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**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**  
Washington, D. C. 20549

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**Form 10-Q**

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

For the quarter ended September 26, 2004

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

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**EXTREME NETWORKS, INC.**

(Exact name of Registrant as specified in its charter)

**DELAWARE**  
[State or other jurisdiction of  
incorporation or organization]

**3585 Monroe Street**  
**Santa Clara, California**  
[Address of principal executive offices]

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

**95051**  
[Zip Code]

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

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

Indicate by check mark whether the Registrant is an accelerated filer (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 October 22, 2004 was 120,853,248.

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FORM 10-Q  
QUARTERLY PERIOD ENDED SEPTEMBER 26, 2004

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## Item 1. Financial Statements

**EXTREME NETWORKS, INC.**  
**CONDENSED CONSOLIDATED BALANCE SHEETS**  
(In thousands)

	September 26, 2004	June 27, 2004
	(Unaudited)	(Note 1)
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 66,341	\$ 59,164
Short-term investments	146,461	162,078
Accounts receivable, net	28,788	32,998
Inventories	23,946	25,889
Prepaid expenses and other current assets	9,670	8,051
Total current assets	275,206	288,180
Property and equipment, net	57,485	59,767
Marketable securities	227,078	204,430
Other assets	25,426	26,896
<b>TOTAL ASSETS</b>	<b>\$ 585,195</b>	<b>\$ 579,273</b>
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
Current liabilities:		
Accounts payable	\$ 20,444	\$ 18,995
Accrued compensation and benefits	14,859	15,827
Restructuring liabilities	6,360	6,085
Lease liability	1,884	2,355
Accrued warranty	9,070	8,297
Deferred revenue	50,592	53,674
Other accrued liabilities	26,150	22,921
Total current liabilities	129,359	128,154
Restructuring liabilities, less current portion	18,527	20,478
Deferred income taxes	762	762
Long-term deposit	320	321
Convertible subordinated notes	200,000	200,000
Commitments and contingencies (Note 2)		
Stockholders' equity:		
Common stock and capital in excess of par value	688,621	687,216
Deferred stock compensation	(7)	(69)
Accumulated other comprehensive loss	(1,312)	(2,388)
Accumulated deficit	(451,075)	(455,201)
Total stockholders' equity	236,227	229,558
<b>TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY</b>	<b>\$ 585,195</b>	<b>\$ 579,273</b>

See accompanying notes to the unaudited condensed consolidated financial statements.

**EXTREME NETWORKS, INC.**  
**CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS**  
(In thousands, except per share amounts)  
(Unaudited)

	Three Months Ended	
	September 26, 2004	September 28, 2003
Net revenues:		
Product	\$ 81,172	\$ 76,756
Service	13,914	10,615
Total net revenues	<u>95,086</u>	<u>87,371</u>
Cost of revenues:		
Product	36,302	33,432
Service	8,228	9,036
Total cost of revenues	<u>44,530</u>	<u>42,468</u>
Gross margin:		
Product	44,870	43,324
Services	5,686	1,579
Total gross margin	<u>50,556</u>	<u>44,903</u>
Operating expenses:		
Sales and marketing	23,230	21,825
Research and development	15,399	13,297
General and administrative	7,123	7,031
Amortization of deferred stock compensation	62	552
Restructuring charge	—	962
Total operating expenses	<u>45,814</u>	<u>43,667</u>
Operating income	4,742	1,236
Other income, net	138	2,299
Income before income taxes	4,880	3,535
Provision for income taxes	754	920
Net income	<u>\$ 4,126</u>	<u>\$ 2,615</u>
Net income per share — basic	<u>\$ 0.03</u>	<u>\$ 0.02</u>
Net income per share — diluted	<u>\$ 0.03</u>	<u>\$ 0.02</u>
Shares used in per share calculation — basic	<u>120,636</u>	<u>116,621</u>
Shares used in per share calculation — diluted	<u>123,376</u>	<u>118,822</u>

See accompanying notes to the unaudited condensed consolidated financial statements.

**EXTREME NETWORKS, INC.**  
**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**  
(In thousands)  
(Unaudited)

	Three Months Ended	
	September 26, 2004	September 28, 2003
Cash flows from operating activities:		
Net income	\$ 4,126	\$ 2,615
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	4,392	5,301
Provision for doubtful accounts (reversal)	—	(200)
Amortization of warrant	1,892	—
Amortization of deferred stock compensation	62	552
Restructuring charge	—	962
Loss on disposal of fixed asset	50	—
Changes in operating assets and liabilities:		
Accounts receivable	4,210	(364)
Inventories	1,943	2,739
Prepaid expenses and other current assets and Other assets	(2,041)	6,994
Accounts payable	1,449	(10,015)
Accrued compensation and benefits	(968)	(735)
Restructuring liabilities	(1,676)	(2,996)
Lease liability	(471)	(628)
Accrued warranty	773	(1,363)
Deferred revenue	(3,082)	915
Other accrued liabilities	3,228	(1,427)
Net cash provided by operating activities	<u>13,887</u>	<u>2,350</u>
Cash flows from investing activities:		
Capital expenditures	(2,160)	(2,295)
Purchases of investments	(130,162)	(70,548)
Sales and maturities of investments	124,207	70,887
Net cash used in investing activities	<u>(8,115)</u>	<u>(1,956)</u>
Cash flows from financing activities:		
Proceeds from issuance of common stock	1,405	1,458
Net cash provided by financing activities	<u>1,405</u>	<u>1,458</u>
Net increase in cash and cash equivalents	7,177	1,852
Cash and cash equivalents at beginning of period	59,164	44,340
Cash and cash equivalents at end of period	<u>\$ 66,341</u>	<u>\$ 46,192</u>

See accompanying notes to the unaudited condensed consolidated financial statements.

**EXTREME NETWORKS, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)**

## 1. Summary of Significant Accounting Policies

*Basis of Presentation*

The unaudited condensed consolidated financial statements of Extreme Networks (referred to as “Extreme Networks” and as “we”, “us” and “our”) included herein have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission (“SEC”). Certain information and footnote disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles have been condensed or omitted pursuant to such rules and regulations. The condensed consolidated balance sheet at June 27, 2004 was derived from audited financial statements as of that date but does not include all disclosures required by generally accepted accounting principles for complete financial statements. These interim financial statements and notes should be read in conjunction with our audited consolidated financial statements and notes thereto included in our Annual Report on Form 10-K for the fiscal year ended June 27, 2004.

The unaudited condensed consolidated financial statements reflect all adjustments, consisting only of normal recurring adjustments, that, in the opinion of management, are necessary for a fair presentation of the results of operations and cash flows for the interim periods presented and the financial condition of Extreme Networks at September 26, 2004. The results of operations for the first quarter of fiscal 2005 are not necessarily indicative of the results that may be expected for fiscal 2005 or any future periods.

*Revenue Recognition*

We derive the majority of our revenue from sales of our modular and stackable networking equipment, with the remaining revenue generated from service fees relating to the service contracts and training on our products. Our revenue recognition policy follows SEC Staff Accounting Bulletin No. 104, *Revenue Recognition* (“SAB 104”). We generally recognize product revenue from our Value-Added Resellers and end-users at the time of shipment, provided that persuasive evidence of an arrangement exists, delivery has occurred, the price of the product is fixed or determinable and collection of the sales proceeds is reasonably assured. Revenue from service obligations under service contracts is deferred and recognized on a straight-line basis. Service contracts typically range from one to five years. When sales arrangements contain multiple deliverables such as hardware, service contracts and other services, we determine whether the deliverables represent separate units of accounting and then allocate revenue to each unit of accounting based on its relative fair value in accordance with Emerging Issues Task Force (“EITF”) Issue No. 00-21, *Revenue Arrangements with Multiple Deliverables* (“EITF 00-21”). We recognize revenue for each unit of accounting when the revenue recognition criteria for each unit of accounting are met in accordance with SAB 104.

We make certain sales to partners in two-tier distribution channels. 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 a monthly sales-out report 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, provide them with credits for changes in selling prices, and allow them to participate in cooperative marketing programs. Cooperative advertising expenses are recorded as marketing expenses to the extent that an advertising benefit separate from the revenue transaction can be identified and the cash paid does not exceed the fair value of that advertising benefit received. The second tier of the distribution channel consists of a large number of third-party resellers that sell directly to end-users and are not granted return privileges, except for defective products during the warranty period. We reduce product revenue for certain price protection rights that may occur under contractual arrangements we have with our customers.

*Inventories*

Inventories consist of (in thousands):

	<u>September 26, 2004</u>	<u>June 27, 2004</u>
Raw materials	\$ 298	\$ 695
Finished goods	23,648	25,194
<b>Total</b>	<b>\$ 23,946</b>	<b>\$ 25,889</b>

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### *Sales to Distributors*

We defer recognition of revenue on all sales to distributors until the distributor successfully resells the product, typically to an authorized Value-Added Reseller. Distributors regularly provide us with reporting of their sales-out for this purpose. Until it is sold, inventory held by distributors is included in our reported finished goods inventory and was \$3.8 million and \$5.1 million at September 26, 2004 at June 27, 2004, respectively. The accounts receivable owed us by distributors, net of the deferred revenue from sales to distributors, is recorded in other current assets, as reflected in the following table (in thousands):

	<u>September 26, 2004</u>	<u>June 27, 2004</u>
Accounts receivable, net of allowance for doubtful accounts of \$724	\$ 16,896	\$ 20,350
Deferred revenue	(15,602)	(20,151)
Other current assets	<u>\$ 1,294</u>	<u>\$ 199</u>

### *Guarantees and Product Warranties*

Financial Accounting Standards Board ("FASB") Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others* ("FIN 45") requires that upon issuance of a guarantee, the guarantor must disclose and recognize a liability for the fair value of the obligation it assumes under that guarantee. We have determined that the requirements of FIN 45 apply to our standard product warranty and to indemnification obligations contained in commercial agreements, including customary intellectual property indemnification for our products contained in agreements with our resellers and end-users, to a guarantee of a lease obligation of one of our former contract manufacturers and to letters of credit issued under our line of credit.

The following table summarizes the activity related to our product warranty liability during the first quarter of fiscal 2005 and fiscal 2004 are as follows (in thousands):

	<u>Three Months Ended</u>	
	<u>September 26, 2004</u>	<u>September 28, 2003</u>
Balance beginning of period	\$ 8,297	\$ 10,200
New warranties issued	3,082	1,491
Warranty expenditures	(3,437)	(2,854)
Change in estimate	1,128	—
Balance end of period	<u>\$ 9,070</u>	<u>\$ 8,837</u>

Our standard hardware warranty period is typically 12 months from the date of shipment to end-users and 14 months from the date of shipment to channel partners, which include resellers and distributors. Upon shipment of products to our customers, including both end-users and channel partners, we estimate expenses for the cost to repair or replace products that may be returned under warranty and accrue a liability in cost of product revenue for this amount. The determination of our warranty requirements is based on actual historical experience with the product or product family, estimates of repair and replacement costs and any product warranty problems that are identified after shipment. We estimate and adjust these accruals at each balance sheet date in accordance with changes in these factors. There was no change in estimate for the first quarter of fiscal 2004. The change in estimate in the first quarter of fiscal 2005 results from a change in the method to accumulate the warranty return rates.

In the normal course of business to facilitate sales of our products, we indemnify our resellers and end-user customers with respect to certain matters. We have agreed to hold the customer harmless against losses arising from a breach of intellectual property infringement or other claims made against certain parties. These agreements may limit the time within which an indemnification claim can be made and the amount of the claim. It is not possible to estimate the maximum potential amount under these indemnification agreements due to the limited history of prior indemnification claims and the unique facts and circumstances involved in each particular agreement. Historically, payments made by us under these agreements have not had a material impact on our operating results or financial position.

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### Deferred Support Revenue

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

	Three Months Ended	
	September 26, 2004	September 28, 2003
Balance beginning of period	\$ 50,178	\$ 44,220
New support arrangements	10,676	10,835
Recognition of support revenue	(12,315)	(9,193)
Balance end of period	\$ 48,539	\$ 45,862

### Stock Based Compensation

We have elected to follow APB Opinion No. 25, *Accounting for Stock Issued to Employees*, in accounting for our employee stock options because, as discussed below, the alternative fair value accounting provided for under SFAS No. 123, *Accounting for Stock-Based Compensation*, ("SFAS 123") requires the use of option valuation models that were not developed for use in valuing employee stock options. Under APB No. 25, because the exercise price of our employee stock options equals the market price of the underlying stock on the date of grant, no compensation expense is recognized in our financial statements.

Pro forma information regarding net income and earnings per share is required by SFAS 123. This information is required to be determined as if we had accounted for our employee stock options and shares issued under the Employee Stock Purchase Plan under the fair value method of that statement. The fair value of options granted in the first quarter of fiscal 2005 and fiscal 2004 was estimated at the date of grant using a Black-Scholes option pricing model with the following weighted average assumptions:

	Stock Option Plan		Employee Stock Purchase Plan	
	Three Months Ended		Three Months Ended	
	September 26, 2004	September 28, 2003	September 26, 2004	September 28, 2003
Expected life	3.5 yrs	3.5 yrs	0.6 yrs	0.6 yrs
Risk-free interest rate	3.0%	2.7%	1.7%	1.1%
Volatility	53%	83%	53%	83%
Expected dividend yield	0.0%	0.0%	0.0%	0.0%

The Black-Scholes option valuation model was developed for use in estimating the fair value of traded options that have no vesting restrictions and are fully transferable. In addition, option valuation models require the input of highly subjective assumptions, including the expected stock price volatility. Because our employee stock options have characteristics significantly different from those of traded options, and because changes in the subjective input assumptions can materially affect the fair value estimate, in the opinion of management, the existing models may not necessarily provide a reliable single measure of the fair value of employee stock options. The weighted-average estimated per share fair value of options granted in the first quarter of fiscal 2005 and fiscal 2004 was \$2.06 and \$3.27, respectively. The weighted-average estimated per share fair value of shares granted under the Employee Stock Purchase Plan in the first quarter of fiscal 2005 and fiscal 2004 was \$1.69 and \$2.47, respectively. Pro forma information regarding net income (loss) and earnings (loss) per share is required by SFAS 123. This information is required to be determined as if we had accounted for shares issued under all of our employee stock options and shares issued under the Employee Stock Purchase Plan under the fair value method of that statement. For purposes of pro forma disclosures, the estimated fair value of the options is amortized to expense over the options' vesting periods. The following pro forma information sets forth our net loss and net loss per share assuming that we had used the SFAS 123 fair value method in accounting for employee stock options and purchases (in thousands, except per share amounts):

	Three Months Ended	
	September 26, 2004	September 28, 2003
Net income – as reported	\$ 4,126	\$ 2,615
Add: APB 25 stock-based employee compensation expense, as reported	62	408
Less: Stock-based employee compensation expense determined under fair value based method, net of tax	(6,931)	(7,380)
Pro forma net loss	\$ (2,743)	\$ (4,357)
Basic net income (loss) per share:		
As reported	\$ 0.03	\$ 0.02
Pro forma	\$ (0.02)	\$ (0.04)
Diluted net income (loss) per share:		
As reported	\$ 0.03	\$ 0.02
Pro forma	\$ (0.02)	\$ (0.04)

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### *Recently Issued Accounting Standards*

#### *Identification of Impaired Investments*

In March 2004, the FASB approved the consensus reached on EITF Issue No. 03-1, *The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments* ("EITF 03-1"). EITF 03-1 provides new guidance for evaluating impairment losses on debt and equity investments, as well as new disclosure requirements for investments that are determined to be other-than-temporarily impaired. In September 2004, the FASB approved the issuance of a FASB Staff Position to delay the requirement to record impairment losses under EITF 03-1. The approved delay applies to all securities within the scope of EITF 03-1 and is expected to end when new guidance is issued and comes into effect. Pending issuance of new guidance, we have not yet evaluated the requirements of EITF 03-1 nor determined its impact on our consolidated financial statements.

### 2. Commitments, Contingencies and Leases

#### *Line of Credit*

We have a revolving line of credit for \$10.0 million with a major lending institution. Borrowings under this line of credit bear interest at the bank's prime rate. As of September 26, 2004, 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 September 26, 2004, we had letters of credit totaling \$0.9 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 September 26, 2004. The line of credit expires on January 27, 2005.

#### *Leases*

As part of our business relationship with MCMS, Inc. ("MCMS"), a former contract manufacturer, we entered into a \$9.0 million operating equipment lease for manufacturing equipment in September 2000 with a third-party financing company; we, in turn, subleased the equipment to MCMS. The equipment lease with the third-party financing company requires us to make monthly payments through September 2005 and to maintain specified financial covenants with which we were in compliance as of September 26, 2004. During the first quarter of fiscal 2002, due to the liquidity problems at MCMS and its voluntary filing for protection under Chapter 11, we recorded a charge of \$9.0 million related to this lease. The liability, net of payments, related to this lease is included in lease liability on the condensed consolidated balance sheets.

#### *Purchase Commitments*

We currently have arrangements with one contract manufacturer and other suppliers for the manufacture of our products. Our arrangements allow them to procure long lead-time component inventory on our behalf based upon a rolling production forecast provided by us. We are obligated to the purchase of long lead-time component inventory that our contract manufacturer procures in accordance with the forecast, unless we give notice of order cancellation outside of applicable component lead-times. As of September 26, 2004, we had non-cancelable commitments to purchase approximately \$18.3 million of such inventory during the second quarter of fiscal 2005.

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### *Legal Proceedings*

On May 27, 2003, Lucent Technologies, Inc. (“Lucent”) filed suit against Extreme Networks and Foundry Networks, Inc. (“Foundry”) in the United States District Court for the District of Delaware, Civil Action No. 03-508. The complaint alleges willful infringement of U.S. Patent Nos. 4,769,810, 4,769,811, 4,914,650, 4,922,486 and 5,245,607 and seeks a judgment: (a) determining that we have willfully infringed each of the five patents; (b) determining that Foundry has willfully infringed four of the five patents; (c) permanently enjoining us from infringement, inducement of infringement and contributory infringement of each of the five patents; (d) permanently enjoining Foundry from infringement, inducement of infringement and contributory infringement of four of the five patents; and (e) awarding Lucent unspecified amounts of trebled damages, together with expenses, costs and attorneys’ fees.

We intend vigorously to defend against Lucent’s allegations. We answered Lucent’s complaint on July 16, 2003, denying infringement and asserting various affirmative defenses and counterclaims that seek judgment: (a) that Lucent’s complaint be dismissed and Lucent be denied all requested relief; (b) declaring that we do not infringe, induce infringement or contribute to the infringement of any valid and enforceable claim of the five patents, (c) that each of the five patents be declared invalid; (d) finding the case exceptional within the definition of 35 U.S.C. § 285; and (e) that Lucent pay our attorneys’ fees and costs.

The court has served the cases against Extreme Networks and Foundry. Discovery is proceeding. A claim construction hearing has been set for November 17, 2004. A pre-trial conference is set for January 14, 2005. No trial date has been set.

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

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

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

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

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

### 3. Comprehensive Income

Comprehensive income was as follows (in thousands):

	Three Months Ended	
	September 26, 2004	September 28, 2003
Net income	\$ 4,126	\$ 2,615
Other comprehensive income (loss):		
Unrealized gain (loss) on investments:		
Change in net unrealized gain (loss) on investments	1,125	(522)
Less: Net gain on investments realized and included in net income	26	9
Net unrealized gain (loss) on investments	1,099	(531)
Unrealized gain on derivatives	1	—
Foreign currency translation adjustments	(24)	156
<b>Total comprehensive income</b>	<b>\$ 5,202</b>	<b>\$ 2,240</b>

### 4. Income Taxes

We recorded an income tax provision of \$0.8 and \$0.9 million for the first quarter of fiscal 2005 and the first quarter of fiscal 2004, respectively. The income tax provision for the first quarter of fiscal 2005 reflects an effective tax rate of 15%, which differs from the statutory tax rate due to benefits to U.S. taxes from net operating loss carryforwards and tax credits, offset by the tax impact on income of foreign operations. The income tax provision in the first quarter of fiscal 2004 reflects an effective tax rate of 26%, which differs from the statutory tax rate primarily due to the tax impact on income of foreign operations.

### 5. Net Income Per Share

Basic earnings 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, warrants and convertible subordinated notes. Dilutive earnings 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, warrants and convertible subordinated notes. The computation of diluted net income per share for the first fiscal quarter of 2005 and 2004 excludes the impact of the conversion of the convertible subordinated notes due in December 2006, which were convertible into 9.5 million shares of common stock, as the impact of adding back to income the after tax interest expense associated with the convertible subordinated notes, and including the impact of the common shares to be issued, would be anti-dilutive in these periods.

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

	Three Months Ended	
	September 26, 2004	September 28, 2003
Net income	\$ 4,126	\$ 2,615
Weighted-average shares of common stock outstanding	120,644	116,836
Less: Weighted-average shares subject to repurchase	(8)	(215)
Weighted-average shares used in per share calculation — basic	120,636	116,621
Incremental shares using the treasury stock method	2,740	2,201
Weighted-average shares used in per share calculation — diluted	123,376	118,822
Net income per share – basic	\$ 0.03	\$ 0.02
Net income per share – diluted	\$ 0.03	\$ 0.02

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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	
	September 26, 2004	September 28, 2003
Stock options outstanding	17,687	4,893
Convertible subordinated notes	9,542	9,542
<b>Total potential shares of common stock excluded from the computation of earnings per share</b>	<b>27,229</b>	<b>14,435</b>

Stock options outstanding are considered to be antidilutive under the treasury stock method when the exercise price of the option exceeds the market value of the shares. The increase in antidilutive stock options outstanding from September 28, 2003 to September 26, 2004 is due to two factors; an increase in the number of options outstanding for approximately 9.6 million shares of common stock, which includes replacement options for approximately 5.1 million shares of common stock associated with the stock option exchange program that were issued in October 2003, and a decrease in the market value of the shares which has increased the number of stock options outstanding that are considered to be antidilutive.

### 6. Restructuring Charge

During fiscal 2004, we recorded restructuring charges of \$6.5 million related to excess facilities. The excess facilities charge represents an increase to the charge initially recognized during fiscal 2002. The commercial real estate market has continued to deteriorate in fiscal 2004 and we have not been able to find suitable tenants to sublease these facilities. The lower projected sublease income has necessitated an increase in reserves that takes into consideration the unfavorable difference between lease obligation payments and projected sublease receipts. The actual cost could differ from this estimate, and additional facilities charges could be incurred if we are unsuccessful in negotiating reasonable termination fees on certain facilities, if facility operating lease rental rates continue to decrease in these markets, if it takes longer than expected to find a suitable tenant to sublease these facilities or if other estimates and assumptions change.

During fiscal 2003, we recorded restructuring charges of \$15.9 million. The restructuring charges included excess facilities charges of \$9.6 million, severance charges of \$4.4 million and asset impairments of \$1.9 million. The excess facilities charge represents an increase to the charge recognized during fiscal 2002 for the domestic and international facilities. Severance charges of \$2.7 million related to a reduction in total staff during the second quarter of fiscal 2003 of approximately 100 people, or 10% of the total workforce, across all departments. Severance charges of \$1.7 million related to a reduction in total staff announced at the end of the fiscal year of approximately 70 people, or 8% of the total workforce, across all departments. The asset impairment charge relates to the write-off of leasehold improvements and office furniture related to excess facilities.

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

	Excess Facilities	Asset Impairments	Severance	Total
Balance at June 29, 2003	\$26,418	\$ —	\$ 1,752	\$28,170
Charge in first quarter of fiscal 2004	876	122	(36)	962
Charge in fourth quarter of fiscal 2004	5,622	—	(97)	5,525
Write-offs	—	(122)	—	(122)
Cash payments	(6,353)	—	(1,619)	(7,972)
Balance at June 27, 2004	26,563	—	—	26,563
Cash payments	(1,676)	—	—	(1,676)
Balance at September 26, 2004	24,887	—	—	24,887
Less: current portion	6,360	—	—	6,360
<b>Restructuring liabilities at September 26, 2004, less current portion</b>	<b>\$18,527</b>	<b>\$ —</b>	<b>\$ —</b>	<b>\$18,527</b>

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

*This quarterly report on Form 10-Q, including the following sections, contains forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995, particularly statements relating to our expectations regarding results of operations, our ability to expand our market penetration, our ability to expand our distribution channels, customer acceptance of our products, our ability to meet the expectations of our customers, product demand and revenue, cash flows, product gross margins, our expectations to continue to develop new products and enhance existing products, our expectations to reduce warranty expenses as a percentage of revenue, 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 expected income tax rate, our expectations that we have sufficient capital to meet our requirements for at least the next twelve months, our expectations regarding the rationalization of our workforce and facilities, and our expectations regarding materials and inventory management. These forward-looking statements involve risks and uncertainties, and the cautionary statements set forth below and those contained in the section entitled "Risk Factors" identify important factors that could cause actual results to differ materially from those predicted in any such forward-looking statements. We caution investors that actual results may differ materially from those projected in the forward-looking statements as a result of certain risk factors identified in this Form 10-Q and other filings we have made with the Securities and Exchange Commission.*

#### **Business Overview**

We develop and sell a family of modular and stackable network infrastructure equipment and offer related service contracts for extended warranty and maintenance agreements. Substantially all of our revenue is derived from the sale of networking equipment and the related service contracts. We believe that understanding the following key developments is helpful to an understanding of our operating results for the first quarter of fiscal 2005.

##### *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 2004 we introduced several new products including the Black Diamond 10K, the Summit 300-48/Altitude 300 and the Summit 400 series, plus a new network software platform ExtremeWare<sup>®</sup> XOS.

##### *Convergence of Voice, Video and Data*

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

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

##### *Expanded Focus on Service Offering*

Extreme's service offering is primarily the provision of service contracts for extended warranty and maintenance agreements related to our networking equipment. To a lesser extent, the service revenue includes professional services related to the design and installation of data networks and training. In the first quarter of fiscal 2005, we continued to focus our service sales efforts on increasing the number of service contracts sold on new equipment and on securing renewals on expiring contracts. Service revenue increased by 31.1% in the first quarter of fiscal 2005 compared to the first quarter of fiscal 2004 and represented 14.6% of total revenues in the first quarter of fiscal 2005 compared to 12.1% in the first quarter of fiscal 2004. Cost of service revenue decreased by \$0.8 million in the first quarter of fiscal 2005 to \$8.2 million and service gross margin improved to 40.9% in the first quarter of fiscal 2005 from 14.9% in the first quarter of fiscal 2004 due to efforts to improve and optimize our service supply chain.

[Table of Contents](#)**Results of Operations**

We were able to achieve the following results in the first quarter of fiscal 2005:

- We increased net product revenue to \$81.2 million, an increase of 5.8% from net product revenue of \$76.8 million in the first quarter of fiscal 2004.
- We recorded service revenue of \$13.9, an increase of 31.1% from service revenue of \$10.6 million in the first quarter of fiscal 2004.
- Total gross margin expanded to 53.2% of net revenues from 51.4% in the first quarter of fiscal 2004.
- Total operating expenses were 48.2% of net revenue as compared to 50.0% in the first fiscal quarter of 2004.
- We achieved net income of \$4.1 million, an increase of 57.8% from net income of \$2.6 million in the first quarter of fiscal 2004.
- Cash flow from operations was \$13.9 million in the first fiscal quarter of 2005. Cash and cash equivalents, short-term investments and marketable securities increased by \$14.2 million in the first quarter of fiscal 2005 to \$439.9 million as of September 26, 2004.

**Net Revenues**

The following table presents net product and service revenues for the first quarter of fiscal 2005 and fiscal 2004 (dollars in thousands):

	Three months ended			
	September 26, 2004	% of Net Revenues	September 28, 2003	% of Net Revenues
Net Revenues:				
Product	\$ 81,172	85.4%	\$ 76,756	87.9%
Service	13,914	14.6%	10,615	12.1%
Total net revenues	\$ 95,086	100.0%	\$ 87,371	100.0%

Net revenues were \$95.1 million in the first quarter of fiscal 2005 and \$87.4 million in the first quarter of fiscal 2004, representing an increase of 8.8% in the first quarter of fiscal 2005 from the first quarter of fiscal 2004.

Product revenue increased to \$81.2 million for the first quarter of fiscal 2005 from \$76.8 million for the first quarter of fiscal 2004, an increase of \$4.4 million. This increase was primarily due to an increase in the volume of units sold.

Service revenue increased to \$13.9 million for the first quarter of fiscal 2005 from \$10.6 million for the first quarter of fiscal 2004, an increase of \$2.9 million. This increase was primarily due to an increase in the number of service contracts outstanding resulting from a focused sales and marketing effort to increase the number of contracts sold with equipment and in obtaining contract renewals and also from increases in our installed base of equipment.

The following table presents the total net revenue geographically for the first quarter of fiscal 2005 and fiscal 2004 (dollars in thousands):

	Three months ended			
	September 26, 2004	% of Net Revenues	September 28, 2003	% of Net Revenues
Net Revenues:				
United States	\$ 39,844	41.9%	\$ 32,993	37.8%
Europe, Middle East and Africa	25,200	26.5%	20,800	23.8%
Japan	18,200	19.1%	18,700	21.4%
Other	11,842	12.5%	14,878	17.0%
Total net revenues	\$ 95,086	100.0%	\$ 87,371	100.0%

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Sales of products and services outside the United States accounted for approximately 58% of our business in the first quarter of fiscal 2005, compared to 62% in the first quarter of fiscal 2004. We expect that export sales will continue to represent a significant portion of net revenue, although export sales may fluctuate as a percentage of net revenue. Substantially all sales transactions are denominated in United States dollars.

We rely upon our two-tiered distribution channel for the majority of our revenues. Revenue through the distributor channel as a percentage of total product revenue was 32% in the first quarter of fiscal 2005 and 35% in the first quarter of fiscal 2004. The level of sales to any customer may vary from period to period; however, we expect that significant customer concentration will continue for the foreseeable future. One distributor of Extreme products, Tech Data Corporation, accounted for 11% of our net revenue for the first quarter of fiscal 2005. No customer accounted for greater than 10% of our net revenue for the first quarter of fiscal 2004.

### *Cost of Revenues and Gross Margin*

The following table presents the gross margin on product and service revenues and the gross margin percentage of product and service revenues for the first quarter of fiscal year 2005 and fiscal 2004 (dollars in thousands):

	Three months ended			
	September 26, 2004	% of Revenue	September 28, 2003	% of Revenue
Gross margin:				
Product	\$ 44,870	55.3%	\$ 43,324	56.4%
Service	5,686	40.9%	1,579	14.9%
Total gross margin	\$ 50,556	53.2%	\$ 44,903	51.4%

Gross margin was \$50.6 million in the first quarter of fiscal 2005 and \$44.9 million in the first quarter of fiscal 2004, representing an increase of 12.6% in the first quarter of fiscal 2005 from the first quarter of fiscal 2004. Gross margin as a percentage of net revenues was 53.2% and 51.4% in the first quarter of fiscal 2005 and the first quarter of fiscal 2004, respectively.

Cost of product revenue includes costs of raw materials, amounts paid to third-party contract manufacturers, costs related to warranty obligations, charges for excess and obsolete inventory and internal costs associated with manufacturing overhead including management, manufacturing engineering, quality assurance, development of test plans and document control. Product gross margin in the first quarter of fiscal 2005 was \$44.9 million, representing 55.3% of product revenues as compared to \$43.3 million in the first quarter of fiscal 2004, or 56.4% of product revenue. The decrease in product gross margin as a percentage of product revenues was primarily due to higher warranty costs in the first quarter of fiscal 2005, including \$1.1 million related to a change in the method to accumulate the warranty return rates.

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

Our cost of service consists primarily of labor, overhead, repair and freight costs and the cost of spares used in providing support under customer service contracts. Service gross margin in the first quarter of fiscal 2005 was \$5.7 million, representing 40.9% of service revenues as compared to \$1.6 million in the first quarter of fiscal 2004, or 14.9% of service revenue. The increase in service gross margin resulted from a number of programs that we implemented during fiscal 2004 and fiscal 2003 to improve service delivery productivity and to enhance customer satisfaction. These programs included implementing a focused sales and marketing effort to increase the number of service contracts by increasing the attachment

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rate of service contract sales on new equipment and on increasing the rate of renewals on existing service contracts. In addition, these programs in fiscal 2004 and fiscal 2003 included expenses incurred to reduce service infrastructure, including outsourcing certain service functions. In recent quarters, including the first quarter of fiscal 2005, the benefits of the programs implemented in fiscal 2004 and fiscal 2003 are being realized in the form of lower cost of revenue on an increasing revenue base. Some of the costs of revenue components such as labor and overhead are of a fixed nature and have not increased as we have expanded our revenue base. Other costs, such as repairs, freight and cost of spares are of a variable nature and the per unit costs have declined as we have expanded our revenue base. The combination of maintaining fixed costs and lowering the per unit variable cost while increasing the revenue base has provided significant leverage in the growth of gross margins.

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

### *Sales and Marketing Expenses*

Sales and marketing expenses consist of salaries, commissions and related expenses for personnel engaged in marketing and sales functions, as well as trade shows and promotional expenses. Sales and marketing expenses increased to \$23.2 million for the first quarter of fiscal 2005 from \$21.8 million for the first quarter of fiscal 2004, an increase of \$1.4 million. This increase was primarily due to increased payroll and related personnel expenses of \$1.4 million, increased marketing and promotional expenses of \$0.3 million and increased spending for travel and related expenses of \$0.2 million, offset partially by a decrease in professional fees of \$0.2 million, decreased depreciation expense of \$0.2 million and reduced spending on contract labor of \$0.1 million. The rate of future spending changes in our sales and marketing expenses, if any, will depend on the pace of recovery in the market for networking products.

### *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 increased to \$15.4 million for the first quarter of fiscal 2005 from \$13.3 million for the first quarter of fiscal 2004, an increase of \$2.1 million. This increase was primarily due to increased payroll and related personnel expenses of approximately \$0.5 million and amortization expense of \$1.5 million related to the fair value of the warrant issued to Avaya as part of the Joint Development Agreement. The fair value of the warrant allocated to the Joint Development Agreement with Avaya is \$17.9 million and is being amortized over a three-year period beginning November 1, 2003. Amortization expense related to this agreement is approximately \$1.5 million per fiscal quarter. We expense all research and development costs as incurred. We believe that continued investment in research and development is critical to attaining our strategic objectives.

### *General and Administrative Expenses*

General and administrative expenses consist primarily of salaries and related expenses for executive, finance and administrative personnel, professional fees and other general corporate expenses. General and administrative expenses increased to \$7.1 million for the first quarter of fiscal 2005 from \$7.0 million for the first quarter of fiscal 2004, an increase of \$0.1 million. This increase was primarily due to increases in payroll and related personnel expenses of \$0.4 million, offset by decreased depreciation expense of \$0.1 million and reductions in various other expenses. Legal expenses related to intellectual property litigation are expected to continue and may also cause general and administrative expenses to increase. We increased expenses as a result of compliance with the Sarbanes-Oxley Act of 2002, including Section 404 thereof, and expect to incur additional expenses throughout fiscal 2005 as we implement procedures to meet the requirements of this act.

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### *Amortization of Deferred Stock Compensation*

Amortization of deferred stock compensation decreased to \$0.1 million for the first quarter of fiscal 2005 from \$0.6 million for the first quarter of fiscal 2004, a decrease of \$0.5 million. Amortization of deferred stock compensation is attributable to unvested stock options subject to forfeiture issued to employees that we assumed in conjunction with acquisitions during fiscal 2001. Deferred stock compensation is amortized as charges to operations, using the graded method, over the vesting periods of the individual stock options, generally four years. Upon termination of an employee, the amount of expense recognized under the graded vesting method that is in excess of the amount actually earned is reversed. For the first quarter of fiscal 2005 and fiscal 2004, there were no reversals of excess compensation expense related to terminated employees. As of September 26, 2004, we have expensed substantially all of the deferred stock compensation associated with the acquisitions in fiscal 2001.

### *Restructuring Charge*

During the first quarter of fiscal 2004, we recorded restructuring charges of \$1.0 million related to excess facilities. The excess facilities charge represents an increase to the charge initially recognized during the third quarter of fiscal 2002. The commercial real estate market continued to deteriorate in fiscal 2004 and we were not able to find suitable tenants to sublease these facilities necessitating an additional charge due to lower projected sublease receipts. As a result of the excess facilities charges recorded in fiscal 2004, rent expense in fiscal 2005 is expected to remain approximately the same as the fiscal 2004 levels.

### *Other Income, Net*

Other income, net decreased to \$0.1 million for the first quarter of fiscal 2005 from \$2.3 million for the first quarter of fiscal 2004, a decrease of \$2.2 million. This decrease was primarily due to the proceeds from the settlement of litigation net of related expenses in the first quarter of fiscal 2004 of \$2.2 million.

### *Provision for Income Taxes*

We recorded an income tax provision of \$0.8 million and \$0.9 million for the first quarter of fiscal 2005 and the first quarter of fiscal 2004, respectively. The effective tax rates were 15% and 26% in the first fiscal quarters of 2005 and 2004, respectively, which differ from the statutory tax rate due to benefits to U.S. taxes from net operating loss carryforwards and tax credits, offset by the tax impact on income of foreign operations. We have provided a full valuation allowance for our net deferred tax assets. We initially recorded this charge during fiscal 2003 in accordance with SFAS No. 109, *Accounting for Income Taxes* ("SFAS 109"), which places greater weight on previous cumulative losses than the outlook for future profitability when determining whether deferred tax assets can be realized. Based upon our most recent three-year history of losses and relying on other guidance specified in SFAS 109, we determined that it was appropriate to establish a full valuation allowance against our deferred tax assets. This valuation allowance will be evaluated periodically and can be reversed partially or totally if business results have sufficiently improved to support realization of our deferred tax assets.

### **Critical Accounting Policies and Estimates**

Our significant accounting policies are more fully described in Note 2 of Notes to Consolidated Financial Statements included in our Form 10-K for the year ended June 27, 2004. 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. We believe the critical accounting policies stated below, among others, affect our more significant judgments and estimates used in the preparation of our consolidated financial statements.

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### *Revenue Recognition*

We derive the majority of our revenue from sales of our modular and stackable networking equipment, with the remaining revenue generated from service fees relating to the service contracts and training on our products. Our revenue recognition policy follows Securities Exchange Commission Staff (“SEC”) Accounting Bulletin No. 104, *Revenue Recognition* (“SAB 104”). 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 established by SAB 104 is not met, revenue is deferred until all criteria have been met. Our total deferred product revenue was \$2.0 million and \$3.0 million as of September 26, 2004 and June 27, 2004, respectively. Revenue from service obligations under service contracts is deferred and recognized on a straight-line basis. Our total deferred revenue for services was \$48.6 million and \$50.7 million as of September 26, 2004 and June 27, 2004, respectively. Service contracts typically range from one to five years.

When sales arrangements contain multiple deliverables such as hardware, service contracts and other services, we determine whether the deliverables represent separate units of accounting and then allocate revenue to each unit of accounting based on its relative fair value in accordance with Emerging Issues Task Force Issue No. 00-21, *Revenue Arrangements with Multiple Deliverables* (“EITF 00-21”). We recognize revenue for each unit of accounting when the revenue recognition criteria for each unit of accounting are met in accordance with SAB 104. The amount of product revenue recognized is impacted by our judgments as to whether an arrangement includes multiple units of accounting and if so, whether vendor-specific objective evidence of fair value exists for those units of accounting. The ability to establish vendor specific objective evidence for any unit of accounting could affect the timing of the revenue recognition.

We make certain sales to partners in two-tier distribution channels. 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 a monthly sales-out report 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, provide them with credits for changes in selling prices, and allow them to participate in cooperative marketing programs. We maintain estimated accruals and allowances for these exposures based upon our historical experience. If actual credits to distributors for inventory returns, 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 and are generally not granted return privileges, except for defective products during the warranty period. We reduce product revenue for certain price protection rights that may occur under contractual arrangements we have with our customers.

We provide an allowance for sales returns based on our historical returns, analysis of credit memo data and our return policies. The allowance for returns reserve was \$2.3 million and \$2.2 million as of September 26, 2004 and June 27, 2004, respectively, for estimated future returns that were recorded as a reduction of our accounts receivable. The allowance is charged to net revenues in the accompanying consolidated statements of operations. The allowance for returns reserve charged to net revenues was \$0.1 million in the first quarter of fiscal 2005 and was a benefit of \$0.5 million in the first quarter of fiscal 2004. If the historical data we use to calculate the estimated sales returns and allowances does not properly reflect future levels of product returns, these estimates are revised, thus resulting in an impact on future net revenues. We estimate and adjust this allowance at each balance sheet date.

### *Inventory Valuation*

Our inventory balance was \$23.9 million as of September 26, 2004, compared with \$25.9 million as of June 27, 2004. We value our inventory at lower of cost or market. The networking industry is characterized by rapid technological change, frequent new product introductions, changes in customer requirements and evolving industry standards. We perform a detailed assessment of inventory at each balance sheet date, which includes a review of, among other factors, demand requirements, product lifecycle and product development plans and quality issues. Based on this analysis, we record adjustments, when appropriate, to reflect inventory at net realizable value. There were no inventory write-downs charged to cost of product revenue in the first quarter of fiscal 2005 and inventory write-downs charged to cost of product revenue was \$0.3 million in the first quarter of fiscal 2004. Although we make every effort to accurately forecast product demand, any

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significant unanticipated changes in demand or technological developments would significantly impact the value of our inventory and our reported operating results. In the future, if we find that our estimates are too optimistic and we determine that our inventory needs to be written down, we will be required to recognize such costs in our cost of product revenue at the time of such determination. Conversely, if we find our estimates are too pessimistic and we subsequently sell product that has previously been written down, our operating margin in that period will be favorably impacted.

### *Accrued Warranty*

Networking products may contain undetected hardware or software errors when new products or new versions or updates of existing products are released to the marketplace. We have experienced such errors in connection with products and product upgrades. Our standard hardware warranty period is typically 12 months from the date of shipment to end-users and 14 months from the date of shipment to channel partners, which include resellers and distributors, and 90 days for software. Upon shipment of products to our customers, including both end-users and channel partners, we estimate expenses for the cost to repair or replace products that may be returned under warranty and accrue a liability for this amount.

Our accrued warranty balance was \$9.1 million as of September 26, 2004, compared with \$8.3 million as of June 27, 2004. The determination of our warranty requirements is based on our actual historical experience with the product or product family, estimates of repair and replacement costs and any product warranty problems that are identified after shipment. We estimate and adjust this accrual at each balance sheet date in accordance with changes in these factors. In the first quarter of fiscal 2005, we charged \$1.1 million to product cost of revenue related to a change in the method to accumulate the warranty return rates. The cost of new warranties issued that was charged to cost of product revenue was \$3.1 million in the first quarter of fiscal 2005 and \$1.5 million in the first quarter of fiscal 2004. While we believe that our warranty accrual is adequate and that the judgments applied in calculating this accrual are appropriate, the assumptions used are based on estimates and these estimated amounts could differ materially from our actual warranty expenses in the future. If actual expenses exceed those we have estimated, our future cost of product revenue would be adversely affected.

### *Allowance for Doubtful Accounts*

Our accounts receivable balance, net of allowance for doubtful accounts, was \$28.8 million and \$33.0 million as of September 26, 2004 and June 27, 2004, respectively. The allowance for doubtful accounts was \$1.4 million as of September 26, 2004 and June 27, 2004. We continually monitor and evaluate the collectibility of our trade receivables based on a combination of factors. We record specific allowances for bad debts in general and administrative expense when we become aware of a specific customer's inability to meet its financial obligation to us, such as in the case of bankruptcy filings or deterioration of financial position. Estimates are used in determining our allowances for all other customers based on factors such as current trends in the length of time the receivables are past due and historical collection experience. We mitigate some collection risk by requiring most of our customers in the Asia-Pacific region, excluding Japan, to pay cash in advance or secure letters of credit when placing an order with us. There was no provision for doubtful accounts charged to operations in the first quarter of fiscal 2005 and the provision for doubtful accounts charged to operations was a benefit of \$0.2 million in the first quarter of fiscal 2004. If a major customer's creditworthiness deteriorates, or if actual defaults are higher than our historical experience, or if other circumstances arise, our estimates of the recoverability of amounts due to us could be overstated, and additional allowances could be required.

### *Deferred Tax Asset Valuation Allowance*

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

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

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### *Legal Contingencies*

We are currently involved in various claims and legal proceedings, including negotiations regarding potential licenses from third parties who have notified us that they believe our products may infringe certain patents. Periodically, we review the status of each significant matter, whether litigation or licensing negotiation, and assess our potential financial exposure. If the potential loss from any claim or legal proceeding is considered probable and the amount can be estimated, we accrue a liability for the estimated loss. Because of uncertainties related to these matters, accruals, if any, are based only on the most current and dependable information available at any given time. As additional information becomes available, we may reassess the potential liability from pending claims and litigation and the probability of claims being successfully asserted against us. As a result, we may revise our estimates related to these pending claims and litigation. Such revisions in the estimates of the potential liabilities could have a material impact on our consolidated results of operations, financial position and cash flows in the future. For further detail, see Note 2 of Notes to these Condensed Consolidated Financial Statements for a description of legal proceedings.

### **Liquidity and Capital Resources**

Cash and cash equivalents, short-term investments and marketable securities increased to \$439.9 million at September 26, 2004 from \$425.7 million at June 27, 2004, an increase of \$14.2 million. This increase was primarily due to cash provided by operating activities of \$13.9 million and proceeds from issuance of common stock of \$1.4 million, partially offset by capital expenditures of \$2.2 million.

We generated \$13.9 million in cash from operations in the first quarter of fiscal 2005. Accounts receivable decreased to \$28.8 million at September 26, 2004 from \$33.0 million at June 27, 2004. Days sales outstanding (“DSO”) in receivables decreased to 28 days at September 26, 2004 from 33 days at June 27, 2004. The decrease in our accounts receivable balance, as well as the decrease in DSO, was primarily due to shipment linearity. Inventory levels decreased to \$23.9 million at September 26, 2004 from \$25.9 million at June 27, 2004. Inventory management remains an area of focus as we balance the need to maintain strategic inventory levels to ensure competitive lead times and avoid stock-outs with the risk of inventory excess or obsolescence caused by, among other things, declining demand, rapidly changing technology and customer requirements. Any significant increase in our inventory levels can be expected to reduce cash and cash equivalents, short-term investments and marketable securities.

We have a revolving line of credit for \$10.0 million with a major lending institution. Borrowings under this line of credit bear interest at the bank’s prime rate. As of September 26, 2004, 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 September 26, 2004, we had letters of credit totaling \$0.9 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 September 26, 2004. The line of credit expires on January 27, 2005. It is our intention to renew this line of credit when it expires.

As part of our business relationship with MCMS, Inc. (“MCMS”), the predecessor-in-interest to Plexus Corp., we entered into a \$9.0 million operating equipment lease for manufacturing equipment in September 2000 with a third-party financing company; we, in turn, loaned the equipment to MCMS. The equipment lease with the third-party financing company requires us to make monthly payments through September 2005 and to maintain specified financial covenants related to profitability and our cash to debt ratio with which we were in compliance as of September 26, 2004. The liability related to this lease is included in lease commitments on the balance sheet.

In December 2001, we completed a private placement of \$200.0 million of convertible subordinated notes. The notes mature on December 1, 2006. Interest is payable semi-annually at 3.5% per annum. The notes are convertible at the option of the holders into our common stock at an initial conversion price of \$20.96 per share, subject to adjustment. The notes are redeemable in cash at our option at an initial redemption price of 101.4% of the principal amount on or after December 2004 if not converted to common stock prior to the redemption date. Each holder of the notes has the right to cause us to repurchase all of such holder’s convertible notes at 100% of the principal amount plus accrued interest upon a change of control of ownership of Extreme Networks, as defined in the offering circular.

The following summarizes our contractual obligations (including interest payments) at September 26, 2004, and the effect such obligations are expected to have on our liquidity and cash flow in future periods (in thousands):

	<u>Total</u>	<u>Less Than 1 Year</u>	<u>1 – 3 Years</u>	<u>3 – 5 Years</u>	<u>After Three Years</u>
<b>Contractual Obligations:</b>					
Convertible subordinated notes	\$ 217,500	\$ 7,000	\$ 210,500	\$ —	\$ —
Non-cancelable inventory purchase commitments	18,302	18,302	—	—	—
Non-cancelable operating lease obligations	33,543	9,609	13,315	5,644	4,975
<b>Total contractual cash obligations</b>	<b>\$ 269,345</b>	<b>\$ 34,911</b>	<b>\$ 223,815</b>	<b>\$ 5,644</b>	<b>\$ 4,975</b>

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We did not have any material commitments for capital expenditures or other non-cancelable purchase commitments as of September 26, 2004. We did not have any off-balance sheet arrangements as of September 26, 2004.

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.

### **Risk Factors**

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

While we have reported profits for recent fiscal quarters, fiscal 2000 was the only year in which we have achieved profitability for the full year. We reported losses for fiscal 2004, fiscal 2003, and fiscal 2002. We anticipate continuing to incur significant sales and marketing, product development and general and administrative expenses and, as a result, we will continue to need to rationalize expense levels and increase revenue levels to maintain profitability in future fiscal quarters.

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

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

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

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

- changes in general and/or specific economic conditions in the networking industry;

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- seasonal fluctuations in demand for our products and services, particularly in Asia-Pacific and Europe;
- linearity of quarterly sales have historically reflected a pattern in which a disproportionate percentage of such sales occur in the last month of the quarter;
- reduced visibility into the implementation cycles for our products and our customers' spending plans;
- our ability to accurately forecast demand for our products, which in the case of lower-than-expected sales, may result in excess or obsolete inventory in addition to non-cancelable purchase commitments for component parts;
- product returns or the cancellation or rescheduling of orders;
- our ability to develop, introduce, ship and support new products and product enhancements and manage product transitions;
- announcements and new product introductions by our competitors;
- our ability to develop and support relationships with enterprise customers, service providers and other potential large customers;
- our ability to achieve targeted cost reductions;
- our ability to obtain sufficient supplies of sole- or limited-source components for our products on a timely basis;
- increases in the prices of the components that we purchase;
- decreases in the prices of the products that we sell;
- our ability to achieve and maintain desired production volumes and quality levels for our products;
- the mix of products sold and the mix of distribution channels through which products are sold;
- downward adjustments resulting from other-than-temporary declines in the carrying value of long-lived assets;
- costs associated with adjustments to the size of our operations;
- costs relating to possible acquisitions and the integration of technologies or businesses; and
- the effect of amortization of deferred compensation and purchased intangibles resulting from existing or new transactions.

On July 12, 2004 we hired a new Senior Vice President of Worldwide Sales. While we believe we have strengthened our executive team and the overall organization, a recent high level of attrition in our sales group could adversely affect our sales. In addition, the integration of new personnel into our sales organization, including our new Senior Vice President, will take time and the impact of their addition to Extreme Networks may not be realized in the near term.

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

### **Intense Competition in the Market for Networking Equipment Could Prevent Us from Increasing Revenue and Returning to Profitability on a Fiscal Year Basis**

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

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

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

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

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

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

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

International sales constitute a significant portion of our net revenues. Our ability to grow will depend in part on the continued expansion of international sales. Sales to customers outside of the United States accounted for approximately 58% and 62% of our net revenue, respectively, for the first quarter of fiscal 2005 and the first quarter of fiscal 2004. Our international sales primarily depend on the success of our resellers and distributors. The failure of these resellers and distributors to sell our products internationally would limit our ability to sustain and grow our revenue. There are a number of risks arising from our international business, including:

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

In addition, conducting our business on a global basis subjects us to a number of frequently changing and complex trade protection measures and import or export regulatory requirements. Our failure to comply with these measures and regulatory requirements may result in the imposition of financial penalties and restrictions on our ability to conduct business in and with certain countries, which may harm our business and damage our reputation. Pursuant to regulations of the U.S. Department of Commerce providing for voluntary disclosure, in the fourth quarter of fiscal 2002 we disclosed information regarding a possible violation of certain export regulations. Following such disclosures the Department of Commerce will determine whether to conduct an investigation. If an investigation is commenced, we believe that these matters will be resolved without a material adverse effect on our business, and we have implemented procedures to reduce the risk of violations in the future.

Our international sales currently are U.S. dollar-denominated. Recently the U.S. dollar exchange rate has fallen against foreign currencies, in particular the Euro. However, future increases in the value of the U.S. dollar relative to foreign currencies could make our products less competitive in international markets. In the future, we may elect to invoice some of

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our international customers in local currency which will expose us to fluctuations in exchange rates between the U.S. dollar and the particular local currency. If we do so, we may decide to engage in hedging transactions to minimize the risk of such fluctuations.

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

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

The network equipment industry has traditionally experienced a rapid erosion of average selling prices due to a number of factors, including competitive pricing pressures, promotional pricing and technological progress. In addition, companies have lowered their prices in order to liquidate excess inventory that has accumulated as a result of the current economic slowdown. We anticipate that the average selling prices of our products will decrease in the future in response to competitive pricing pressures, excess inventories, increased sales discounts and new product introductions by us or our competitors, including, for example, competitive products manufactured with low-cost merchant silicon. We may experience substantial decreases in future operating results due to the erosion of our average selling prices. Competitive pressures are expected to increase as a result of the industry slowdown that began in the first half of 2001, coupled with the downturn in the broader economy. To maintain our gross margin, we must develop and introduce on a timely basis new products and product enhancements and continually reduce our product costs. Our failure to do so would likely cause our revenue and gross margins to decline, which could have a material adverse effect on our operating results and cause the price of our common stock to decline.

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

At September 26, 2004, two customers, NextCom K.K. and Hitachi Cable Ltd. accounted for 21% and 11%, respectively, of our accounts receivable balance. Some of our customers are forecasting that their revenue for the foreseeable future will generally be lower than originally anticipated. Some of these customers are experiencing, or are likely to experience, serious cash flow problems and, as a result, may find it increasingly difficult to obtain financing, if financing is available at all. If our customers are not successful in generating sufficient revenue or securing alternate financing arrangements, they may not be able to pay, or may delay payment of, the amounts that they owe us. In particular, sales to the service provider market are especially volatile and continued declines or delays in sale orders from this market may harm our financial condition. Furthermore, they may not order as many products from us as originally forecast, or cancel orders with us entirely. The inability of some of our potential customers to pay us for our products may adversely affect our cash flow, the timing of our revenue recognition and the amount of revenue, which may cause our stock price to decline.

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

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

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

In particular, the networking industry has been characterized by the successive introduction of new technologies or standards that have dramatically reduced the price and increased the performance of switching equipment. To remain competitive, we

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need to introduce products in a timely manner that incorporate, or are compatible with, these emerging technologies. We are particularly dependent upon the successful introduction of new products. We cannot ensure that any new products we introduce will be commercially successful. We have experienced delays in releasing new products and product enhancements in the past that resulted in lower quarterly revenue than anticipated. We may experience similar delays in product development and releases in the future, and any delay in product introduction could adversely affect our ability to compete, causing our operating results to be below our expectations or the expectations of public market analysts or investors.

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

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

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

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

We are actively involved in disputes and licensing discussions with, and have received notices from, others regarding their claimed proprietary rights, and as the functionality and features of our products expands, these disputes and discussions could increase or become harder to resolve. The corporations with whom we have or could have disputes or discussions include corporations with extensive patent portfolios and substantial financial assets who are actively engaged in programs to generate substantial revenues from their patent portfolios, and who are seeking or may seek significant payments or royalties from us and others in our industry. We cannot ensure that we will always be able successfully to defend ourselves against such claims or conclude licensing discussions on favorable terms. If we are found to infringe the proprietary rights of others, or if we otherwise settle such claims or enter into licensing arrangement to resolve potential disputes, we could be compelled to pay damages, royalties or other payments and either obtain a license to those intellectual property rights or alter our products so that they no longer infringe upon such proprietary rights. Any license could be very expensive to obtain or may not be available at all. Similarly, changing our products or processes to avoid infringing the rights of others may be costly or impractical. Litigation resulting from claims that we are infringing the proprietary rights of others has resulted and could in the future result in substantial costs and a diversion of resources, and could have a material adverse effect on our business, financial condition and results of operations. Due to the number of companies with extensive patent portfolios in our industry who are or may be actively involved in licensing programs, we believe that even if we do not infringe any patents, we will incur significant expenses in the future due to disputes or licensing negotiations, though the amounts can not be determined. We cannot assure you that any such expenses will not be material or otherwise adversely affect our operating results.

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

We have received notice from several companies alleging that we may be infringing their patents. One of these companies, Lucent Technologies, Inc., filed a claim against us alleging patent infringement, and we are in litigation as of the date of this filing. Following examination of this claim, we believe it is without merit and we have responded accordingly. Without regard to the merits of this or any other claim, if judgments by a court of law on this or any other claim received in the future were to be upheld, or if we were otherwise to agree to the settlement of such claims, the consequences to us may be severe and could require us, among other actions to:

- stop selling our products that incorporate the challenged intellectual property;

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

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

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

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

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

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

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

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

- the demand for switching products (Gigabit Ethernet and Layer 3 switching technologies in particular) in the enterprise and service provider markets;
- the performance, price and total cost of ownership of our products;
- the availability and price of competing products and technologies;
- our ability to match supply with demand for certain products; and
- the success and development of our resellers, distributors and field sales channels.

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

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

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

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

To date, a limited number of resellers, distributors and other customers have accounted for a significant portion of our revenue. One distributor of Extreme products accounted for 11% of our net revenue for the first quarter of fiscal 2005. No customer accounted for greater than 10% of our net revenue for the first quarter of fiscal 2004. If any of our large customers stop or delay purchases, our revenue and profitability would be adversely affected.

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

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

- our service providers and enterprise customers can stop purchasing, and our resellers and distributors can stop marketing, our products at any time;
- our reseller agreements are non-exclusive and are for one-year terms, with no obligation upon the resellers to renew the agreements; and
- our reseller, distributor and end-user customer agreements generally do not require minimum purchases.

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

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

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

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

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

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

- ASICs;

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

Our principal limited-source components include:

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

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

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

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

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

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

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

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

Our ability to successfully implement our business plan and comply with regulations requires an effective planning and management process. We need to continue improving our existing, and implement new, operational and financial systems, procedures and controls. Any delay in the implementation of, or disruption in the transition to, new or enhanced systems, procedures or controls, could harm our ability to record and report financial and management information on a timely and accurate basis, or to forecast future results. In addition, rules adopted by the Securities and Exchange Commission pursuant to Section 404 of the Sarbanes-Oxley Act of 2002 require annual review and evaluation of our internal control systems, and attestation of these systems by our independent auditors. We are currently undergoing a review of our internal control systems and procedures and considering improvements that will be necessary in order for us to comply with the requirements of Section 404 by the end of fiscal 2005. This process will require us to hire additional personnel and retain outside advisory services and will result in additional accounting and legal expenses, which has and may continue to cause our operating expenses to increase.

**If We Are Unable To Favorably Assess The Effectiveness Of Our Internal Control Over Financial Reporting, or If Our Independent Auditors Are Unable To Provide An Unqualified Attestation Report On Our Assessment, Our Stock Price Could Be Adversely Affected.**

Pursuant to Section 404 of the Sarbanes-Oxley Act of 2002 and beginning with our Annual Report on Form 10-K for the fiscal year ending July 3, 2005, our management will be required to report on, and our independent auditors to attest to, the effectiveness of our internal control over financial reporting as of the end of fiscal 2005. The rules governing the standards that must be met for management to assess our internal control over financial reporting are new and complex, and require significant documentation, testing and possible remediation. While we are in the process of reviewing, documenting and testing our internal control over financial reporting, we may encounter problems or delays in completing the implementation of any changes necessary to make a favorable assessment of our internal control over financial reporting. In addition, in connection with the attestation process by our independent auditors, we may encounter problems or delays in completing the implementation of any requested improvements and receiving a favorable attestation. If we cannot favorably assess the effectiveness of our internal control over financial reporting, or if our independent auditors are unable to provide an unqualified attestation report on our assessment, investor confidence and our stock price could be adversely affected.

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

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

In particular, if we are required to record stock option grants as compensation expense on our income statement, our profitability may be reduced significantly. The current methodology for expensing such stock options is based on, among other things, the historical volatility of the underlying stock. Our stock price has been historically volatile. Therefore, the adoption of an accounting standard requiring companies to expense stock options would negatively impact our profitability and may adversely impact our stock price. In addition, the adoption of such a standard could limit our ability to continue to use stock options as an incentive and retention tool, which could, in turn, hurt our ability to recruit employees and retain existing employees.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

In addition, terrorist acts or acts of war targeted at the United States, and specifically Silicon Valley, could cause damage or disruption to us, our employees, facilities, partners, suppliers, distributors and resellers, and customers, which could have a material adverse effect on our operations and financial results.

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

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

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

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

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

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

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

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

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

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

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

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

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

- difficulties in the assimilation of acquired operations, technologies and/or products;
- unanticipated costs associated with the acquisition or investment transaction;
- the diversion of management's attention from other business concerns;
- adverse effects on existing business relationships with suppliers and customers;
- risks associated with entering markets in which we have no or limited prior experience;
- the potential loss of key employees of acquired organizations; and
- substantial charges for the amortization of certain purchased intangible assets, deferred stock compensation or similar items.

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

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

We believe that our existing working capital and cash available from credit facilities and future operations, will enable us to meet our working capital requirements for at least the next 12 months. However, if cash from future operations is insufficient, or if cash is used for acquisitions or other currently unanticipated uses, we may need additional capital. The development and marketing of new products and the expansion of reseller and distribution channels and associated support personnel requires a significant commitment of resources. In addition, if the markets for our products develop more slowly than anticipated, or if we fail to establish significant market share and achieve sufficient net revenues, we may continue to consume significant amounts of capital. As a result, we could be required to raise additional capital. To the extent that we raise additional capital

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through the sale of equity or convertible debt securities, the issuance of such securities could result in dilution of the shares held by existing stockholders. If additional funds are raised through the issuance of debt securities, such securities may provide the holders certain rights, preferences, and privileges senior to those of common stockholders, and the terms of such debt could impose restrictions on our operations. We cannot assure you that additional capital, if required, will be available on acceptable terms, or at all. If we are unable to obtain sufficient amounts of additional capital, we may be required to reduce the scope of our planned product development and marketing efforts, which could harm our business, financial condition and operating results.

### **We Have Substantial Debt Obligations**

In connection with the sale of convertible subordinated notes in December 2001, we incurred \$200 million of indebtedness. We will require substantial amounts of cash to fund scheduled payments of interest on the convertible notes, payment of the principal amount of the convertible notes, future capital expenditures, payments on our leases and any increased working capital requirements. If we are unable to meet our cash requirements out of cash flow from operations, there can be no assurance that we will be able to obtain alternative financing. The degree to which we are financially leveraged could materially and adversely affect our ability to obtain financing for working capital, acquisitions or other purposes and could make us more vulnerable to industry downturns and competitive pressures. In the absence of such financing, our ability to respond to changing business and economic conditions, to make future acquisitions, to absorb adverse operating results or to fund capital expenditures or increased working capital requirements would be significantly reduced. Our ability to meet our debt service obligations will be dependent upon our future performance, which will be subject to financial, business and other factors affecting our operations, some of which are beyond our control. If we do not generate sufficient cash flow from operations to repay the notes at maturity, we could attempt to refinance the notes; however, no assurance can be given that such a refinancing would be available on terms acceptable to us, if at all. Any failure by us to satisfy our obligations with respect to the notes at maturity (with respect to payments of principal) or prior thereto (with respect to payments of interest or required repurchases) would constitute a default under the indenture and could cause a default under agreements governing our other indebtedness.

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

We have certain long-term real estate lease commitments carrying future obligations for non-cancelable lease payments. Reductions in our workforce and the restructuring of operations since fiscal 2002 have resulted in the need to consolidate certain of these leased facilities, located primarily in Northern California, for which we recorded excess facilities charges of approximately \$6.5 million in fiscal 2004, \$9.6 million in fiscal 2003 and \$25.4 million in fiscal 2002. For more information, see Note 6 of Notes to these Condensed Consolidated Financial Statements. We continue to attempt to sublease certain of these facilities and have estimated the amount of sublease income to offset the carrying costs of these facilities when establishing our excess facilities charges. However, we may not be able to sublease these facilities at the times or on the terms we anticipated when we took the excess facilities charge and therefore if the market does not improve, we may incur additional charges in the future. In addition, we may incur additional charges for excess facilities as a result of additional reductions in our workforce or future restructuring of operations. We will continue to be responsible for all carrying costs of these facilities until such time as we can sublease these facilities or terminate the applicable leases based on the contractual terms of the lease agreements, and these costs may have an adverse effect on our business, operating results and financial condition.

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

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

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

**Securities We Issue to Fund Our Operations Could Dilute Your Ownership**

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

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

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

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

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

*Interest Rate Sensitivity*

The primary objective of our investment activities is to preserve principal while at the same time maximize the income we receive from our investments without significantly increasing risk. Some of the securities that we have invested in may be subject to market risk. This means that a change in prevailing interest rates may cause the principal amount of the investment to fluctuate. For example, if we hold a security that was issued with a fixed interest rate at the then-prevailing rate and the prevailing interest rate later rises, the principal amount of our investment will probably decline. To minimize this risk, we maintain our portfolio of cash equivalents and short-term investments in a variety of securities, including commercial paper, other non-government debt securities and money market funds. In general, money market funds are not subject to market risk because the interest paid on such funds fluctuates with the prevailing interest rate. The following table presents the amounts of our cash equivalents, short-term investments and marketable securities that are subject to market risk by range of expected maturity and weighted-average interest rates as of September 26, 2004. This table does not include money market funds because those funds are not subject to market risk.

	Maturing in			Total	Fair Value
	Three months or less	Three months to one year	Greater than one year		
Included in cash and cash equivalents	\$ 11,711			\$ 11,711	\$ 11,711
Weighted average interest rate	1.57%				
Included in short-term investments	\$64,735	\$ 81,726		\$ 146,461	\$ 146,461
Weighted average interest rate	1.93%	2.68%			
Included in marketable securities			\$ 227,078	\$227,078	\$227,078
Weighted average interest rate			2.45%		
Long-term debt			\$ 200,000	\$200,000	\$194,998
Average fixed rate			3.50%		

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### *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 have conducted some transactions in foreign currencies during the first quarter of fiscal 2005 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 September 26, 2004, these forward foreign currency contracts had a notional principal amount of \$5.9 million (fair value of \$1,000). 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 September 26, 2004, we held foreign currency forward contracts with a notional principal amount of \$4.0 million (fair value of \$38,000). These contracts have maturities of less than 45 days. Changes in the fair value of these foreign exchange forward contracts are offset largely by remeasurement of the underlying assets and liabilities.

We do not enter into foreign exchange forward contracts for speculative or trading purposes. Foreign currency transaction gains from operations, including the impact of hedging, were \$0.1 million for the first quarter of fiscal 2005 and the first quarter of fiscal 2004.

### Item 4. Controls and Procedures

Under the supervision and with the participation of our management, including our chief executive officer and chief financial officer, we evaluated the effectiveness of our disclosure controls and procedures, as such term is defined in Rule 13a-15(e) promulgated under the Securities Exchange Act of 1934, as amended. Based on this evaluation, our chief executive officer and chief financial officer concluded that our disclosure controls and procedures were effective as of the end of the period covered by this quarterly report in providing reasonable assurance that information required to be disclosed by Extreme Networks in reports that it files under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in Securities and Exchange Commission rules and forms.

As required by Section 404 of the Sarbanes Oxley Act of 2002, we continue to test and evaluate our internal control procedures to determine whether our controls are designed and operating effectively. The requirements of Section 404 have caused most public companies to substantially increase the documentation of internal controls and to implement additional controls. As a result of our testing and evaluation performed to date, we have noted that improvements could be made in the design or operation of our internal control structure. We believe adequate compensating controls exist in these areas; however, we are developing plans to implement improvements or additional control procedures. We have disclosed these matters to the audit committee of our board of directors and to our independent auditors. There were no significant changes to our internal controls during our last fiscal quarter that materially affected, or are reasonably likely to materially affect, our internal controls over financial reporting.

## **PART II. Other Information**

### Item 1. Legal Proceedings

On May 27, 2003, Lucent filed suit against Extreme Networks and Foundry Networks, Inc. ("Foundry") in the United States District Court for the District of Delaware, Civil Action No. 03-508. The complaint alleges willful infringement of U.S. Patent Nos. 4,769,810, 4,769,811, 4,914,650, 4,922,486 and 5,245,607 and seeks a judgment: (a) determining that we have willfully infringed each of the five patents; (b) determining that Foundry has willfully infringed four of the five patents; (c) permanently enjoining us from infringement, inducement of infringement and contributory infringement of each of the five patents; (d) permanently enjoining Foundry from infringement, inducement of infringement and contributory infringement of four of the five patents; and (e) awarding Lucent unspecified amounts of trebled damages, together with expenses, costs and attorneys' fees.

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We intend vigorously to defend against Lucent's allegations. We answered Lucent's complaint on July 16, 2003, denying infringement and asserting various affirmative defenses and counterclaims that seek judgment: (a) that Lucent's complaint be dismissed and Lucent be denied all requested relief; (b) declaring that we do not infringe, induce infringement or contribute to the infringement of any valid and enforceable claim of the five patents, (c) that each of the five patents be declared invalid; (d) finding the case exceptional within the definition of 35 U.S.C. § 285; and (e) that Lucent pay our attorneys' fees and costs.

The court has served the cases against Extreme Networks and Foundry. Discovery is proceeding. A claim construction hearing has been set for November 17, 2004. A pre-trial conference is set for January 14, 2005. No trial date has been set.

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

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

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

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

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

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds – None

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Item 3. Defaults Upon Senior Securities – None

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

Item 5. Other Information – None

Item 6. Exhibits

- a) Exhibits:
  - 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

**SIGNATURES**

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

EXTREME NETWORKS, INC.  
(Registrant)

/S/ WILLIAM R. SLAKEY

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**WILLIAM R. SLAKEY**  
Senior Vice President and Chief Financial Officer

November 4, 2004

SECTION 302 CERTIFICATION OF GORDON L. STITT  
AS CHIEF EXECUTIVE OFFICER

I, Gordon L. Stitt, certify that:

1. I have reviewed this Form 10-Q of Extreme Networks, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the registrant and have:
  - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - (b) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - (c) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent function):
  - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Dated: November 4, 2004

/s/ GORDON L. STITT

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Gordon L. Stitt  
Chief Executive Officer

SECTION 302 CERTIFICATION OF WILLIAM R. SLAKEY  
AS CHIEF FINANCIAL OFFICER

I, William R. Slakey, certify that:

1. I have reviewed this Form 10-Q of Extreme Networks, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the registrant and have:
  - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - (b) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - (c) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent function):
  - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Dated: November 4, 2004

/s/ WILLIAM R. SLAKEY

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William R. Slakey  
Chief Financial Officer

CERTIFICATION OF GORDON L. STITT AS CHIEF EXECUTIVE OFFICER, PURSUANT TO  
18 U.S.C. SECTION 1350,  
AS ADOPTED PURSUANT TO  
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

In connection with the Quarterly Report of Extreme Networks, Inc. (the "Company") on Form 10-Q for the period ended September 26, 2004, as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Gordon L. Stitt, Chief Executive Officer of the Company, certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that:

- (1) The Report fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78m or 78o(d)); and
- (2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

/s/ GORDON L. STITT

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Gordon L. Stitt  
Chief Executive Officer  
November 4, 2004

CERTIFICATION OF WILLIAM R. SLAKEY AS CHIEF FINANCIAL OFFICER, PURSUANT TO  
18 U.S.C. SECTION 1350,  
AS ADOPTED PURSUANT TO  
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

In connection with the Quarterly Report of Extreme Networks, Inc. (the "Company") on Form 10-Q for the period ended September 26, 2004, as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, William R. Slakey, Chief Financial Officer of the Company, certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that:

- (1) The Report fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78m or 78o(d)); and
- (2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

/s/ WILLIAM R. SLAKEY

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William R. Slakey  
Chief Financial Officer  
November 4, 2004