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

Form 10-Q

(Mark One)

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

For the quarter ended September 30, 2001 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 0-25711

EXTREME NETWORKS, INC.
(Exact name of Registrant as specified in its charter)

| DELAWARE | 77-0430270 |
|---|---|
| [State of other jurisdiction of incorporation or organization] | [I.R.S. Employer Identification No.] |

| 3585 Monroe Street<br>Santa Clara. California | 95051 |
|---|---|
| [Address of principal executive offices] | [Zip Code] |

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

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes X No

The number of shares of the Registrant's Common Stock, $.001 par value, outstanding at November 1, 2001 was 114,173,331

EXTREME NETWORKS, INC.
FORM 10-Q
QUARTERLY PERIOD ENDED SEPTEMBER 30, 2001

INDEX

Part I. Financial Information
Item 1. Financial Statements

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

| | September 30, 2001 (Unaudited) | June 30, 2001 (Note 1) |
|---|---|---|
| **Assets** | | |
| Current assets: | | |
| Cash and cash equivalents | $ 123,334 | $ 87,722 |
| Short-term investments | 36,931 | 69,374 |
| Accounts receivable, net | 52,077 | 63,211 |
| Inventories | 51,584 | 60,529 |
| Deferred taxes | 25,883 | 35,855 |
| Other current assets | 414 | 2,235 |
| Total current assets | 290,223 | 318,926 |
| Property and equipment, net | 57,966 | 57,251 |
| Restricted investments | 80,000 | 80,000 |
| Investments | 45,145 | 34,406 |
| Goodwill and purchased intangible assets, net | 102,034 | 113,886 |
| Deferred taxes | 69,857 | 40,028 |
| Other assets | 6,243 | 12,025 |
| | $ 651,468 | $ 656,522 |
| **Liabilities and stockholders' equity** | | |
| Current liabilities: | | |
| Accounts payable | $ 50,230 | $ 35,890 |
| Accrued compensation and benefits | 11,526 | 13,309 |
| Accrued purchase commitments | 9,500 | 9,926 |
| Deferred revenue | 30,860 | 25,537 |
| Other accrued liabilities | 28,530 | 22,832 |
| Total current liabilities | 130,646 | 107,494 |
| Long-term deposit | 266 | 266 |
| Commitments and contingencies (Note 4) | | |
| Stockholders' equity: | | |
| Common stock and capital in excess of par value | 644,735 | 640,655 |
| Deferred stock compensation | (17,478) | (20,351) |
| Accumulated other comprehensive income | 1,618 | 769 |
| Accumulated deficit | (108,319) | (72,311) |
| Total stockholders' equity | 520,556 | 548,762 |
| | $ 651,468 | $ 656,522 |

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 30, | |
|---|---|---|
| | 2001 | 2000 |
| Net revenue | $ 108,289 | $ 119,342 |
| Cost and expenses: | | |
| Cost of revenue | 83,312 | 58,090 |
| Research and development | 16,411 | 11,743 |
| Sales and marketing | 36,985 | 35,115 |
| General and administrative | 8,113 | 4,279 |
| Amortization of goodwill, purchased intangible assets and deferred stock compensation | 14,726 | 6,850 |
| Total costs and expenses | 159,547 | 116,077 |
| Operating income (loss) | (51,258) | 3,265 |
| Loss on investments | (6,000) | - |
| Other income, net | 2,422 | 3,709 |
| Income (loss) before income taxes | (54,836) | 6,974 |
| Provision (benefit) for income taxes | (18,828) | 2,441 |
| Net income (loss) | $ (36,008) | $ 4,533 |
| Net income (loss) per share - basic | $ (0.32) | $ 0.04 |
| Net income (loss) per share - diluted | $ (0.32) | $ 0.04 |
| Shares used in per share calculation - basic | 111,953 | 105,990 |
| Shares used in per share calculation - diluted | 111,953 | 118,892 |

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 30, 2001 | Three Months Ended September 30, 2000 |
|---|---|---|
| Operating activities: | | |
| Net income (loss) | $ (36,008) | $ 4,533 |
| Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities: | | |
| Depreciation | 7,747 | 2,984 |
| Amortization of goodwill and purchased intangible assets | 11,852 | 6,955 |
| Provision for doubtful accounts | 2,700 | - |
| Provision for inventory reserves | 5,000 | - |
| Deferred income taxes | (19,857) | - |
| Amortization of deferred stock compensation | 2,873 | 21 |
| Equity share of affiliate losses and write-down of investments | 6,000 | 750 |
| Compensation expense for options granted to consultants | 210 | 210 |
| Changes in operating assets and liabilities: | | |
| Accounts receivable | 8,434 | (13,190) |
| Inventories | 3,945 | (35,427) |
| Other current and noncurrent assets | 1,604 | 525 |
| Accounts payable | 14,340 | (5,961) |
| Accrued compensation and benefits | (1,783) | (765) |
| Accrued purchase commitments | (426) | - |
| Deferred revenue | 5,323 | 4,092 |
| Other accrued liabilities | 5,698 | 1,845 |
| Net cash provided by (used in) operating activities | 17,652 | (33,428) |
| Investing activities: | | |
| Capital expenditures | (8,462) | (13,819) |
| Purchases and maturities of investments, net | 22,558 | (11,418) |
| Minority investments | - | (3,000) |
| Net cash provided by (used in) investing activities | 14,096 | (28,237) |
| Financing activities: | | |
| Proceeds from issuance of common stock | 3,864 | 8,450 |
| Net cash provided by financing activities | 3,864 | 8,450 |
| Net increase (decrease) in cash and cash equivalents | 35,612 | (53,215) |
| Cash and cash equivalents at beginning of period | 87,722 | 116,721 |
| Cash and cash equivalents at end of period | $ 123,334 | $ 63,506 |

See accompanying notes to the unaudited condensed consolidated financial statements.

## 1. BASIS OF PRESENTATION

The accompanying unaudited condensed consolidated financial statements have been prepared by Extreme Networks, Inc., pursuant to the rules and regulations of the Securities and Exchange Commission and include the accounts of Extreme Networks, Inc. and its wholly-owned subsidiaries ("Extreme" or collectively, the "Company"). 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. In the opinion of the Company, the unaudited financial statements reflect all adjustments, consisting only of normal recurring accruals, necessary for a fair presentation of the financial position at September 30, 2001 and the operating results and cash flows for the three months ended September 30, 2001 and September 30, 2000. The condensed balance sheet at June 30, 2001 has been derived from audited financial statements as of that date but does not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. These financial statements and notes should be read in conjunction with the Company's audited consolidated financial statements and notes thereto for the year ended June 30, 2001, included in the Company's Form 10-K filed with the Securities and Exchange Commission.

The results of operations for the three months ended September 30, 2001 are not necessarily indicative of the results that may be expected for the future quarters or the fiscal year ending June 30, 2002. Certain items previously reported in specific financial statement captions have been reclassified to conform to the 2002 presentation. Such reclassifications have not impacted previously reported operating income (loss) or net income (loss) amounts.

## 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

### Nature of Operations

Extreme was incorporated in California on May 8, 1996 and was reincorporated in Delaware on March 31, 1999. Extreme is a leading provider of network infrastructure equipment for business applications and services.

### Fiscal Year

The Company's fiscal year is a 52/53-week fiscal accounting year. Fiscal 2002 and 2001 are 52-week fiscal years. The September 30, 2001 quarter closed on September 30, 2001 and comprised 13 weeks of revenue and expense activity. All references herein to "fiscal 2001" or "2001" represent the year ended July 1, 2001.

### Principles of Consolidation

The consolidated financial statements include the accounts of Extreme and its wholly-owned subsidiaries. All significant inter-company balances and transactions have been eliminated. Investments in which management intends to maintain more than a temporary 20% to 50% interest, or otherwise has the ability to exercise significant influence, are accounted for under the equity method. Investments in which we have less than a 20% interest and/or do not have the ability to exercise significant influence are carried at the lower of cost or estimated realizable value.

Assets and liabilities of foreign operations are translated to U.S. dollars at current rates of exchange, and revenues and expenses are translated using weighted average rates. Foreign currency transaction gains and losses have not been significant. Gains and losses from foreign currency translation are included as a separate component of other comprehensive income (loss).

Accounting Estimates

The preparation of financial statements and related disclosures in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Estimates are used for, but are not limited to, the accounting for the allowance for doubtful accounts, inventory reserves, depreciation and amortization, sales returns, warranty costs and income taxes. Actual results could differ materially from these estimates.

Accounting Reclassification

Effective September 30, 2001, Extreme no longer reports deferred revenue associated with inventory at distributors in its deferred revenue account or accounts receivable account in its condensed consolidated balance sheet. Deferred revenue and accounts receivable balances for all previous periods have been reclassified to conform to the current year presentation. The reclassification made to the balance sheet at June 30, 2001, was a decrease in accounts receivable of $12.5 million, a decrease in other current assets of $19.3 million and a decrease in deferred revenue of $31.8 million. This reclassification had no impact on working capital or results of operations.

Cash Equivalents and Short-Term and Long Term Investments

Extreme considers cash and all highly liquid investment securities purchased with an original or remaining maturity of less than three months at date of purchase to be cash equivalents. Extreme's investments comprise U.S., state and municipal government obligations and corporate securities. Investments with maturities of less than one year are considered short term and investments with maturities greater than one year are considered long term.

To date, all marketable securities have been classified as available-for-sale and are carried at fair value, with unrealized gains and losses, when material, reported net-of-tax as a separate component of stockholders' equity. Realized gains and losses on available-for-sale securities are included in interest income. The cost of securities sold is based on specific identification. Premiums and discounts are amortized over the period from acquisition to maturity and are included in investment income, along with interest and dividends.

Extreme also has certain other minority investments in privately held companies. These investments are included in other long term assets on our balance sheet and are generally carried at cost. We monitor these investments for other than temporary impairment and make appropriate reductions in carrying values when necessary. Extreme recorded write-downs of $6.0 million related to impairments of its privately held investments for the three months ended September 30, 2001. A total of $3.9 million of carrying value remained as of September 30, 2001. Extreme did not record any write-downs of its privately held investments for the three months ended September 30, 2000.

Fair Value of Financial Instruments

The carrying amounts of certain of Extreme's financial instruments, including cash and equivalents, approximate fair value because of their short maturities. The fair values of investments are determined using quoted market prices for those securities or similar financial instruments.

Derivatives

Extreme adopted Statement of Financial Accounting Standards ("SFAS") No. 133, "Accounting for Derivative Instruments and Hedging Activities" ("FAS 133") for the year ending June 30, 2001. We enter into foreign exchange forward contracts to offset the impact of currency fluctuations on certain nonfunctional operating expenses, denominated in Japanese Yen, the Euro, Swedish Krona and the British pound. The foreign exchange forward contracts we enter into have original maturities ranging from one to three months. We do not enter into foreign exchange forward contracts for trading purposes. See Note 5.

Inventories

Inventories consist of raw materials and finished goods and are stated at the lower of cost or market (on a first-in, first-out basis).

Inventories consist of (in thousands):

| | September 30, 2001 | June 30, 2001 |
|---|---|---|
| Raw materials | $ 14,229 | $ 20,671 |
| Finished goods | 37,355 | 39,858 |
| Total | $ 51,584 | $ 60,529 |

Restricted Investments

Extreme restricted $80.0 million of its investment securities as collateral for specified obligations of Extreme, as the lessee, under two operating leases for its campus facility. These investment securities are restricted as to the terms of withdrawal and are managed by a third party subject to certain limitations under our investment policy. (See Note 4)

Concentration of Credit Risk, Product and Significant Customers and Supplier Information

Extreme may be subject to concentration of credit risk as a result of certain financial instruments consisting principally of marketable investments and accounts receivable. Extreme has placed its investments with high-credit quality issuers. Extreme will not invest an amount exceeding 10% of the corporation's combined cash, cash equivalents, short-term and long-term investments, in the securities of any one obligor or maker, except for obligations of the United States, obligations of United States agencies and money market accounts. Extreme performs ongoing credit evaluations of its customers and generally does not require collateral. Two customers accounted for 18% and 11% of our revenue for the three months ended September 30, 2001 and one customer accounted for 13% of our revenue for the three months ended September 30, 2000.

One supplier currently manufacturers all of Extreme's ASICs which are used in all of Extreme's networking products. Any interruption or delay in the supply of any of these components, or the inability to procure these components from alternate sources at acceptable prices and within a reasonable time, would materially adversely affect Extreme's business, operating results and financial condition. In addition, qualifying additional suppliers can be time-consuming and expensive and may increase the likelihood of errors. Extreme attempts to mitigate these risks by working closely with its ASIC supplier regarding production planning and product introduction timing.

Extreme currently derives substantially all of its revenue from sales of our Summit, BlackDiamond and Alpine products. Extreme expects that revenue from these products will account for a substantial portion of our revenue for the foreseeable future. Accordingly, widespread market acceptance of Extreme's products is critical to our future success.

Goodwill and Purchased Intangible Assets

We record goodwill when the cost of net assets we acquire exceeds their fair value. Goodwill is amortized on a straight-line basis over lives ranging from 2 to 5 years. The cost of identified intangible assets is generally amortized on a straight-line basis over periods ranging from 2 to 5 years. Goodwill and purchased intangible assets consists of the following (in thousands):

| | September 30, 2001 | June 30, 2001 |
|---|---|---|
| Goodwill | $ 143,325 | $ 143,325 |

| | | |
|---|---|---|
| Purchased intangible assets | 11,158 | 11,158 |
| | 154,483 | 154,483 |
| Less: accumulated amortization | (52,449) | (40,597) |
| | $ 102,034 | $ 113,886 |

Income Taxes

Income tax expense (benefit) is based on pre-tax financial accounting income (loss). Deferred tax assets and liabilities are recognized for the expected tax consequences of temporary differences between the tax bases of assets and liabilities and their reported amounts.

Valuation of Long-Lived Assets, Certain Identifiable Intangibles and Goodwill

In accordance with SFAS No. 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed of," we regularly perform reviews of the carrying value of long-lived assets and certain identifiable intangibles for impairment. The reviews look for the existence of facts or circumstances, either internal or external, which indicate that the carrying value of the asset cannot be recovered. No such impairment has been indicated to date. If, in the future, management determines the existence of impairment indicators, we would use undiscounted cash flows to initially determine whether impairment should be recognized. If necessary, we would perform a subsequent calculation to measure the amount of the impairment loss based on the excess of the carrying value over the fair value of the impaired assets. If quoted market prices for the assets are not available, the fair value would be calculated using the present value of estimated expected future cash flows. The cash flow calculations would be based on management's best estimates, using appropriate assumptions and projections at the time.

Revenue Recognition

Extreme generally recognizes product revenue at the time of shipment, assuming that collectibility is probable, unless we have future obligations such as installation or are required to obtain customer acceptance. When significant obligations remain after products are delivered, revenue and related costs are deferred until such obligations are fulfilled. Amounts billed in excess of revenue recognized are included as deferred revenue and accounts receivable in the accompanying consolidated balance sheets. Revenue from service obligations under maintenance contracts, is deferred and recognized on a straight-line basis over the contractual period, which is typically 12 months.

Extreme makes certain sales to partners in two-tier distribution channels. The first tier consists of a limited number of third-party distributors that sell primarily to resellers and on occasion to end-user customers. Distributors are generally given privileges to return a portion of inventory. Under specified conditions, we grant the right to distributors to return unsold products to us. The distributors are contractually limited in terms of the value of products that can be returned to Extreme (up to 15% of net purchases in the immediately preceding calendar quarter to be credited against future purchases). We defer recognition of revenue on sales to distributors until the distributors sell the product. Extreme no longer reports deferred revenue associated with inventory at distributors in its deferred revenue account or accounts receivable account in its condensed consolidated balance sheet. Deferred revenue and accounts receivable balances for all previous periods have been reclassified to conform to the current year presentation. 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. Extreme generally records revenue to resellers upon shipment net of returns allowances based on its experience.

Warranty Reserves

Extreme's hardware warranty period is typically 12 months from the date of shipment to the end user. Upon shipment of products to its customers, Extreme estimates expenses for the cost to repair or replace products that may be returned under warranty and accrues the amount as revenue is recognized.

Advertising

Cooperative advertising obligations are accrued and the costs expensed at the same time the related revenue is recognized. All other advertising costs are expensed as incurred. Advertising expenses for the quarters ended September 30, 2001 and September 30, 2000 were approximately $2.0 million and $2.2 million, respectively.

Net Income (Loss) Per Share

Basic earnings (loss) per share is calculated by dividing net income (loss) by the weighted average number of common shares outstanding during the period, less shares subject to repurchase, and excludes any dilutive effects of options, warrants and convertible securities. Dilutive earnings per common share is calculated by dividing net income (loss) by the weighted average number of common shares used in the basic earnings per common share calculation plus the dilutive effect of options, warrants and convertible securities. Diluted net loss per share is the same as basic net loss per share for the three months ended September 30, 2001 because Extreme had a net loss for this period. Had Extreme been profitable during this period, diluted earnings per share would have been impacted by the calculated effect of outstanding stock options of 4,701,000.

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

| | Three Months Ended September 30, | |
|---|---|---|
| | 2001 | 2000 |
| Net income (loss) | $ (36,008) | $ 4,533 |
| Weighted-average shares of common stock outstanding | 113,714 | 107,151 |
| Less: Weighted-average shares subject to repurchase | (1,761) | (1,161) |
| Weighted-average shares used in per share calculation - basic | 111,953 | 105,990 |
| Incremental shares using the treasury stock method | - | 12,902 |
| Weighted-average shares used in per share calculation - diluted | 111,953 | 118,892 |
| Net income (loss) per share - basic | $ (0.32) | $ 0.04 |
| Net income (loss) per share - diluted | $ (0.32) | $ 0.04 |

Recently Issued Accounting Standards

In September 2000, the Financial Accounting Standards Board issued SFAS No. 140, "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities - a replacement of FASB Statement No. 125" ("FAS 140"). SFAS 140 revises certain standards for accounting for securitization and other transfers of financial assets and collateral. In addition, FAS 140 requires certain additional disclosures that were not previously required. The additional disclosure requirements were effective for financial statements for fiscal years ending after December 15, 2000 and have been adopted for the year ended June 30, 2001. The revised accounting standards of FAS 140 are effective for transactions occurring after March 31, 2001. The application of the revised accounting standards of FAS 140 has not had a material impact on the business, results of operations or financial condition of Extreme.

In July 2001, the FASB issued Statement of Financial Accounting Standards ("SFAS") No. 141, "Business Combinations" ("FAS 141"). FAS 141 establishes new standards for accounting and reporting for business combinations and requires that the purchase method of accounting be used for all business combinations initiated after June 30, 2001. We adopted this statement effective July 2001. The adoption of FAS 141 had no impact on our financial position or results of operations.

In July 2001, the FASB issued SFAS No. 142, "Goodwill and Other Intangible Assets" ("FAS 142"), which establishes new standards for goodwill and other intangible assets. Under the new rules, goodwill and indefinite lived intangible assets are no longer amortized but are reviewed annually for impairment. Separable intangible assets that are not deemed to have an indefinite life will continue to be amortized over their useful lives. The amortization provisions of FAS 142 apply to goodwill and intangible assets acquired after June 30, 2001. With respect to goodwill and intangible assets acquired prior to July 1, 2001, the Company will apply the new accounting rules beginning fiscal year 2003. We are currently assessing the financial impact FAS 142 will have on our Consolidated Financial Statements. Goodwill and intangible assets from business combinations before July 1, 2001 will continue to be amortized prior to the adoption of FAS 142. Upon the adoption of FAS 142, we are required to evaluate our existing goodwill and intangible assets from business combinations completed before July 1, 2001 and make any necessary reclassifications in order to comply with the new criteria in FAS 141 for recognition of intangible assets. Application of the nonamortization provisions of FAS 142 will eliminate approximately $23.2 million in amortization of goodwill and intangibles with indefinite lives for fiscal 2003.

In October 2001, the FASB issued the Statement of Financial Accounting Standards No. 144 "Accounting for the Impairment or Disposal of Long-Lived Assets" ("FAS 144"). FAS 144 addresses financial accounting and reporting for the disposal of long-lived assets. FAS 144 becomes effective for financial statements issued for fiscal years beginning after December 15, 2001 and interim periods within those fiscal years. Extreme is currently evaluating the potential impact, if any, the adoption of FAS 144 will have its financial position and results of operation.

## 3. BUSINESS COMBINATIONS AND INVESTMENTS

### Acquisitions in Fiscal Year 2001

During fiscal year 2001, Extreme acquired privately-held Optranet, Inc. ("Optranet"), a developer of broadband access equipment in which Extreme previously held a minority interest. In addition, a related party of Extreme was a significant investor of Optranet at the time of Extreme's initial investment. Also during fiscal year 2001, Extreme acquired privately-held Webstacks, Inc. ("Webstacks"), a developer of broadband access equipment in which Extreme previously held a minority interest. In addition, a related party of Extreme was a significant investor of Webstacks at the time of Extreme's initial investment. In connection with these acquisitions, Extreme acquired all outstanding stock and assumed all outstanding stock options of the respective acquirees. All acquisitions were accounted for as purchase business combinations. Accordingly, the results of operations of the acquired companies have been included with those of Extreme for periods subsequent to the respective dates of acquisition. The fair value of the intangible assets was determined based upon a valuation using a combination of methods, including an income approach for the technology and a cost approach for the assembled workforce.

The value of the acquired in-process technology for the acquired companies was computed using a discounted cash flow analysis rate of 30% on the anticipated income stream of the related product revenue. The discounted cash flow analysis was based on management's forecast of future revenue, cost of revenue and operating expenses related to the products and technologies purchased from these companies. The calculation of value was then adjusted to reflect only the value creation efforts of these companies prior to the close of the acquisition. The acquired intangible assets and goodwill are being amortized using the straight-line method over their estimated useful lives of five years. Amortization of acquired intangibles and goodwill associated with the acquisitions of Optranet and Webstacks totaled $2.1 million and $2.7 million, respectively, for the three months ended September 30, 2001. Extreme recognized deferred stock compensation associated with unvested stock options issued to employees that were assumed in conjunction with these acquisitions. This amount is included as a component of stockholders' equity and is being amortized ratably by charges to operations over the vesting period of the options. Amortization of stock-based compensation associated with the acquisitions of Optranet and Webstacks totaled $2.6 million and $0.3 million, respectively, for the three months ended September 30, 2001 and relates to options awarded to employees in research and development.

The following table presents the purchase price allocation of these acquisitions during fiscal year 2001 (in millions):

| | Optranet | Webstacks |
|---|---|---|
| In-process research and development | $ 13.4 | $ 16.8 |
| Assembled workforce | 1.5 | 0.9 |
| Deferred compensation | 21.9 | 2.5 |
| Net fair value of tangible assets acquired and liabilities assumed | 2.6 | 1.4 |
| Deferred tax liabilities | (7.4) | -- |
| Excess of cost over fair value of net assets acquired | 41.2 | 53.1 |
| Purchase price | $ 73.2 | $ 74.7 |
| Acquisition date | January 2001 | March 2001 |
| Shares of Company stock issued | 1.4 | 2.9 |
| Employee stock options assumed | 0.6 | 0.1 |
| Total shares of Company stock issued and assumed | 2.0 | 3.0 |
| Cash received in the acquisition | $ 1.6 | $ 0.7 |

Pursuant to the terms of the merger agreement with Webstacks, Extreme paid $13.2 million of additional cash consideration to the former shareholders of Webstacks in October 2001 as a result of the accomplishments of certain technology milestones. This amount has been recorded as additional goodwill.

As of January 31, 2001, Optranet had in-process research and development efforts under way for the design and development of printed circuit boards ("PCB"). These PCBs will deliver networking solutions that allow for high speed Ethernet Layer 3 switching and IP services over wide area T-1 and DS-3 network technologies, and VDSL modules over voice grade cabling. The development efforts for the products were at varying levels of completion estimated to be between 20% and 85% complete, had a fair value of $13.4 million as of January 31, 2001 and are expected to be complete during the first six months of fiscal 2002.

As of March 7, 2001, Webstacks had in-process research and development efforts under way for the design and development of both stand alone proxy switches and PCBs. These switches and PCBs will extend Extreme's IP services to provide robust Layer 4 - 7 switching solutions required for building today's high-performance content aware networks. The development efforts for the products were at varying levels of completion estimated to be between 45% and 60% complete, had a fair value of $16.8 million as of March 7, 2001 and are expected to be complete by January 2002.

Pro forma results of operations have not been presented for Optranet or Webstacks because the prior operating results of these entities were not material on either an individual or an aggregate basis.

## 4. COMMITMENTS AND CONTINGENCIES

### Leases

In June 2000, we entered into two operating lease agreements for approximately 16 acres of land and the accompanying 275,000 square feet of buildings to house our primary facility in Santa Clara, California. Our lease payments will vary based on LIBOR which was 2.6% at September 30, 2001, plus a spread. Our combined lease payments are estimated to be approximately $2.5 million on an annual basis over the lease terms. The leases are for five years and can be renewed for two five-year periods, subject to the approval of the lessor. At the expiration or termination of the leases, we have the option to either purchase these properties for $31.4 million and $48.6 million, respectively, or arrange for the sale of the properties to a third party for at least $31.4 million and $48.6 million, respectively, with a contingent liability for any deficiency. If the properties under these leases are not purchased or sold as described above, we will be obligated for additional lease payments of approximately $30.5 million and $41.3 million, respectively.

As part of the above lease transactions, Extreme restricted $80.0 million of its investment securities as collateral for specified obligations as the lessor under the leases. These investment securities are restricted as to withdrawal and are managed by a third party subject to certain limitations under Extreme's investment policy. The leases also require us to maintain specified financial covenants with which we were in compliance as of September 30, 2001.

As part of our business relationship with MCMS, one of our contract manufacturers, we have entered into a $9.0 million equipment lease for manufacturing equipment with a third party financing company; we in turn sublease the equipment to MCMS. Due to the liquidity problems at MCMS and their voluntary filing for protection under Chapter 11 on September 18, 2001 (See "Risk Factors") we have recorded a charge of $9.0 million related to the equipment lease in the quarter ended September 30, 2001.

Legal Proceedings

On March 14, 2001, Nortel Networks, Inc. and Nortel Networks Limited (collectively, "Nortel") filed suit against us in the United States District Court for the District of Massachusetts, Civil Action No. 01-10443EFH. The complaint alleges willful infringement of U.S. Patent Nos. 5,790,554 (the "554 Patent") ; 5,490,252; 5,408,469; 5,398,245; 5,159,595 and 4,736,363, and seeks a judgment: (a) determining that the Company has infringed each of the six patents; (b) permanently enjoining and restraining the Company from further infringement of each of the six patents; and (c) awarding unspecified amounts of trebled damages, together with interest, costs and attorneys' fees. We answered Nortel's complaint on May 17, 2001, denying that we have infringed any of the six patents and also asserting various affirmative defenses and counterclaims that seek judgment: (a) that Nortel's complaint be dismissed; (b) that each of the six patents be declared invalid; (c) declaring that we are not infringing any of the six patents; and (d) that Nortel pay our attorneys' fees and costs. On May 17, 2001, we also sought transfer of the action to the United States District Court for the Northern District of California. On June 28, 2001, the court denied our motion to transfer, and the action will thus proceed in Massachusetts. On July 9, 2001, the court granted a motion by F5 Networks, Inc. ("F5") to intervene in the action. F5 contends that it is the designer, developer, and manufacturer of the product accused of infringing the 554 Patent of Count VI of Nortel's complaint. F5 had also sought to sever and transfer Count VI in favor of an action concerning the 554 Patent pending between F5 and Nortel in the United States District Court for the Western District of Washington, but that motion was denied on July 9, 2001 without opinion. On July 13, 2001, Nortel demanded $150 million in settlement of alleged past damages. Discovery is proceeding. As set forth above, we have denied Nortel's allegations and intend to defend the action vigorously. We cannot assure you, however, that we will prevail in this litigation. Our failure to prevail in this litigation could have a material adverse effect on our consolidated financial position, results of operations and cash flows in the future.

Beginning on July 6, 2001, multiple purported securities fraud class action complaints were filed in the United States District Court for the Southern District of New York. We are aware of at least two such complaints, Capuano v. Morgan Stanley & Co., Inc., et al, No. 01 CV 6148 (S.D.N.Y. July 6, 2001) (which does not name us or our officers or directors as defendants) and Hui v. Extreme Networks, Inc., et al., No. 01 CV 6700 (S.D.N.Y. July 23, 2001). The complaints are brought purportedly on behalf of all persons who purchased our common stock from November 17, 1999 through December 6, 2000. The Hui complaint names as defendants Extreme Networks and certain of our present and former officers, as well as several investment banking firms that served as underwriters of our initial public offering. It alleges liability under Sections 11and 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 offering did not disclose that: (1) the underwriters had agreed to allow certain customers to purchase shares in the offering 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 pre-determined prices. We are aware that similar allegations have been made in lawsuits challenging over 140 other initial public offerings conducted in 1999 and 2000. No specific damages are claimed. We believe that the allegations against us and the officers are without merit, and intend to contest them vigorously. We cannot assure you, however, that we will prevail in this litigation. Failure to prevail could have a material adverse effect on our consolidated financial position, results of operations and cash flows in the future.

Extreme is subject to other legal proceedings, claims and litigation arising in the ordinary course of business. While the outcome of these matters is currently not determinable, management does not expect that the ultimate costs to resolve these matters will have a material adverse effect on our consolidated financial position, results of operations or cash flows.

5. FOREIGN EXCHANGE FORWARD CONTRACTS

On July 2, 2000, Extreme adopted FAS 133, which requires that all derivatives be recorded on the balance sheet at fair value. Changes in the fair value of derivatives that do not qualify, or are not effective as hedges must be recognized currently in earnings. Upon adoption, we did not hold any derivative instruments.

Extreme sells product around the globe in US dollars but has international operations with expenses in foreign currencies which are paid from Extreme's US dollar cash flows. Extreme has a foreign currency cash flow hedging program to minimize the foreign currency risk associated with the forecasted cash flows using forward contracts with a maximum term of 90 days. If the US dollar weakens against the foreign currencies (primarily Japanese Yen, the Euro, Swedish Krona and British pound), the increase in the cost of the forecasted foreign currency denominated expenses is offset by the increase in value of the forward contracts designated as hedges. Conversely, when the US dollar strengthens, the decline in cost of the forecasted foreign currency cash flows offsets the losses in the value of the forward contracts. As the critical terms of the forward contract and the underlying exposure are matched at inception, forward contract effectiveness is calculated by comparing the change in the fair value of the contract to the change in fair value of the anticipated expense, with the effective portion of the hedge recorded in accumulated other comprehensive income (loss). Any residual change in fair value of the instruments is recognized immediately in other income (expense), net.

At September 30, 2001, Extreme had forward foreign exchange contracts of less than three months duration, to exchange principally Japanese Yen, British pounds, Swedish Krona and Euros for U.S. dollars in the net amount of $7.1 million. Of these amounts, forward contracts to purchase foreign currency represented $7.3 million and forward contracts to sell foreign currency represented $0.2 million.

6. INCOME TAXES

The Company has recorded a tax benefit of $18.8 million for the three months ended September 30, 2001. The benefit for the three months ended September 30, 2001 results in an effective tax rate of 34% which consists primarily of federal and state income tax benefits, offset by foreign taxes and nondeductible goodwill.

7. COMPREHENSIVE INCOME (LOSS)

The following are the components of accumulated other comprehensive income, net of tax (in thousands):

| | September 30, 2001 | June 30, 2001 |
|---|---|---|
| Unrealized gain on investments | $ 1,467 | $ 710 |
| Change in fair value of derivatives | (1) | - |
| Foreign currency translation adjustments | 152 | 59 |
| Accumulated other comprehensive income | $ 1,618 | $ 769 |

The following schedule of other comprehensive income (loss) shows the gross current-period gain (loss) and the reclassification adjustment (unaudited, in thousands):

| | Three Months Ended | |
|---|---|---|
| | September 30, 2001 | September 30, 2000 |
| Net income (loss) | $ (36,008) | $ 4,533 |
| Other comprehensive income (loss): | | |
| Change in unrealized gain on investments, net | 757 | 628 |
| Change in unrealized loss on derivatives | (1) | - |
| Change in accumulated translation adjustments | 93 | (73) |
| Total comprehensive income (loss) | $ (35,159) | $ 5,088 |

8. SUBSEQUENT EVENT

On October 31, 2001, Extreme filed a Tender Offer Statement on Schedule TO with the Securities and Exchange Commission related to a voluntary stock option exchange program for its employees. The Company's executive officers, directors and vice presidents are not eligible to participate in this program. Under the program, Extreme employees will be given the opportunity to voluntarily cancel unexercised vested and unvested stock options previously granted to them that have an exercise price of $10.00 or more. The cancelled options will be exchanged for replacement stock options to be granted at a future date. The replacement options will be for the same number of shares as the cancelled options. The replacement stock options will be granted with an exercise price equal to the fair market value of Extreme stock on the date of grant, which will be at least six months plus one day after the option cancellation date of December 4, 2001. The program will be open for at least twenty business days after the formal offering documents are filed with the Securities and Exchange Commission. Employees may change or withdraw their election to exchange options at any time prior to the end of the offering period. In order to receive new options, an employee must remain employed with Extreme or one of its subsidiaries until the date when the replacement options are granted.

Part I. Financial Information
Item 2. Management's Discussion and Analysis of
Financial Condition and Results of Operations

When used in this discussion and elsewhere in this Form 10-Q, the words "may," "should," "believes," "expects," "anticipates," "estimates" and similar expressions identify forward-looking statements. Such statements, which include statements concerning operating expenses, anticipated growth, potential expansion of research and development and sales and support staff, working capital, product mix, pricing trends and the mix of export sales are subject to risks and uncertainties, including those set forth below under "Risk Factors." Our actual results could differ materially from those projected in these forward-looking statements which could have a material adverse effect on our business, operating results and financial condition. These forward-looking statements speak only as of the date hereof and there may be events in the future that would alter our expectations but which we are not able to predict accurately or over which we have no control. We have no obligation, and expressly disclaim any such obligation, to update or alter any such forward looking statements whether as a result of new information, future events or otherwise.

This Management's Discussion and Analysis of Financial Condition and Results of Operations should be read in conjunction with "Risk Factors" set forth on page 19 and in our other filings with the U.S. Securities and Exchange Commission. All dollar amounts in this Management's Discussion and Analysis are in millions.

Results of Operations

Net revenue. Net revenue decreased from $119.3 million for the three months ended September 30, 2000 to $108.3 million for the three months ended September 30, 2001, a decrease of $11.0 million. This decrease was due primarily to a decline in revenue from customers in North America, as our business was negatively impacted by the cautious purchasing behavior of customers in the current economic environment partially offset by an increase in revenues from customers in Japan.

Our revenue is derived from sales of our Summit, BlackDiamond and Alpine product families and fees for services relating to our products, including maintenance and training. 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. See "Risk Factors --If a Key Reseller, Distributor or Other Significant Customer Cancels or Delays a Large Purchase, Our Net Revenue May Decline and the Price of Our Stock May Fall." Two customers accounted for 18% and 11% of our revenue for the three months ended September 30, 2001 and one customer accounted for 13% of our revenue for the three months ended September 30, 2000.

We market and sell our products primarily through resellers, distributors and, to a lesser extent, original equipment manufacturers and our field sales organization. We sell our products through more than 250 resellers in approximately 50 countries. For the three months ended September 30, 2001 and September 30, 2000, sales to customers outside of North America accounted for approximately 70% and 51% of our net revenue, respectively. We expect that export sales will continue to represent a significant portion of net revenue, although we cannot assure you that export sales as a percentage of net revenue will remain at current levels. Currently, all of our international sales are denominated in U.S. dollars.

We have experienced a rapid and increasingly severe downturn in the economy. This downturn has adversely affected demand for our products and services and made it increasingly difficult to accurately forecast future production requirements. We expect this economic downturn to continue for at least the remainder of calendar year 2001 and we do not know the extent, severity or length of this economic downturn in the United States or in the other geographic regions where we currently sell our products.

Gross profit. Gross profit decreased from $61.3 million for the three months ended September 30, 2000 to $25.0 million for the three months ended September 30, 2001, a decrease of $36.3 million. Gross margins decreased from 51.3% for the three months ended September 30, 2000 to 23.1% for the three months ended September 30, 2001. This decrease was primarily due to $31.4 million in charges related to our outsourced manufacturing activities including a charge for leased equipment with one contract manufacturer, the stocking of our service depots with inventory worldwide to meet customer support demands under contract and excess and obsolete inventory due to an aggressive product introduction cycle that we expect to roll-out over the next 12 months.

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, testing and enhancement of our products. Research and development expenses increased from $11.7 million for the three months ended September 30, 2000 to $16.4 million for the three months ended September 30, 2001, an increase of $4.7 million. The increase was primarily due to higher payroll and related personnel expenses due to the addition of new personnel, partly through acquisitions, to support our multiple product development efforts as well as prototype costs. We expense all research and development expenses as incurred. We believe that continued investment in research and development is critical to attaining our strategic objectives and, as a result, we expect these expenses to not change significantly in the near term.

Sales and marketing expenses. Sales and marketing expenses consist of salaries, commissions and related expenses for personnel engaged in marketing, sales and field service support functions, as well as trade shows and promotional expenses. Sales and marketing expenses increased from $35.1 million for the three months ended September 30, 2000 to $37.0 million for the three months ended September 30, 2001, an increase of $1.9 million. This increase was primarily due to the hiring of additional personnel and marketing programs. We do not expect that sales and marketing expenses will change significantly in the near term.

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 from $4.3 million for the three months ended September 30, 2000 to $8.1 million for the three months ended September 30, 2001, an increase of $3.8 million. This increase was primarily due to a $2.7 million charge for bad debt expense and increases in professional fees. We do not expect that general and administrative expenses will change significantly in the near term.

Amortization of goodwill, purchased intangible assets and deferred stock compensation. Amortization of goodwill, purchased intangible assets and deferred stock compensation increased from $6.9 million for the three months ended September 30, 2000 to $14.7 million for the three months ended September 30, 2001, an increase of $7.8 million. This increase was due to the amortization related to the Optranet and Webstacks acquisitions (see Note 3 of Notes to Condensed Consolidated Financial Statements) that occurred in fiscal 2001. We are required under generally accepted accounting principles to review our intangibles assets for impairment when events or changes in circumstances indicate the carrying value may not be recoverable. This review could result in a significant charge to earnings in the period any impairment is determined.

Loss on investments. Loss on investments increased to $6.0 million for the three months ended September 30, 2001. Extreme monitors its minority equity investments for impairment and makes appropriate reductions in carrying values when necessary. No impairment write-downs were made during the three months ended September 30, 2000.

Other income, net. Other income, net decreased from $3.7 million for the three months ended September 30, 2000 to $2.4 million for the three months ended September 30, 2001, a decrease of $1.3 million. This decrease was due to decreased interest income earned on investments due to lower interest rates.

Income taxes. We recorded a tax benefit of $18.8 million for the three months ended September 30, 2001. The benefit for the three months ended September 30, 2001 results in an effective tax rate of 34% which consists primarily of federal and state income tax benefits, offset by foreign taxes and nondeductible goodwill. FASB Statement No. 109 provides for the recognition of deferred tax assets if realization of such assets is more likely than not. We intend to evaluate the realizability of the deferred tax assets on a quarterly basis.

## Liquidity and Capital Resources

Cash and cash equivalents and short-term investments increased from $157.1 million at June 30, 2001 to $160.3 million at September 30, 2001, an increase of $3.2 million. This increase is primarily due to a decrease in accounts receivable and an increase in accounts payable; partially offset by a net loss. Extreme no longer reports deferred revenue associated with inventory at distributors in its deferred revenue account or accounts receivable account in its condensed consolidated balance sheet. Deferred revenue and accounts receivable balances for all previous periods have been reclassified to conform to the current year presentation.

Inventory management remains an area of focus as we balance the need to maintain strategic inventory levels to ensure competitive lead times and avoid stock-outs with the risk of inventory excess or obsolescence because of recent declining demand, rapidly changing technology and customer requirements. Any significant increase in our inventory levels, can be expected to reduce cash, cash equivalents, short-term investments and long-term investments.

In June 2000, we entered into two operating lease agreements for approximately 16 acres of land and the accompanying 275,000 square feet of buildings to house our primary facility in Santa Clara, California. Our lease payments vary based on LIBOR which was 2.6% at September 30, 2001, plus a spread. We estimate that our combined lease payments will be approximately $2.5 million on an annual basis over the lease terms. The leases are for five years and can be renewed for two five-year periods, subject to the approval of the lessor. At the expiration or termination of the leases, we have the option to either purchase these properties for $31.4 million and $48.6 million, respectively, or arrange for the sale of the properties to a third party for at least $31.4 million and $48.6 million, respectively, with a contingent liability for any deficiency. If the properties under these leases are not purchased or sold as described above, we will be obligated for additional lease payments of approximately $30.5 million and $41.3 million, respectively.

As part of the above lease transactions, Extreme restricted $80.0 million of its investment securities as collateral for specified obligations as the lessor under the leases. These investment securities are restricted as to withdrawal and are managed by a third party subject to certain limitations under Extreme's investment policy. The leases also require us to maintain specified financial covenants with which we were in compliance as of September 30, 2001.

As part of our business relationship with MCMS, one of our contract manufacturers, we have entered into a $9.0 million equipment lease for manufacturing equipment with a third party financing company; we in turn sublease the equipment to MCMS. Due to the liquidity problems at MCMS and their voluntary filing for protection under Chapter 11 on September 18, 2001 (See "Risk Factors") we have recorded a charge of $9.0 million related to the equipment lease in the quarter ended September 30, 2001.

Pursuant to the terms of the merger agreement with Webstacks, Extreme paid $13.2 million of additional cash consideration to the former shareholders of Webstacks in October 2001 as a result of the accomplishments of certain technology milestones. This amount has been recorded as additional goodwill.

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. 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. We cannot assure you that such additional capital, if required, will be available on acceptable terms, or at all. 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, long-term investments 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 Have a Limited History of Profitability, We Are Not Currently Profitable and We Cannot Assure You That We Will Return to Profitability in the Future

Fiscal 2000 was the first year in which Extreme achieved profitability. We reported a loss for fiscal 2001 and the quarter ended September 30, 2001. In the foreseeable future, we anticipate continuing to incur significant sales and marketing, product development and general and administrative expenses and, as a result, we will need to generate and sustain significantly higher revenue to return to and sustain profitability. In addition, the amortization of purchased goodwill and intangibles, and deferred compensation associated with acquisitions, will result in material charges that will reduce our profitability. Further, the impact of the current economic slowdown could result in additional one-time charges.

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

Our failure to control our operating expenses at a level that is consistent with anticipated revenues may cause our financial results to be worse than expected. A high percentage of our expenses are fixed in the short term, so any delay in generating or recognizing revenue, as occurred in the quarter ended September 30, 2001, 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.

We may experience a delay in generating or recognizing revenue for a number of reasons. Orders at the beginning of each quarter typically 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 for shipment in that quarter to achieve our revenue objectives. In addition, the timing of product releases, purchase orders and product availability could result in a majority of our product shipments to be scheduled for 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 customer agreements include acceptance provisions that delay our ability to recognize revenue upon shipment.

Our quarterly revenue and operating results have varied significantly in the past and may vary significantly in the future due to a number of factors, including, but not limited to, the following:

- changes in general and/or specific economic conditions in the networking industry;
- seasonal fluctuations in demand for our products and services, particularly in Asia and Europe;
- our ability to accurately forecast demand for our products, which in the case of lower-than-expected sales may result in excess and/or obsolete inventory on hand or under non-cancelable purchase commitments;
- unexpected 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;
- costs relating to possible acquisitions and the integration of technologies or businesses; and
- the effect of amortization of goodwill, deferred compensation, and purchased intangibles resulting from existing or new transactions.

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.

As a result of the September 11, 2001 events in New York City and Washington, D.C., the United States and global economies have weakened and may continue to deteriorate, which may result in further decreases in our revenues and cause our stock price to decline. In addition, it is anticipated that in the wake of these events, the United States and global capital markets will experience a period of continuing volatility. These events contributed to a decline in revenue from our customers in North America for the quarter ended September 30, 2001, and they may continue to have a negative impact on our business as a result of the cautious purchasing behavior of customers.

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

The market for networking equipment is intensely competitive. Our principal competitors include Cisco Systems, Enterasys Networks, Foundry Networks, Nortel Networks and Riverstone Networks. In addition, a number of private companies have announced plans for new 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. 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.

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. If we fail to do so, we may not compete successfully with our competitors, which could have a material adverse effect on our revenue and future profitability.

We Expect the Average Selling Prices of Our Products to Decrease Which May Reduce Gross Margins or Revenue

The network equipment industry has experienced rapid erosion of average selling prices due to a number of factors, including competitive pricing pressures, promotional pricing, rapid technological change and a slowdown in the economy that has resulted in excess inventory and lower prices as companies attempt to liquidate this inventory. We may experience substantial decreases in future operating results due to the erosion of our average selling prices. We anticipate that the average selling prices of our products will decrease in the future in response to competitive pricing pressures, increased sales discounts and new product introductions by us or our competitors, including, for example, competitive products manufactured with low-cost merchant silicon. Competitive pressures are expected to increase as a result of the industry slowdown that occurred in the first half of 2001 coupled with the recent downturn in the broader economy. To maintain our gross margins, 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 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

With the recent economic slowdown, some of our customers are forecasting that their revenue for the foreseeable future will generally be lower than anticipated. Some of these customers are experiencing, or are likely to experience, serious cash flow problems and as a result find it increasingly difficult to obtain financing on attractive terms, if at all. As a result, if some of these customers are not successful in generating sufficient revenue or securing alternate financing arrangements, they may not be able to pay, or may delay payment for the amounts that they owe us. Furthermore, they may not order as many products from us as originally forecast. The inability of some of our potential customers to pay us for our products may adversely affect our cash flow and the timing of our revenue recognition, which may cause our stock price to decline.

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

The network equipment market is characterized by rapid technological change, frequent new product introductions, changes in customer requirements and evolving industry standards. If we do not address these changes by regularly introducing new products, our product line 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 purchasing our existing products. These actions could have a material adverse effect on our operating results by unexpectedly decreasing sales, increasing inventory levels of older products and exposing us to greater risk of product obsolescence. The market for switching products is evolving and we believe our ability to compete successfully in this market is dependent upon the continued compatibility and interoperability of our products with products and architectures offered by other vendors. In particular, the networking industry has been characterized by the successive introduction of new technologies or standards that have dramatically reduced the price and increased the performance of switching equipment. To remain competitive we need to introduce products in a timely manner that incorporate or are compatible with these emerging technologies. We cannot assure you that new products 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.

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

Prior to the quarter ended March 31, 2001, we experienced rapid growth and expansion that placed, and may in the future place, a significant strain on our resources. Subsequent to the quarter ended March 31, 2001, we incurred unanticipated costs to downsize our operations to a level consistent with the downward forecast in sales. Even if we manage periods of expansion and contraction effectively, we may make mistakes in operating our business such as inaccurate sales forecasting, incorrect material planning or inaccurate financial reporting. This may lead to unanticipated fluctuations in our operating results. Our net revenue increased significantly during the last fiscal year. Furthermore, from September 30, 2000 to September 30, 2001, the number of our employees increased from 792 to 999, notwithstanding a reduction in workforce of approximately 10% of our employees conducted in April 2001. We cannot assure you that we will continue to achieve a similar pattern of growth or that we will be able to size our operations in accordance with the potential growth or decline of our business in the future.

Delays in the Implementation of New Management Information Systems May Cause a Significant Burden on Our Operations

We are implementing additional management information systems and developing further operating, administrative, financial and accounting systems and controls to maintain close coordination among our executive, engineering, accounting, finance, marketing, sales and operations organizations. In addition, we plan to transition to a new enterprise resource planning system. We may be unable to install adequate control systems in an efficient and timely manner, and our current or planned personnel systems, procedures, and controls may not be adequate to support our future operations. The difficulties associated with installing and implementing these new systems, procedures, and controls may place a significant burden on our management and our internal resources. In addition, as we grow internationally, we need to expand our worldwide operations and enhance our communications infrastructure. Any delay in the implementation of such new or enhanced systems, procedures or controls, or any disruption in the transition to such new or enhanced systems, procedures or controls, could adversely affect our ability to accurately forecast sales demand, manage our supply chain, and record and report financial and management information on a timely and accurate basis.

We Must Continue to Develop and Increase Our Productivity Of Our Indirect Distribution Channels to Increase Net Revenue and Improve Our Operating Results

Our distribution strategy focuses primarily on developing and increasing our productivity of our indirect distribution channels through resellers and distributors. 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 would suffer. Many of our resellers also sell products that compete with our products. We are developing a two-tier distribution structure in Europe and the United States that has required, and will in the future require, us to enter into agreements with a number of stocking distributors. We have entered into two-tier distribution agreements; however, we cannot assure you that we will be able to enter into additional distribution agreements or that we will be able to successfully manage the transition of resellers to a two-tier distribution channel. 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 will market 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

In the year ended June 30, 2001, we derived substantially all of our revenue from sales of our Summit, BlackDiamond and Alpine products. 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, service provider and MAN 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.

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 cost-effective manner. In the past, we have experienced delays in product development and such delays may occur in the future. We are currently engaged in development of a third-generation chipset planned for use in future products. The introduction of new and enhanced products may cause our customers to defer or cancel orders for existing products. Therefore, to the extent customers defer or cancel orders in the expectation of new product releases, any delay in the development or introduction of new products could cause our operating results to suffer. The risk that we will be unable to achieve and maintain widespread levels of market acceptance for our current and future products may significantly impair our revenue growth.

If a Key Reseller, Distributor, or Other Significant Customer Cancels or Delays a Large Purchase, Our Net Revenue 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. If any of our large customers stop or delay purchases, our revenue and profitability would be adversely affected. For example, in the quarter ended September 30, 2001, two customers accounted for 18% and 11% of our net revenue. 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 vary 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, particularly in view of the high per unit sales price of our products and the length of our sales cycles.

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 provider 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 defer recognition of revenue on sales to distributors until the distributors sell the product.

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 timing of our revenue is difficult to predict because of our reliance on indirect sales channels and the length and variability of our sales cycle. Our products have a relatively high per unit sales price, and the purchase of our products often constitutes a significant strategic decision by an enterprise 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; and
- 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.

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, and printed circuit boards have been, and may be in the future, in short supply. While we have been able to meet our needs to date, we have in the past, and are likely in the future, to encounter shortages and delays in obtaining these or other components and this could have a material adverse effect on our ability to meet customer orders. Our principal sole-source components include:

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

Our principal limited-source components include:

- flash memories;
- dynamic and static random access memories, or DRAMs and SRAMs, respectively; 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 which could have a material adverse effect on our operating results and financial condition. If orders exceed forecasts, we may have inadequate inventory 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 these suppliers. From time to time we have experienced shortages and allocations of certain components, resulting in delays in filling orders. In addition, during the development of our products, we have experienced delays in the prototyping of our ASICs, which in turn has led to delays in product introductions. We cannot assure you that such delays will not occur in the future. Furthermore, we cannot assure you that the performance of the components as incorporated in our products will meet the quality requirements of our customers.

Our Dependence on Contract Manufacturers for Substantially 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 independent contractors to manufacture our products. We do not have long-term contracts with any of these manufacturers. We currently utilize three companies - Flextronics International, Ltd., located in San Jose, California, Solectron Corporation, located in Milpitas, California, and MCMS, Inc., located in Nampa, Idaho. We have experienced delays in product shipments from contract manufacturers in the past, which in turn delayed product shipments to our customers. Similar or other problems may arise in the future, such as inferior quality, insufficient quantity of products, or the interruption or discontinuance of operations of any manufacturer, any of which could have a material adverse effect on our business and operating results.

Specifically, as stated in their Form 10-Q filed with the Securities and Exchange Commission on July 16, 2001, MCMS faces severe near-term liquidity problems. In addition, on September 18, 2001, as a result of severe liquidity problems, MCMS announced that it had reached an agreement to sell substantially all of its operating assets to Manufacturers' Services Limited. Simultaneously, MCMS announced that it, and its two U.S. subsidiaries, have voluntarily filed for protection under Chapter 11 of the U.S. Bankruptcy Code in the United States Bankruptcy Court for the District of Delaware in Wilmington to implement the sale. In response to this situation, we have perfected security interests in our personal property located on the premises of MCMS, obtained a written acknowledgement from MCMS in regard to manufacturing equipment, products and materials owned and/or leased by us that are located on the premises of MCMS, and are managing the orderly transition of production processes to other manufacturers. Our inability to execute this plan 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.

We do not know whether we will effectively manage our contract manufacturers or that these manufacturers will meet our future requirements for timely delivery of products of sufficient quality and quantity. We intend to regularly introduce new products and product enhancements, which will require that we rapidly achieve a critical mass of volume production by coordinating our efforts with those of our suppliers and contract manufacturers. The inability of our contract manufacturers to provide us with adequate supplies of high-quality products or the loss of any of our contract manufacturers 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.

As part of our cost-reduction efforts, we will need to realize lower per unit product costs from our contract manufacturers by means of volume efficiencies. 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.

Our Limited Ability to Protect Our Intellectual Property and Defend Against Claims 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 assure you 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. 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. We are actively involved in disputes and licensing discussions with others regarding their claimed proprietary rights. If we infringe the proprietary rights of others, we could be compelled to either obtain a license to those intellectual property rights or alter our products so that these 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 propriety rights of others could 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.

The networking industry in which we operate is prone to intellectual property claims by and among competing parties. We cannot assure you that we will always successfully defend ourselves against such claims.

We 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.

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 three major companies alleging that we are infringing their patents. One of these companies, Nortel Networks, 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 have denied Nortel's allegations and intend to defend the action vigorously. 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, the consequences to us may be severe and could require us to, among other actions:

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

We and Manufacturers of Our Products Rely on a Continuous Power Supply to Conduct Operations, and an Energy Crisis Could Disrupt Our Business and Increase Our Expenses

California is in the midst of an energy crisis that could disrupt our operations and increase our expenses. In the event of an acute power shortage, that is, when power reserves for California fall below 1.5%, electricity providers have on some occasions implemented, and may in the future continue to implement, rolling blackouts. Two of the three manufacturers of our products, Flextronics and Solectron, are located in California. As a result of this crisis, these contractors may be unable to manufacture sufficient quantities of our products to meet our needs, or they may increase the fees charged for their services. We do not have long-term contracts with either Flextronics or Solectron. The inability of our contract manufacturers to provide us with adequate supplies of products would cause a delay in our ability to fulfill our orders, which could harm our business, and any increase in their fees could adversely affect our financial condition.

In addition, the majority of our operations are located in California. We currently do not have backup generators or alternate sources of power in the event of a blackout. If blackouts interrupt our power supply, we would temporarily be unable to continue operations at our facilities. Any such interruption in our ability to continue operations at these facilities could damage our reputation, harm our ability to retain existing customers and to obtain new customers, and could result in lost revenue, any of which could substantially harm our business and results of operation.

Our Headquarters Are Located in Northern California Where Disasters May Occur That Could Disrupt Our Operations and Harm Our Business

Our corporate headquarters are located in Silicon Valley in Northern California. Northern California historically 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 and our manufacturers' property.

In addition, terrorist acts or acts of war targeted at the United States, and specifically Silicon Valley, could cause damage or disruption to Extreme, 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 Objectives

Our success depends to a significant degree upon the continued contributions of our key management, engineering, sales and marketing and operations personnel, many of whom would be difficult to replace. In particular, we believe that our future success is highly dependent on Gordon Stitt, chairman, president and chief executive officer; Stephen Haddock, vice president and chief technical officer; and Herb Schneider, vice president of engineering. We do not have employment contracts with these personnel 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, finance and operations personnel. The market for these personnel is competitive, especially in the San Francisco Bay Area, and we have had difficulty-hiring employees, particularly software 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 recent stock market decline, which has caused many of our employees' options to be "under water." There can be no assurance that we will be successful in attracting and retaining such 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 received claims like this from other companies and, although to date they have not resulted in material litigation, we do not know whether we will receive additional claims in the future as we seek to hire qualified personnel or that such claims will not result in material litigation. We could incur substantial costs in defending against any such claims, regardless of the merits of such claims.

Our Products Must Comply With Evolving Industry Standards and Complex Government Regulations or Else Our Products May Not Be Widely Accepted, Which May Prevent Us From Growing Our Net Revenue or Achieving Profitability

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 changes, 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.

Failure to Successfully Expand Our Sales and Support Organizations or Educate Them About Our Product Families May Harm Our Operating Results

The sale of our products and services requires a concerted effort targeted at several levels within a prospective customer's organization. We may not be able to increase net revenue unless we expand our sales force. We cannot assure you that we will be able to successfully integrate new employees into our company or to educate our employees about our rapidly evolving product families. A failure to do so may hurt our revenue growth and consequently hurt our operating results.

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

International sales constitute a significant portion of our sales. Our ability to grow will depend in part on the continued expansion of international sales. Sales to customers outside of North America accounted for approximately 70% and 55% of our net revenue for the three months ended September 30, 2001 and in fiscal 2001, respectively. Our international sales primarily depend on our resellers and distributors. The failure of our resellers and distributors to sell our products internationally would limit our ability to sustain and grow our revenue. In addition, 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;
- import or export licensing requirements;
- difficulty in safeguarding intellectual property;
- political and economic turbulence;
- potential adverse tax consequences; and
- unexpected changes in regulatory requirements, including export restrictions.

Our international sales currently are U.S. dollar-denominated. As a result, an increase in the value of the U.S. dollar relative to foreign currencies could make our products less competitive in international markets. In the future, we may elect to invoice some of our international customers in local currency which will expose us to fluctuations in exchange rates between the U.S. dollar and the particular local currency. If we do so, we may decide to engage in hedging transactions to minimize the risk of such fluctuations. We have entered into foreign exchange forward contracts to offset the impact of payment of operating expenses in local currencies to some of our operating foreign subsidiaries. However, if we are not successful in managing these hedging transactions, we could incur losses from hedging activities.

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 would complement our current product offerings, augment our market coverage or enhance our technical capabilities, or that may otherwise offer growth opportunities. We are reviewing 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 by us could have a material adverse effect on our operating results and/or the price of our common stock. In addition, with any acquisition, we may be required to absorb the costs associated with the acquisition long before we are able to realize any benefits from the acquisition.

Acquisitions and investment activities also entail numerous risks, including:

- difficulties in the assimilation of acquired operations, technologies 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;
- substantial charges for the amortization of certain purchased intangible assets, deferred stock compensation or similar items; and
- impairment charges taken in the future for goodwill amounts that cannot be supported in future periods.

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. 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.

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 Revenue and Prevent Us From Achieving Profitability

We believe that our existing working capital, based on proceeds from the initial public offering in April 1999, proceeds from the secondary offering in October 1999, 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 revenue, we may continue to consume significant amounts of capital. As a result, we could be required to raise additional capital. To the extent that we raise additional capital through the sale of equity or convertible debt securities, the issuance of such securities could result in dilution of the shares held by existing stockholders. If additional funds are raised through the issuance of debt securities, such securities may provide the holders certain rights, preferences, and privileges senior to those of common stockholders, and the terms of such debt could impose restrictions on our operations. We cannot assure you that additional capital, if required, will be available on acceptable terms, or at all. If we are unable to obtain sufficient amounts of additional capital, we may be required to reduce the scope of our planned product development and marketing efforts, which could harm our business, financial condition and operating results.

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

Network products frequently contain undetected software or hardware errors when new versions are first released to the marketplace. In the past, we have experienced such errors in connection with new products and product upgrades. We expect that such errors will be found from time to time in new or enhanced products after the commencement of commercial shipments. These problems may have a material adverse effect on our business by causing us to incur significant warranty and repair costs, diverting the attention of our engineering personnel from new product development efforts, and causing significant customer relations problems.

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 caused by our products or another vendor's 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.

Provisions in Our Charter or Agreements May Delay or Prevent a Change of Control

Provisions in our certificate of incorporation and bylaws may delay or prevent a change of control or changes in our management. These provisions include:

- the division of the board of directors into three separate classes;
- the right of the board of directors to elect a director to fill a vacancy created by the expansion of the board of directors; and
- the ability of the board of directors to alter our bylaws without getting stockholder approval.

Furthermore, we are subject to the provisions of section 203 of the Delaware General Corporation Law. These provisions prohibit large stockholders, in particular those owning 15% or more of the outstanding voting stock, from consummating a merger or combination with a corporation unless this stockholder receives board approval for the transaction or 66 2/3% of the shares of voting stock not owned by the stockholder approve the merger or combination. In addition, we adopted a stockholders' rights agreement in fiscal 2001.

## 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 long-term investments that are subject to market risk by range of expected maturity and weighted-average interest rates as of September 30, 2001. This table does not include money market funds because those funds are not subject to market risk.

| | Maturing in | | | | |
|---|---|---|---|---|---|
| | Three months or less | Three months to one year | Greater than one year | Total | Fair Value |
| | | | (In thousands) | | |
| Included in cash and cash equivalents .... | $ 59,010 | | | $ 59,010 | $ 59,010 |
| Weighted average interest rate ......... | 4.58% | | | | |
| Included in short-term investments ....... | | $ 36,931 | | $ 36,931 | $ 36,931 |
| Weighted average interest rate ......... | | 6.80% | | | |
| Included in investments .................. | | | $ 45,145 | $ 45,145 | $ 45,145 |
| Weighted average interest rate ......... | | | 4.67% | | |

### Exchange Rate Sensitivity

Currently, all of our sales and the majority of our expenses are denominated in U.S. 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 three months ended September 30, 2001 and expect to continue to do so, we do not anticipate that foreign exchange gains or losses will be significant.

### Foreign Exchange Forward Contracts

We enter into foreign exchange forward contracts to offset the impact of currency fluctuations on certain nonfunctional operating expenses, denominated in Japanese Yen, the Euro, Swedish Krona and British pound. The foreign exchange forward contracts we enter into have original maturities ranging from one to three months. We do not enter into foreign exchange forward contracts for trading purposes. See Note 5 of Notes to Condensed Consolidated Financial Statements.

PART II. Other Information

Item 1. Legal Proceedings

On March 14, 2001, Nortel Networks, Inc. and Nortel Networks Limited (collectively, "Nortel") filed suit against us in the United States District Court for the District of Massachusetts, Civil Action No. 01-10443EFH. The complaint alleges willful infringement of U.S. Patent Nos. 5,790,554 (the "554 Patent") ; 5,490,252; 5,408,469; 5,398,245; 5,159,595 and 4,736,363, and seeks a judgment: (a) determining that the Company has infringed each of the six patents; (b) permanently enjoining and restraining the Company from further infringement of each of the six patents; and (c) awarding unspecified amounts of trebled damages, together with interest, costs and attorneys' fees. We answered Nortel's complaint on May 17, 2001, denying that we have infringed any of the six patents and also asserting various affirmative defenses and counterclaims that seek judgment: (a) that Nortel's complaint be dismissed; (b) that each of the six patents be declared invalid; (c) declaring that we are not infringing any of the six patents; and (d) that Nortel pay our attorneys' fees and costs. On May 17, 2001, we also sought transfer of the action to the United States District Court for the Northern District of California. On June 28, 2001, the court denied our motion to transfer, and the action will thus proceed in Massachusetts. On July 9, 2001, the court granted a motion by F5 Networks, Inc. ("F5") to intervene in the action. F5 contends that it is the designer, developer, and manufacturer of the product accused of infringing the 554 Patent of Count VI of Nortel's complaint. F5 had also sought to sever and transfer Count VI in favor of an action concerning the 554 Patent pending between F5 and Nortel in the United States District Court for the Western District of Washington, but that motion was denied on July 9, 2001 without opinion. On July 13, 2001, Nortel demanded $150 million in settlement of alleged past damages. Discovery is proceeding. As set forth above, we have denied Nortel's allegations and intend to defend the action vigorously. We cannot assure you, however, that we will prevail in this litigation. Our failure to prevail in this litigation could have a material adverse effect on our consolidated financial position, results of operations and cash flows in the future.

Beginning on July 6, 2001, multiple purported securities fraud class action complaints were filed in the United States District Court for the Southern District of New York. We are aware of at least two such complaints, Capuano v. Morgan Stanley & Co., Inc., et al, No. 01 CV 6148 (S.D.N.Y. July 6, 2001) (which does not name us or our officers or directors as defendants) and Hui v. Extreme Networks, Inc., et al., No. 01 CV 6700 (S.D.N.Y. July 23, 2001). The complaints are brought purportedly on behalf of all persons who purchased our common stock from November 17, 1999 through December 6, 2000. The Hui complaint names as defendants Extreme Networks and certain of our present and former officers, as well as several investment banking firms that served as underwriters of our initial public offering. It alleges liability under Sections 11and 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 offering did not disclose that: (1) the underwriters had agreed to allow certain customers to purchase shares in the offering 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 pre-determined prices. We are aware that similar allegations have been made in lawsuits challenging over 140 other initial public offerings conducted in 1999 and 2000. No specific damages are claimed. We believe that the allegations against us and the officers are without merit, and intend to contest them vigorously. We cannot assure you, however, that we will prevail in this litigation. Failure to prevail could have a material adverse effect on our consolidated financial position, results of operations and cash flows in the future.

Item 2. Changes in Securities - None

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 and Reports on Form 8-K - none

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/HAROLD L. COVERT

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HAROLD L. COVERT
Vice President, Chief Financial Officer
And Secretary

November 13, 2001