70%	\$ 121,260	58.03%	\$ 129,539	59.20%
Service	8,543	56.26%	6,841	46.70%	23,281	51.36%	19,639	44.10%
Total gross profit	\$ 44,418	57.53%	\$ 47,103	57.40%	\$ 144,541	56.84%	\$ 149,178	56.60%

Gross profit was \$44.4 million in the third quarter of fiscal 2009, a decrease of \$2.7 million or 5.7% from \$47.1 million in the third quarter of fiscal 2008.

Cost of product revenues 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. We outsource substantially all of our manufacturing and supply chain management operations and conduct quality assurance, manufacturing engineering and document control at our facility in Santa Clara, California. Accordingly, a significant portion of our cost of product revenues consists of payments to our primary contract manufacturers, Flextronics International, Ltd. located in Guadalajara, Mexico and Alpha Networks, located in Hsinchu, Taiwan.

Product gross profit in the third quarter of fiscal 2009 was \$35.9 million, representing a decrease of \$4.4 million or 10.9% from the third quarter of fiscal 2008. As a percentage of revenue, product gross margin decreased 1.9 percentage points. The decrease in product gross profit was primarily driven by competitive pricing and changes in product mix totaling \$5.1 million, offset by decreased distribution costs and expense controls of \$0.7 million.

Product gross profit for the first nine months of fiscal 2009 was \$121.3 million, a decrease of \$8.3 million or 6.4% from \$129.5 million in the first nine months of fiscal 2008. As a percentage of revenue, product gross margin decreased 1.1 percentage points. The decrease in product gross profit was primarily driven by competitive pricing and increased material cost of \$9.8 million, offset by a decrease in excess and obsolescence costs and expense controls of \$1.5 million.

Our cost of service revenues consists primarily of labor, overhead, repair and freight costs and the cost of spares used in providing support under customer service contracts. Service gross profit was \$8.5 million in the third quarter of fiscal 2009, an increase of \$1.7 million or 24.9% from \$6.8 million in the third quarter of fiscal 2008. As a percentage of service revenues, service gross margin grew 9.6 percentage points. The increase in service gross profit in the third quarter of fiscal 2009 was primarily due to the use of written down inventory of \$0.8 million, lower repair costs of \$0.6 million due to improved quality and an increase in service revenues of \$0.3 million primarily due to an increase in maintenance revenue in EMEA.

Service gross profit was \$23.3 million for the first nine months of fiscal 2009, an increase of \$3.7 million or 18.5% from \$19.6 million in the first nine months of fiscal 2008. As a percentage of service revenues, service gross margin grew 7.3 percentage points. The increase in service gross profit is primarily the result of an increase of \$0.4 million in maintenance revenue in EMEA, the use of written down inventory of \$0.8 million, a reduction of customer specific warranty programs of \$0.9 million and lower repair costs of \$1.2 million due to improved quality. We believe service gross profit to continue to be positively impacted by the usage of written down inventory for at least the next three quarters.

Sales and Marketing Expenses

Sales and marketing expenses consist of salaries, commissions and related expenses for personnel engaged in marketing and sales functions, as well as trade shows and promotional expenses. Sales and marketing expenses decreased to \$24.3 million for the third quarter of fiscal 2009 from

Edgar Filing: EXTREME NETWORKS INC - Form 10-Q

\$25.2 million for the third quarter of fiscal 2008, a decrease of \$0.9 million, or 3.7%. This decrease was primarily driven by lower commission expense of \$0.5 million, lower general sales and marketing expenses of \$0.5 million, lower travel of \$0.4 million, offset by a one-time, paid-time-off (PTO) charge of \$0.5 million. Sales and marketing expenses increased to \$75.9 million for the first nine months of fiscal 2009 from \$74.8 million, an increase of \$1.1 million or 1.5%. The increase was primarily due to higher foreign exchange charges of \$0.6 million, one-time PTO charge of \$0.5 million, higher customer evaluation unit expense of \$0.4 million, higher general sales and marketing expenses of \$0.4 million, offset by lower commissions of \$0.5 million due to lower sales volume, and lower stock based compensation of \$0.3 million.

Table of Contents

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 \$13.9 million for the third quarter of fiscal 2009 from \$15.6 million for the third quarter of fiscal 2008, a decrease of \$1.7 million or 10.6%. The decrease was primarily due to lower project spending of \$0.9 million, lower salaries and benefits of \$0.5 million primarily due to a decrease in our variable compensation and PTO expenses and a reduction of \$0.3 million as a result of our cost saving efforts.

Research and development expenses decreased to \$44.5 million for the first nine months of fiscal 2009 from \$49.2 million for the first nine months of fiscal 2008, a decrease of \$4.8 million or 9.7%. The decrease was primarily due to lower salaries and benefits of \$2.0 million primarily due to a decrease in variable compensation expense, decreased warrant amortization expense of \$1.0 million, lower project spending of \$0.8 million, lower depreciation expense of \$0.5 million and a decrease in stock based compensation and other spending of \$0.4 million. We expense all research and development costs as incurred.

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 \$7.0 million for the third quarter of fiscal 2009 from \$8.6 million for the third quarter of fiscal 2008, a decrease of \$1.6 million, or 19.1%. This decrease was primarily due to lower litigation fees of \$1.4 million, lower professional fees of \$1.0 million, offset by higher salaries and wages of \$0.3 million and contract labor and general expenses of \$0.6 million.

General and administrative expenses decreased to \$22.8 million for the first nine months of fiscal 2009 from \$23.7 million for the first nine months of fiscal 2008, a decrease of \$0.9 million or 3.8%. The decrease was primarily due to lower litigation fees of \$1.6 million, lower stock based compensation of \$0.4, lower general expenses of \$0.6 million, offset by higher contract labor and professional fees of \$1.7 million.

Restructuring Charge, Net of Reversal

During the fiscal third quarter of 2009 and fiscal year 2008 we recorded restructuring charges, net of reversal, of \$2.1 million, and \$0.9 million, respectively. The charges in the third quarter of fiscal 2009:

\$0.8 million related to our termination of 1% of our workforce, exiting a leased facility where the terminated employees worked and the write-off of impaired assets as part of our strategic plan. This restructuring was completed by the end of the third quarter of fiscal 2009.

\$1.8 million related to a reduction-in-force of a further 5% of our workforce to reduce operating costs and realign our organization in the current competitive operating environment. The reduction-in-force was executed in the third quarter of fiscal 2009 and is expected to be completed by the end of the fourth quarter of fiscal 2009.

These charges were offset by a reversal of \$0.5 million of restructuring expense due to higher projected sublease receipt from a sublease renewal arrangement.

The charges in fiscal 2008 were for excess facilities charges and represented increases to the charges initially recognized during the fourth and third quarter of fiscal 2002, respectively due to changes in original estimates. The commercial real estate market continued to deteriorate through fiscal 2008, and we were not able to find suitable tenants to sublease these excess facilities necessitating additional charges due to lower projected sublease receipts.

Table of Contents**Share-based Compensation Costs**

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

	Three Months Ended		Nine Months Ended	
	March 29, 2009	March 30, 2008	March 29, 2009	March 30, 2008
Cost of product revenue	\$ 93	\$ 125	\$ 109	\$ 351
Cost of service revenue	79	65	173	182
Sales and marketing	420	424	923	1,225
Research and development	387	415	848	1,131
General and administrative	255	275	578	843
Total share-based compensation expense	\$ 1,234	1,304	\$ 2,631	3,732
Share-based compensation cost capitalized in inventory	3	1	(4)	(7)
Total share-based compensation cost	\$ 1,237	\$ 1,305	\$ 2,627	\$ 3,725

In accordance with the Financial Accounting Standards Board (*FASB*) Statement No. 123(R), 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 to the Condensed Consolidated Financial Statements in Part I, Item 1 of this Quarterly Report on Form 10-Q. 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 the first quarter of fiscal 2006, and valued (on a pro forma basis) 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 the first quarter of fiscal 2006, and valued in accordance with FAS 123R, the expected volatility used to estimate the fair value of the options was based on a combination of the historical volatility on our stock and the implied volatility. We used the straight-line method for expense attribution, estimated forfeitures, and only recognized expense for those shares expected to vest. Our estimated forfeiture rate in the third quarter of fiscal 2009, based on our historical forfeiture experience, is approximately 9%.

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 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 share-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 awards expected to vest. If our actual forfeiture rate is materially different from our estimate, the share-based compensation expense could be materially different.

Table of Contents**Interest Income**

Interest income was \$0.7 million in the third quarter of fiscal 2009 as compared to \$2.7 million in the third quarter of fiscal 2008, a decrease of \$2.0 million or 75.0%. The decrease was due to decreased funds available for investments and decreased interest rates earned on investments. Cash, cash equivalents and investments were \$120.8 million as of March 29, 2009, a decrease of \$110.2 million or 47.7% as compared to \$231.1 million as of March 30, 2008. The decrease in cash was primarily due to \$101.4 million used to repurchase shares of our common stock in the first quarter of fiscal 2009, \$4.0 million used in operations, \$4.2 million for capital expenditures, offset by \$1.9 million received for common stock purchases. Average interest yield in the third quarter of fiscal 2009 was 2.6% as compared to 5.0% in the third fiscal quarter of 2008.

Interest Expense

Interest expense in the third quarter of fiscal 2009 and third quarter of fiscal 2008 was immaterial and was primarily related to interest amortization of technology agreements.

Other Income / (Expense), Net

Other income (expense) net, was income of \$0.4 million in the third fiscal quarter of 2009 as compared to expense of \$0.2 million in the third quarter of fiscal 2008, an increase in income of \$0.6 million. The increase in other income (expense), net was primarily due to the fluctuation in foreign exchange gain of \$0.7 million resulting from the stronger U.S. dollar as compared to the EURO and other foreign currencies.

Other income (expense), net also includes an unrealized loss of \$4.6 million resulting from the transfer of our ARS from available-for-sale to trading securities in accordance with SFAS 115 offset by \$4.6 million gain in fair value of the Put Option related to our acceptance of the UBS Rights offer to repurchase our ARS. See further discussions below under *Capital Resources and Financial Condition*.

Provision for Income Taxes

We recorded income tax provisions of \$0.4 million for the third quarter of both fiscal 2009 and fiscal 2008. The income tax provisions for the three months ended March 29, 2009 and March 30, 2008 consisted of U.S. alternative minimum tax, taxes on foreign income and U.S. state income taxes. The income tax provisions for both quarters were calculated based on the results of operations for the three month periods ended March 29, 2009 and March 30, 2008, and may not reflect the annual effective rate. Since we have net operating loss carryforwards to offset U.S. taxable income, we are not using an annual effective tax rate to apply to the taxable income for the quarter.

We have provided a full valuation allowance for our US net deferred tax assets. We initially recorded this charge during fiscal 2003 in accordance with SFAS No. 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, we determined that it was appropriate to retain the full valuation allowance against our US 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 US deferred tax assets.

Critical Accounting Policies and Estimates

Our significant accounting policies are more fully described in Note 2 of the Notes to Consolidated Financial Statements included in our Annual Report on Form 10-K for the year ended June 29, 2008. 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 critical 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, except as described below, during the three-month period ended March 29, 2009 compared to those discussed in our Annual Report on Form 10-K for the year ended June 29, 2008.

Table of Contents***Revenue Recognition***

Historically, our products have been hardware-focused and we have recognized revenue in accordance with the principles of SAB 104 and EITF 00-21. We have monitored a variety of factors with respect to our product evolution, including whether the software component of our products is becoming more-than-incidental to the hardware product. As noted in our Annual Report in Form 10-K for the year ended June 29, 2008, we anticipated a transition to the American Institute of Certified Public Accountants Statement of Position 97-2 *Software Revenue Recognition* (SOP 97-2) and related interpretations relating to the sale of products with a significant software component.

During the first quarter of fiscal 2009, we concluded that software had become more-than-incidental to the product shipped. Effective beginning the first quarter of fiscal 2009, we adopted SOP 97-2 for products shipped during the quarter containing software that is more-than-incidental. Such shipments grew during the second quarter of fiscal 2009 to represent of a majority of our shipped products. For arrangements with multiple software elements, we allocate revenue to each element of the arrangement using the residual method based on vendor specific objective evidence of fair value of the undelivered elements. We determine vendor specific objective evidence of fair value based on the price charged when the item is sold separately. The adoption of SOP 97-2 did not have a significant impact on our results of operations for the first three quarters of fiscal 2009.

We apply the provisions of Staff Accounting Bulletin No. 104, *Revenue Recognition*, and Emerging Issues Task Force No. 00-21, *Revenue Arrangements with Multiple Deliverables* to the sales of products and services for which software is incidental to our equipment. 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 elements using the residual method.

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, professional services, and training its products. We generally recognize product revenue from our 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.

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 distributors to participate in cooperative marketing programs. We maintain estimated accruals and allowances for these exposures based upon our historical experience. In connection with cooperative advertising programs, we do not meet the criteria in EITF 01-09 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. If actual credits to distributors for changes in selling prices and cooperative marketing programs were to deviate significantly from our estimates, which are based on contractual arrangements and historical experience, our future revenue could be adversely affected.

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, we do not grant return privileges, except for defective products during the warranty period, nor do we grant pricing credits. Accordingly, we recognize revenue upon transfer of title and risk of loss to the value-added reseller, which is generally upon shipment. We reduce product revenue for cooperative marketing activities and certain price protection rights that may occur under contractual arrangements that we have with our resellers.

We provide an allowance for sales returns based on our historical returns, analysis of credit memo data and our return policies. The allowance for sales returns was \$1.1 million and \$1.2 million as of March 29, 2009 and June 29, 2008, respectively, for estimated future returns that were recorded as a reduction of our accounts receivable. The provision for returns is charged to net revenues in the accompanying consolidated statements of operations, and was \$0 and \$0.3 million in the third quarter of fiscal 2009 and the third quarter of fiscal 2008, respectively. If the historical data that we use 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. We estimate and adjust this allowance at each balance sheet date.

Recently Issued Accounting Standards

Edgar Filing: EXTREME NETWORKS INC - Form 10-Q

On October 10, 2008, the FASB issued FSP No. 157-3, Determining the Fair Value of a Financial Asset When the Market for That Asset is Not Active, (**FSP 157-3**) that clarifies the application of SFAS 157 in a market that is not active and provides an example to illustrate key considerations in determining the fair value of a financial asset when the market for that financial assets is not active. FSP 157-3 is applicable to the valuation of auction-rate securities held by us for which there was no active market as of March 29, 2009. FSP 157-3 is effective upon issuance, including prior periods for which the financial statements have not been issued. The adoption of FSP 157-3 during the three month period ended September 28, 2008 did not have a material impact on the our consolidated results of operations or financial condition.

Table of Contents

In April 2009, the FASB issued FSP No. FAS 157-4, *Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly*, which provides guidance on determining fair value when there is no active market or where the price inputs being used represent distressed sales. FSP No. 157-4 is effective for interim and annual periods ending after June 15, 2009. We are currently evaluating the impact that the adoption of FSP No. 157-4 may have on our consolidated results of operations and financial condition.

In April 2009, the FASB issued FSP No. FAS 115-2 and FAS 124-2, *Recognition and Presentation of Other-Than-Temporary Impairments*, which provides operational guidance for determining other-than-temporary impairments (OTTI) for debt securities. FSP No. 115-2 and 124-2 is effective for interim and annual periods ending after June 15, 2009. We are currently evaluating the impact that the adoption of FSP No. 115-2 and 124-2 may have on our consolidated results of operations and financial condition.

In April 2009, the FASB issued FSP FAS 107-1 and APB 28-1, *Interim Disclosures About Fair Value of Financial Instruments* (**FSP FAS 107-1**). FSP FAS 107 extends the disclosure requirements of FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments* (**Statement 107**), to interim financial statements of publicly traded companies as defined in APB Opinion No. 28, *Interim Financial Reporting*. Statement 107 requires disclosures of the fair value of all financial instruments (recognized or unrecognized), except for those specifically listed in paragraph 8 of Statement 107, when practicable to do so. These fair value disclosures must be presented together with the carrying amount of the financial instruments in a manner that clearly distinguishes between assets and liabilities and indicates how the carrying amounts relate to amounts reported on the balance sheet. An entity must also disclose the method(s) and significant assumptions used to estimate the fair value of financial instruments. FSP FAS 107 is effective for interim reporting periods ending after June 15, 2009. We are currently evaluating the impact that the adoption of FSP FAS 107 may have on our consolidated results of operations and financial condition.

Effective June 30, 2008, we adopted SFAS No. 159 *The Fair Value Option for Financial Assets and Financial Liabilities* (**SFAS 159**). SFAS 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 SFAS 159 are optional and adoption began for fiscal years beginning after November 15, 2007. We adopted the fair value option as it relates to the Put Option under this Statement and the adoption did not have a material impact on our consolidated results of operations or financial condition.

In May 2008, the FASB issued SFAS No. 162, *The Hierarchy of Generally Accepted Accounting Principles*. SFAS No. 162 defines the order in which accounting principles that are generally accepted should be followed. SFAS No. 162 was effective during the first quarter of fiscal 2009. The adoption of SFAS No. 162 did not have an impact on our consolidated results of operations or financial condition.

In December 2007, the FASB issued SFAS No. 141 (Revised 2007), *Business Combinations* (**SFAS 141R**). SFAS 141R will significantly change the accounting for business combinations. Under SFAS 141R, an acquiring entity will be required to recognize all the assets acquired and liabilities assumed in a transaction at the acquisition-date fair value with limited exceptions. It also amends the accounting treatment for certain specific items including acquisition costs and non controlling minority interests and includes a substantial number of new disclosure requirements. SFAS 141R applies prospectively to us for business combinations for which the acquisition date is on or after June 29, 2009. We are currently evaluating the impact on the adoption of SFAS 141R may have on our consolidated results of operations and financial condition.

Table of Contents

In December 2007, the FASB issued SFAS No. 160, *Noncontrolling Interests in Consolidated Financial Statements – an amendment of Accounting Research Bulletin No. 51 (SFAS 160)*. SFAS 160 clarifies the classification in a company's consolidated balance sheet and the accounting for and disclosure of transactions between the company and holders of non-controlling interests. SFAS 160 is effective for us on January 1, 2009. Early adoption is not permitted. We do not expect the adoption of SFAS 160 will have a material impact on our consolidated financial statements.

Liquidity and Capital Resources

The following summarizes information regarding our cash, investments, and working capital (in thousands):

	As of	
	March 29, 2009	June 29, 2008
Cash, cash equivalents, short-term investments and marketable securities	\$ 120,813	\$ 225,672
Working capital	\$ 16,988	\$ 80,096

The decrease in cash, investments and working capital is primarily due to the use of \$101.4 million to repurchase 28,571,428 shares of common stock. Refer to further discussions below under *Key Components of Cash Flows and Liquidity*.

Key Components of Cash Flows and Liquidity

A summary of the sources and uses of cash and cash equivalents is as follows (in thousands):

	Nine months ended	
	March 29 2009	March 30 2008
Net cash provided by operating activities	\$ (3,999)	\$ 15,023
Net cash (used in) provided by investing activities	\$ 71,723	\$ (17,967)
Net cash provided by (used in) financing activities	\$ (99,499)	\$ 3,257
Net decrease in cash and cash equivalents	\$ (31,775)	\$ 313

Cash and cash equivalents, short-term investments and marketable securities decreased to \$120.8 million at March 29, 2009 from \$225.7 million at June 29, 2008, a decrease of \$104.9 million. This decrease was primarily due to the use of \$101.4 million to repurchase 28,571,428 shares of common stock, cash used in operations of \$4.0 million, capital expenditures of \$4.2 million, offset by \$1.9 million received for common stock purchases.

Table of Contents

Cash flow used in operating activities was \$4.0 million in the first nine months of fiscal 2009. Net income was \$1.9 million and included significant non-cash charges including depreciation of \$4.2 million, \$2.6 million in share-based compensation expense and \$0.8 million in the provision for excess and obsolete inventory. Accounts receivable, net, decreased to \$43.6 million at March 29, 2009 from \$64.4 million at June 28, 2008. Days sales outstanding in receivables was 51 days at March 29, 2009 and 59 days at June 28, 2008 due to decreased revenue. Accounts payable decreased to \$15.4 million due to decreased inventory purchases at quarter end and reduced spending as a result of economic downturn. Net inventory levels increased to \$22.8 million at March 29, 2009 from \$13.9 million at June 28, 2008 due to a decrease in revenue for the first nine months of fiscal 2009. Inventory management remains an area of focus as we balance the need to maintain strategic inventory levels to ensure competitive lead times with the risk of inventory excess or obsolescence because of declining demand, rapidly changing technology and customer requirements. Deferred revenue, net, which consists of product and service revenue deferrals, decreased to \$39.8 million at March 29, 2009 from \$40.3 million at June 28, 2008. The \$0.5 million decrease was due a \$1.4 million decrease in deferred service contract revenue, offset by \$0.9 million increase in product revenue, net. Deferred revenue, net of cost of sales to distributors, decreased \$1.7 million from \$14.1 million at June 29, 2008 to \$12.4 million at March 29, 2009. The decrease was primarily due to a reduction of inventory held by distributors in Europe.

Cash and cash equivalents, short-term investments and marketable securities decreased \$22.7 million from \$143.5 million as of December 28, 2008 to \$120.8 million as of March 29, 2009, primarily due to cash used in operations of \$21.8 million. The timing of trade accounts payable and accrued liabilities payments in the fiscal third quarter were the primary reason for the \$21.8 million use of cash in operations.

Cash flow provided by investing activities was \$71.7 million. Capital expenditures were \$4.2 million and purchases of investments were \$33.6 million, offset by proceeds from maturities of investments and marketable securities of \$28.2 million and sales of investments and marketable securities of \$81.3 million.

Cash used in financing activities was \$99.5 million. Cash used to repurchase common stock, including expenses, was \$101.4 million, offset by proceeds from issuance of common stock of \$1.9 million.

We repurchased 28,571,428 shares of our common stock on September 19, 2008 at \$3.50 per share. Total cash expenditures were \$101.4 million for the shares repurchased, including direct costs associated with the repurchase. Primarily as a result of the share repurchase, our outstanding shares of common stock decreased from 116,867,768 as of August 29, 2008 to 88,635,762 as of March 29, 2009.

We have a revolving line of credit for \$10.0 million with a major lending institution which was renewed on January 22, 2009, and is contractually available to us until January 22, 2010. Borrowings under this line of credit bear interest at the bank's prime rate. As of March 29, 2009, 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 March 29, 2009, we had letters of credit totaling \$0.2 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 March 29, 2009.

In October 2008, we entered into a secured line of credit with UBS, collateralized by our ARS held by UBS. The maximum amount of credit available under this line of credit is \$28.8 million. On November 7, 2008 we accepted the UBS Rights Offer and hence the terms of the no net cost loan program apply to this line of credit. Under this program, the interest rate on this secured credit facility will be equivalent to the interest rate earned by us on the ARS at UBS, resulting in no net interest cost to us. There are currently no outstanding borrowings under this line of credit.

Table of Contents*Contractual Obligations*

The following summarizes our contractual obligations at March 29, 2009, 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	More Than Five Years
Contractual Obligations:					
Non-cancelable inventory purchase commitments	\$ 20,490	\$ 20,490			
Non-cancelable operating lease obligations	19,700	7,387	8,839	3,349	125
Other non-cancelable purchase commitments	3,497	1,013	2,484		
Total contractual cash obligations	\$ 43,687	\$ 28,890	\$ 11,323	\$ 3,349	\$ 125

Non-cancelable inventory purchase commitments represent the purchase of long lead-time component inventory that our contract manufacturers procure in accordance with our forecast. Inventory purchase commitments were \$20.5 million as of March 29, 2009, a decrease of \$8.0 million from \$28.5 million as of June 29, 2008. The decrease was primarily related to decreased inventory demand due to lower sales in the quarter-ended March 29, 2009 as compared to the quarter-ended June 29, 2008.

We did not have material commitments for capital expenditures as of March 29, 2009. Other non-cancelable purchase commitments represent OEM and technology agreements.

Table of Contents

Off-Balance Sheet Arrangements

We did not have any off-balance sheet arrangements as of March 29, 2009.

Capital Resources and Financial Condition

As of March 29, 2009, in addition to \$38.6 million in cash and cash equivalents, we had \$4.5 million invested in short-term and \$77.7 million invested in long-term marketable investments for a total cash and cash equivalents, short-term investments and marketable securities of \$120.8 million.

At March 29, 2009, we held approximately \$40.8 million (par value) of illiquid non-current Auction Rate Securities (ARS). The decline in value of these securities reflects market related liquidity conditions resulting from the general collapse of the credit markets and not the issuer's creditworthiness. The ARS are collateralized by student loan portfolios that are approximately 93% guaranteed by the US Department of Education and maintain a credit rating of AAA and AA. Historically, these securities provided liquidity to investors through their interest rate reset feature—i.e., interest rates on these securities are reset through a bidding process (or auction) at frequent, pre-determined intervals (typically every 7 to 28 days). At each reset, investors could either rollover and maintain their holdings or liquidate them at par value. Since February 2008, auctions related to our ARS have failed as a result of the deterioration of the credit markets, rendering these securities illiquid.

On November 7, 2008, we accepted an offer (the **UBS Rights Offer**) from UBS AG (**UBS**), providing us with certain rights related to our ARS (the **Rights**). The Rights permit us to require UBS to purchase our 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 our ARS at any time until July 2, 2012, so long as we receive payment at par value upon any sale or disposition. We expect to sell our ARS under the Rights in the period beginning 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 our ARS. So long as we hold our ARS, they will continue to accrue interest as determined by the auction process or the terms of the ARS if the auction process fails.

In October 2008, we and UBS entered into a secured line of credit collateralized by our ARS held by UBS. The maximum amount of credit available under this line of credit is \$28.8 million. When we accepted the UBS Rights Offer in November 2008, the terms of the UBS no net cost loan program were applied to this line of credit. Under this program, the interest rate on this secured credit facility will be equivalent to the interest rate earned by us on the ARS, resulting in no net interest cost to us. There are currently no outstanding borrowings under this line of credit.

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.

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 maximizing 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.

Edgar Filing: EXTREME NETWORKS INC - Form 10-Q

We hold a variety of interest bearing ARS that represent investments in pools of student loans. These ARS investments are intended to provide liquidity via an auction process that resets the applicable interest rate at predetermined calendar intervals, allowing investors to either roll over their holdings or gain immediate liquidity by selling such interests at par. The recent uncertainties in the credit markets have affected all of our holdings in ARS investments and auctions for our investments in these securities have failed to settle on their respective settlement dates. On November 7, 2008, we accepted the UBS Rights Offer from UBS, providing us with rights related to our ARS. The Rights permit us to require UBS to purchase our ARS at par value, which is defined as the price equal

Table of Contents

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 our ARS at any time until July 2, 2012, so long as we receive payment at par value upon any sale or disposition. We expect to sell our ARS under the Rights in the period beginning 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 our ARS. So long as we hold our ARS, they will continue to accrue interest as determined by the auction process or the terms of the ARS if the auction process fails. As of March 29, 2009, we continue to classify our entire balance of ARS in long-term marketable securities in our consolidated balance sheet because of our inability to determine when our investments in ARS would settle.

Table of Contents

The valuation of our investment portfolio is subject to uncertainties that are difficult to predict. Factors that may impact its valuation include changes to credit ratings of the securities, discount rates and ongoing strength and quality of market credit and liquidity.

If the current market conditions deteriorate further, or the anticipated recovery in market values does not occur, we may be required to record impairment charges in future quarters.

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 March 29, 2009. This table does not include money market funds because those funds are generally not subject to market risk.

	Three months or less	Three months to one year	Maturing in Greater than one year	Total	Fair Value
Included in cash and cash equivalents	\$ 9,520			\$ 9,520	\$ 9,520
Weighted average interest rate	0.11%				
Included in short-term investments		\$ 4,510		\$ 4,510	\$ 4,510
Weighted average interest rate		3.51%			
Included in marketable securities			\$ 77,708	\$ 77,708	\$ 77,708
Weighted average interest rate			2.77%		

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.

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 March 29, 2009, these forward foreign currency contracts had a notional principal amount of \$5.0 million. 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 March 29, 2009, we held foreign currency forward contracts with a notional principal amount and fair value of \$13.2 million and \$0.7 million, respectively. 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 gains and losses from operations, including the impact of hedging, were a gain of \$0.8 million in the third quarter of fiscal 2009 and loss of \$0.4 million in the third quarter of fiscal 2008.

**Item 4. Controls and Procedures
Evaluation of Disclosure Controls and Procedures**

Disclosure controls and procedures are controls and procedures designed to reasonably assure that information required to be disclosed in our reports filed under the Securities Exchange Act of 1934 as amended, such as this Report, is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms and to reasonably assure that such information is accumulated and communicated to our management, including the Chief Executive Officer (**CEO**) and the Chief Financial Officer (**CFO**), as appropriate to allow timely decisions regarding required disclosure.

Table of Contents

Under the supervision and with the participation of our management, including our CEO and CFO, we evaluated the effectiveness of the design and operation of our disclosure controls and procedures as of the end of the period covered by this Report. Based on this evaluation, our CEO and CFO concluded that our disclosure controls and procedures were effective as of the end of the period covered by this Report.

Management's Report on Internal Control over Financial Reporting

Our management is responsible for establishing and maintaining adequate internal control over our financial reporting. There are inherent limitations in the effectiveness of any system of internal control, including the possibility of human error and the circumvention or overriding of controls. Accordingly, even effective internal controls can provide only reasonable assurances with respect to financial statement preparation. Further because of changes in conditions, the effectiveness of internal control may vary over time.

We assessed the effectiveness of our internal control over financial reporting as of the end of the period covered by this Report. In making this assessment, we used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in Internal Control-Integrated Framework.

Based on our assessment using those criteria, we concluded that, as of the end of the period covered by this Report, our internal control over financial reporting is effective.

Changes in Internal Control over Financial Reporting

There were no changes in our internal control over financial reporting during the quarter ended March 29, 2009 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Inherent Limitations on Effectiveness of Controls

Our management, including the CEO and CFO, does not expect that our disclosure controls or our internal control over financial reporting will prevent or detect all error and all fraud. A control system, no matter how well designed and operated, can provide only reasonable, not absolute, assurance that the control system's objectives will be met. Our controls and procedures are designed to provide reasonable assurance that our control system's objective will be met and our CEO and CFO have concluded that our disclosure controls and procedures are effective at the reasonable assurance level. The design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. Further, because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that misstatements due to error or fraud will not occur or that all control issues and instances of fraud, if any, within Extreme Networks have been detected. These inherent limitations include the realities that judgments in decision-making can be faulty and that breakdowns can occur because of simple error or mistake. Controls can also be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the controls. The design of any system of controls is based in part on certain assumptions about the likelihood of future events. Projections of any evaluation of the effectiveness of controls in future periods are subject to risks. Over time, controls may become inadequate because of changes in conditions or deterioration in the degree of compliance with policies or procedures. Notwithstanding these limitations, our disclosure controls and procedures are designed to provide reasonable assurance of achieving their objectives. Our CEO and CFO have concluded that our disclosure controls and procedures are, in fact, effective at the reasonable assurance level.

Table of Contents

PART II. Other Information

Item 1. Legal Proceedings

For information regarding litigation matters that we deem significant, refer to Part I, Item 3, Legal Proceedings of our Annual Report on Form 10-K for the fiscal year ended June 29, 2008 and Note 3 to our Notes to Condensed Consolidated Financial Statements, included in Part I, Item 1 of our Quarterly Reports on Form 10-Q for the quarters ended September 28, 2008 and December 28, 2008 and this Report which are incorporated herein by reference.

Item 1A. Risk Factors

In addition to the other information set forth in this Report, you should carefully consider the factors discussed in Part I, Item 1A. Risk Factors in our Annual Report on Form 10-K for the fiscal year ended June 29, 2008 and Part II, Item 1A, Risk Factors in our Quarterly Reports on Form 10-Q for the quarters ended September 28, 2008 and December 28, 2008, which to our knowledge have not materially changed. Those risks, which could materially affect our business, financial condition or future results, are not the only risks we face. Additional risks and uncertainties not currently known to us or that we currently deem to be immaterial also may adversely affect our business, financial condition and/or operating results.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds Not applicable

Item 3. Defaults Upon Senior Securities Not applicable

Item 4. Submission of Matters to a Vote of Security Holders - Not applicable

Item 5. Other Information None

Item 6. Exhibits

(a) Exhibits:

- 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/ KAREN ROGGE

KAREN ROGGE

Senior Vice President and Chief Financial Officer

May 6, 2009