EXTREME NETWORKS INC
Form 10-Q
February 09, 2006
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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 January 1, 2006

OR

¨ **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the transition period from ______ to ______

Commission file number 000-25711

EXTREME NETWORKS, INC.

(Exact name of Registrant as specified in its charter)

DELAWARE	**77-0430270**
[State or other jurisdiction	**[I.R.S. Employer**
of incorporation or organization]	**Identification No.]**
3585 Monroe Street	
Santa Clara, California	**95051**
[Address of principal executive offices]	**[Zip Code]**

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

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

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

Large accelerated filer ¨ Accelerated filer x Non-accelerated filer ¨

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

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

January 20, 2006 was 121,718,688.

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EXTREME NETWORKS, INC.

FORM 10-Q

QUARTERLY PERIOD ENDED JANUARY 1, 2006

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Part I. Financial Information

Item 1. Financial Statements

EXTREME NETWORKS, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS

(In thousands)

	January 1, 2006	July 3, 2005
	(Unaudited)	(Note 1)
ASSETS		
Current assets:		
Cash and cash equivalents	$ 86,636	$ 127,470
Short-term investments	280,522	127,889
Accounts receivable, net	33,585	30,778
Inventories, net	21,935	25,943
Prepaid expenses and other current assets	6,529	12,410
Total current assets	429,207	324,490
Property and equipment, net	47,945	50,438
Marketable securities	89,117	185,045
Other assets	21,198	23,641
TOTAL ASSETS	$ 587,467	$ 583,614
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 22,244	$ 18,283
Accrued compensation and benefits	14,068	14,032
Restructuring liabilities	6,069	6,066
Lease liability		471
Accrued warranty	7,022	7,471
Deferred revenue	37,480	36,688
Convertible subordinated notes	200,000	
Other accrued liabilities	19,656	21,893
Total current liabilities	306,539	104,904
Restructuring liabilities, less current portion	10,853	13,890
Deferred revenue, less current portion	9,873	13,785
Deferred income taxes	817	757
Other long-term liabilities	2,266	2,266
Convertible subordinated notes		200,000
Commitments and contingencies (Note 3)		
Stockholders equity:		

Common stock and capital in excess of par value	699,317	693,158
Treasury stock	(6,809)	
Accumulated other comprehensive loss	(3,133)	(2,887)
Accumulated deficit	(432,256)	(442,259)
Total stockholders equity	257,119	248,012
TOTAL LIABILITIES AND STOCKHOLDERS EQUITY	$ 587,467	$ 583,614

See accompanying notes to the unaudited condensed consolidated financial statements.

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EXTREME NETWORKS, INC.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(In thousands, except per share amounts)

(Unaudited)

	Three Months Ended		Six Months Ended	
	January 1, 2006	December 26, 2004	January 1, 2006	December 26, 2004
Net revenues:				
Product	$ 76,998	$ 85,763	$ 158,915	$ 166,935
Service	15,789	14,538	31,794	28,452
Total net revenues	92,787	100,301	190,709	195,387
Cost of revenues:				
Product [(1)]	33,517	37,957	69,443	74,259
Service [(1)]	8,488	8,387	17,196	16,615
Total cost of revenues	42,005	46,344	86,639	90,874
Gross margin:				
Product	43,481	47,806	89,472	92,676
Service	7,301	6,151	14,598	11,837
Total gross margin	50,782	53,957	104,070	104,513
Operating expenses:				
Sales and marketing [(1)]	23,962	23,766	49,878	46,996
Research and development [(1)]	15,670	14,858	31,933	30,257
General and administrative [(1)]	6,052	7,539	13,227	14,662
Amortization of deferred stock compensation [(1)]		5		67
Total operating expenses	45,684	46,168	95,038	91,982
Operating income	5,098	7,789	9,032	12,531
Other income, net	1,427	3,616	2,356	3,754
Income before income taxes	6,525	11,405	11,388	16,285
Provision for income taxes	875	1,455	1,385	2,209
Net income	$ 5,650	$ 9,950	$ 10,003	$ 14,076
Net income per share basic	$ 0.05	$ 0.08	$ 0.08	$ 0.12

Net income per share diluted	$ 0.05	$ 0.08	$ 0.08	$ 0.11
Shares used in per share calculation - basic	123,007	121,042	123,013	120,839
Shares used in per share calculation - diluted	124,806	124,390	124,762	123,853

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

Cost of product revenue	$ 196	$	$ 366	$
Cost of service revenue	92		200	
Sales and marketing	594	13	1,376	25
Research and development	442	91	967	94
General and administrative	250		535	
Amortization of deferred stock compensation		5		67
Total stock-based compensation expense	$ 1,574	$ 109	$ 3,444	$ 186

See accompanying notes to the unaudited condensed consolidated financial statements.

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EXTREME NETWORKS, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)

(Unaudited)

	Six Months Ended	
	January 1, 2006	December 26, 2004
Cash flows from operating activities:		
Net income	$ 10,003	$ 14,076
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	6,097	8,657
Provision for doubtful accounts	716	
Provision for excess and obsolete inventory	155	260
Deferred income taxes	60	150
Amortization of warrant	2,667	3,783
Amortization of deferred stock compensation		67
Loss on disposal of assets		50
Stock-based compensation	3,444	
Net changes in operating assets and liabilities:		
Accounts receivable	(2,298)	2,161
Inventories	3,854	3,083
Prepaid expenses and other current assets and other assets	4,431	(2,524)
Accounts payable	3,961	3,566
Accrued compensation and benefits	37	1,417
Restructuring liabilities	(3,034)	(3,261)
Lease liability	(471)	(942)
Accrued warranty	(449)	(204)
Deferred revenue	(3,120)	(5,612)
Other accrued liabilities	(2,550)	(3,332)
Net cash provided by operating activities	23,503	21,395
Cash flows from investing activities:		
Capital expenditures	(3,604)	(3,402)
Purchases of investments	(167,590)	(196,309)
Sales and maturities of investments	110,951	188,822
Net cash used in investing activities	(60,243)	(10,889)
Cash flows from financing activities:		
Proceeds from issuance of common stock	2,715	2,872
Repurchase of common stock	(6,809)	
Net cash provided by (used in) financing activities	(4,094)	2,872
Net increase (decrease) in cash and cash equivalents	(40,834)	13,378

Cash and cash equivalents at beginning of period	127,470	59,164
Cash and cash equivalents at end of period	$ 86,636	$ 72,542

See accompanying notes to the unaudited condensed consolidated financial statements.

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EXTREME NETWORKS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

1. Summary of Significant Accounting Policies

Basis of Presentation

The unaudited condensed consolidated financial statements of Extreme Networks, Inc. (referred to as Extreme Networks and as we , us and our) included herein have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission (SEC). Certain information and footnote disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles have been condensed or omitted pursuant to such rules and regulations. The condensed consolidated balance sheet at July 3, 2005 was derived from audited financial statements as of that date but does not include all disclosures required by generally accepted accounting principles for complete financial statements. These interim financial statements and notes should be read in conjunction with our audited consolidated financial statements and notes thereto included in our Annual Report on Form 10-K for the fiscal year ended July 3, 2005.

The unaudited condensed consolidated financial statements reflect all adjustments, consisting only of normal recurring adjustments, that, in the opinion of management, are necessary for a fair presentation of the results of operations and cash flows for the interim periods presented and the financial condition of Extreme Networks at January 1, 2006. The results of operations for the second quarter of fiscal 2006 are not necessarily indicative of the results that may be expected for fiscal 2006 or any future periods.

Revenue Recognition

We derive the majority of our revenue from sales of our modular and stackable networking equipment, with the remaining revenue generated from service fees relating to the service contracts and training on our products. We generally recognize product revenue from our value-added resellers and end-users at the time of shipment, provided that persuasive evidence of an arrangement exists, delivery has occurred, the price of the product is fixed or determinable and collection of the sales proceeds is reasonably assured. Revenue from service obligations under service contracts is deferred and recognized on a straight-line basis over the contractual service period. Service contracts typically range from one to five years. When sales arrangements contain multiple deliverables, such as hardware, service contracts and other services, we determine whether the deliverables represent separate units of accounting and then allocate revenue to each unit of accounting based on their relative fair values. We recognize revenue for each unit of accounting when the revenue recognition criteria for each unit of accounting are met. Shipping costs are included in cost of product revenues.

We make certain sales to partners in two distribution channels, or tiers. The first tier consists of a limited number of independent distributors that sell primarily to resellers and, on occasion, to end-user customers. We defer recognition of revenue on all sales to these distributors until the distributors sell the product, as evidenced by monthly sales-out reports that the distributors provide to us. We grant these distributors the right to return a portion of unsold inventory to us for the purpose of stock rotation. We also grant these distributors certain price protection rights. The distributor-related deferred revenue and receivables are adjusted at the time of the stock rotation return or price reduction. We also provide distributors with credits for changes in selling prices, and allow them to participate in cooperative marketing programs. Cooperative advertising expenses are recorded as marketing expenses to the extent that an advertising benefit separate from the revenue transaction can be identified and the cash paid does not exceed the fair value of that advertising benefit received. We maintain estimated accruals and allowances for these exposures based upon our historical experience. The second tier of the distribution channel consists of a large number of third-party resellers that sell directly to end-users and are not granted return privileges, except for defective products during the warranty period. We reduce product revenue for certain price protection rights that may occur under contractual arrangements we have with our resellers.

Inventories

Inventories consist of raw materials and finished goods and are stated at the lower of cost, determined on a first-in, first-out basis, or market. Inventories, which are net of an allowance for excess and obsolete inventory (which we determine primarily based on future demand forecasts) of $4.5 million and $4.8 million at January 1, 2006 and July 3, 2005, respectively, consist of (in thousands):

	January 1, 2006	July 3, 2005
Raw materials	$ 7	$ 369
Finished goods	21,928	25,574
Total	$ 21,935	$ 25,943

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Sales to Distributors

We defer recognition of revenue on all sales to distributors until the distributor successfully resells the product, typically to an authorized reseller. Distributors regularly provide us their sales-out reports for this purpose. Until it is sold, inventory held by distributors is included in our reported finished goods inventory and was $3.5 million and $3.7 million at January 1, 2006 and July 3, 2005, respectively. The accounts receivable owed us by distributors, net of the deferred revenue from sales to distributors, is recorded in prepaid expenses and other current assets, as reflected in the following table (in thousands):

	January 1, 2006	July 3, 2005
Accounts receivable, net of allowance for doubtful accounts of $1,844 ($619 at July 3, 2005)	$ 18,498	$ 23,249
Deferred revenue	(16,310)	(16,779)
Net, included in Prepaid expenses and other current assets	$ 2,188	$ 6,470

Guarantees and Product Warranties

Financial Accounting Standards Board (FASB) Interpretation No. 45, *Guarantor s Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others* (FIN 45) requires that upon issuance of a guarantee, the guarantor must disclose and recognize a liability for the fair value of the obligation it assumes under that guarantee.

We have determined that the requirements of FIN 45 apply to our standard product warranty liability. The following table summarizes the activity related to our product warranty liability during the six months ended January 1, 2006 and December 26, 2004 (in thousands):

	Six Months Ended	
	January 1, 2006	December 26, 2004
Balance beginning of period	$ 7,471	$ 8,297
New warranties issued	5,582	5,719
Warranty expenditures	(6,031)	(7,051)
Change in estimate		1,128
Balance end of period	$ 7,022	$ 8,093

Our standard hardware warranty period is typically 12 months from the date of shipment to end-users. Upon shipment of products to our customers, we estimate expenses for the cost to repair or replace products that may be returned under warranty and accrue a liability in cost of product revenue for this amount. The determination of our warranty requirements is based on actual historical experience with the product or product family, estimates of repair and replacement costs and any product warranty problems that are identified after shipment. We estimate and adjust these accruals at each balance sheet date in accordance with changes in these factors. The change in estimate in the six months of fiscal 2005 results from a change in the method we used to accumulate warranty return rates. There was no change in estimate for the first six months of fiscal 2006.

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

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Deferred Support Revenue

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

	Six Months Ended	
	January 1, 2006	**December 26, 2004**
Balance beginning of period	$ 47,849	$ 50,178
New support arrangements	25,905	21,695
Recognition of support revenue	(29,014)	(25,381)
Balance end of period	44,740	46,492
Less current portion	34,867	30,537
Non-current deferred revenue	$ 9,873	$ 15,955

Recently Issued Accounting Standards

Identification of Impaired Investments

In March 2004, the FASB approved the consensus reached on EITF Issue No. 03-1, *The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments* (EITF 03-1). EITF 03-1 provides new guidance for evaluating impairment losses on debt and equity investments, as well as new disclosure requirements for investments that are determined to be other-than-temporarily impaired. In September 2004, the FASB approved the issuance of a FASB Staff Position to delay the requirement to record impairment losses under EITF 03-1.

In June 2005, the FASB decided not to provide additional guidance on the meaning of other-than-temporary impairment under EITF 03-1. In November 2005, the FASB issued FASB Staff Position Paper (FSP) 115-1, *The Meaning of Other-Than-Temporary Impairment and its Application to Certain Investments* (FSP 115-1), superseding EITF 03-1. FSP 115-1 replaced the accounting guidance on the determination of whether an investment is other-than-temporarily impaired as set forth in EITF 03-1 with references to existing other-than-temporary impairment guidance. FSP 115-1 will be effective for other-than-temporary impairment analyses conducted in periods beginning after December 15, 2005.

As substantially all of our investments are investment grade government and corporate debt securities that have maturities of less than 3 years, and we have both the ability and intent to hold the investments until maturity, we do not expect FSP 115-1 to have a material impact on our financial position and results of operations.

Accounting for Electronic Equipment Waste Obligations

In June 2005, the FASB issued FSP No. FAS 143-1, *Accounting for Electronic Equipment Waste Obligations* (FSP 143-1). FSP 143-1 provides guidance in accounting for obligations associated with Directive 2002/96/EC (the Directive) on Waste Electrical and Electronic Equipment adopted by the European Union. FAS 143-1 is required to be applied to the later of the first reporting period ending after June 6, 2005 or the date of the Directive s adoption into law by the applicable EU member countries in which we have significant operations. The Directive distinguishes between new and historical waste. New waste relates to products put on the market after August 13, 2005. FSP 143-1 directs commercial users to apply the provisions of FASB Statement No. 143, *Accounting for Asset Retirement Obligations*, and the related FASB Interpretation No. 47, *Accounting for Conditional Asset Retirement Obligations*, for the measurement and recognition of the liability and asset retirement obligation associated with the historical waste management requirements of the Directive. Additionally, FSP 143-1 provides guidance for the accounting by producers for the financing of the obligations of historical waste held by private households.

We adopted FAS 143-1 in the first quarter of fiscal 2006 and concluded that no significant liability had been incurred as of January 1, 2006. We are continuing to analyze the impact of the Directive, and FSP 143-1, on our financial position and results of operations as additional EU member countries adopt the Directive.

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Separate from the requirements of FSP 143-1, we believe that the internal cost of compliance with the Directive, and the liability associated with new waste obligations, which according to the Directive is to be borne solely by the producers of the new equipment, was not significant for the quarter and six months ended January 1, 2006, but could be significant in the future.

2. Stock-Based Compensation

On July 4, 2005, we adopted the fair value recognition provisions of Financial Accounting Standards Board (FASB) Statement No. 123(R), *Share-Based Payment*, (FAS 123R). Prior to July 4, 2005, we accounted for share-based payments under the recognition and measurement provisions of APB Opinion No. 25, *Accounting for Stock Issued to Employees* (APB 25), and related Interpretations, as permitted by FASB Statement No. 123, *Accounting for Stock-Based Compensation* (FAS 123). In accordance with APB 25 no compensation cost was required to be recognized for options granted that had an exercise price equal to the market value of the underlying common stock on the date of grant.

We adopted FAS 123R using the modified-prospective-transition method. Under that transition method, compensation cost recognized in the six months ended January 1, 2006 includes: a) compensation cost for all share-based payments granted prior to, but not yet vested as of July 4, 2005, based on the grant-date fair value estimated in accordance with the original provisions of Statement 123, and b) compensation cost for all share-based payments granted subsequent to July 4, 2005, based on the grant-date fair value estimated in accordance with the provisions of FAS 123R. The results for the prior periods have not been restated.

As a result of adopting FAS 123R on July 4, 2005 our net income for the second quarter and six months ended January 1, 2006 is $1.6 million and $3.4 million lower, respectively, than if we had continued to account for share-based compensation under APB 25 as we did in the comparable prior year periods. Diluted earnings per share for the quarter and six months ended January 1, 2006 would have been $0.06 and $0.11, respectively, if we had not adopted FAS 123R, compared to reported diluted earnings per share of $0.05 and $0.08, respectively. We have not recognized, and do not expect to recognize in the near future, any tax benefit related to employee stock based compensation cost as a result of the full valuation allowance on our net deferred tax assets and our net operating loss carryforwards. The total compensation cost capitalized in inventory was less than $0.1 million as of January 1, 2006. Stock-based compensation cost of $0.1 million and $0.2 million was recognized in expense in accordance with APB 25 for the three and six month periods ended December 26, 2004, respectively.

As of January 1, 2006, we have the following share-based compensation plans:

2005 Equity Incentive Plan

The 2005 Equity Incentive Plan (the 2005 Plan) was adopted by our Board of Directors on October 20, 2005, and approved by stockholders on December 2, 2005. The 2005 Plan replaces the 1996 Stock Option Plan (the 1996 Plan), 2000 Stock Plan (the 2000 Plan) and 2001 Stock Plan (the 2001 Plan).

Under the 2005 Plan, we may grant stock options, stock appreciation rights, restricted stock, restricted stock units, performance shares, performance units, and other stock-based or cash-based awards to employees and consultants. The 2005 Plan also authorizes the grant of awards of stock options, stock appreciation rights, restricted stock and restricted stock units to non-employee members of the board of directors and deferred compensation awards to officers, directors and certain management or highly compensated employees. The 2005 Plan authorizes the issuance of up to 12,000,000 shares of our common stock, and up to 11,000,000 shares subject to awards that remain outstanding under the 1996

Plan, 2000 Plan and 2001 Plan as of December 2, 2005 and which subsequently terminate without having been exercised or which are forfeited, will be added to the shares available under the 2005 Plan. As of January 1, 2006, 22,929,600 shares were available for future grant under the 2005 Plan.

1999 Employee Stock Purchase Plan

In January 1999, the Board of Directors approved the adoption of Extreme Network s 1999 Employee Stock Purchase Plan (the Purchase Plan). On December 2, 2005, the stockholders approved an amendment to the Purchase Plan to increase the maximum number of shares of common stock that may be issued under the plan by 5,000,000 to a total of 12,000,000 shares. The Purchase Plan permits eligible employees to acquire shares of our common stock through periodic payroll deductions of up to 15% of total compensation. No more than 625 shares may be purchased on any purchase date per employee. Each offering period has a maximum duration of 12 months. The price at which the common stock may be purchased is 85% of the lesser of the fair market value of our common stock on the first day of the applicable offering period or on the last day of the respective purchase period. Through January 1, 2006, 5,756,531 shares had been purchased under the Purchase Plan. As of January 1, 2006, the total unrecognized compensation cost related to the Purchase Plan was $0.2 million and is expected to be recognized over a weighted average period of approximately five months.

Amended 1996 Stock Option Plan

In January 1999, the Board of Directors approved an amendment to the 1996 Stock Option Plan (the 1996 Plan) to (i) increase the share reserve by 10,000,000 shares, (ii) to remove certain provisions which are required to be in option plans maintained by California privately-held companies and (iii) to rename the 1996 Plan as the Amended 1996 Stock Option Plan.

Under the 1996 Plan, which was originally adopted in September 1996, options may be granted for common stock, pursuant to actions by the Board of Directors, to eligible participants. A total of 56,387,867 shares were reserved under the 1996 Plan. Options granted are exercisable as determined by the Board of Directors. Options vest over a period of time as determined by the Board of Directors, generally four years. Options have a contractual term of ten years. Effective December 2, 2005, the 1996 Plan was terminated.

2000 Stock Option Plan

In March 2000, the Board of Directors adopted the 2000 Nonstatutory Stock Option Plan (the 2000 Plan). Options may be granted for common stock, pursuant to actions by the Board of Directors, to eligible participants. Generally, only non-officer employees are eligible to participate in the 2000 Plan, except that options may be granted to officers under this plan in connection with written offers of employment. A total of 4,000,000 shares were reserved under the 2000 Plan. Options vest over a period of time as determined by the Board of Directors, generally four years. Options have a contractual term of ten years. Effective December 2, 2005, the 2000 Plan was terminated.

2001 Stock Option Plan

In May 2001, the Board of Directors adopted the 2001 Nonstatutory Stock Option Plan (the 2001 Plan). Options may be granted for common stock, pursuant to actions by the Board of Directors, to eligible participants. Generally, only non-officer employees are eligible to participate in the 2001 Plan, except that options may be granted to officers under this plan in connection with written offers of employment. A total of 4,000,000 shares were reserved under the 2001 Plan. Options vest over a period of time as determined by the Board of Directors, generally four years. Options have a contractual term of ten years. Effective December 2, 2005, the 2001 Plan was terminated.

A summary of the status of our non-vested shares as of January 1, 2006 and changes during the first six months of fiscal 2006, is presented below:

	Number of Shares	Weighted-Average Grant-

	(000 s)	Date Fair Value
Non-vested shares at July 3, 2005	33	$ 6.28
Granted	165	4.75
Vested	(27)	6.06
Canceled	(5)	5.82
Non-vested shares at January 1, 2006	166	$ 4.81

During the first six months of fiscal 2006, we granted non-vested stock awards under the 2001 Plan for 164,500 shares of common stock with a weighted average grant date fair value per share of $4.75. The shares were placed in an escrow account and will be released to the recipients as the shares vest over periods of up to twenty-four months. If a participant terminates employment prior to the vesting dates, the unvested shares will be canceled and returned to the 2001 Plan. We recognize compensation expense on the awards over the vesting period based on an intrinsic value calculation as of the date of grant. As of January 1, 2006, there was approximately $0.6 million in unrecognized compensation costs related to non-vested stock. This cost is expected to be recognized over a weighted-average period of approximately 1.0 years.

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The following table summarizes stock option activity during the first six months of fiscal 2006 under all plans:

	Number of Shares (000 s)	Weighted-Average Exercise Price Per Share	Weighted-Average Remaining Contractual Term	Aggregate Intrinsic Value ($ 000 s)
Options outstanding at July 3, 2005	21,138	$ 6.87		
Granted	4,252	$ 4.50		
Exercised	(317)	$ 3.04		
Canceled	(2,363)	$ 7.48		
Options outstanding at January 1, 2006	22,710	$ 6.42	7.76	$ 5,300
Exercisable at January 1, 2006	14,739	$ 7.15	7.69	$ 3,417

As of January 1, 2006, there was $7.7 million of total unrecognized compensation cost related to unvested stock options. This cost is expected to be recognized over a weighted-average period of approximately 1.5 years. The total intrinsic value of options exercised in the first six months of fiscal 2006 and fiscal 2005 was $0.5 million and $0.8 million, respectively. The fair value of options vested in the first six months of fiscal 2006 is $2.6 million.

The fair value of each option award is estimated on the date of grant using the Black-Scholes-Merton option valuation model with the weighted average assumptions noted in the following table. The expected term of options granted is derived from historical data on employee exercise and post-vesting employment termination behavior. The risk-free rate for periods within the contractual life of the option is based on the U.S. Treasury yield curve in effect at the time of grant. Expected volatility is based on both the implied volatilities from traded options on our stock and historical volatility on our stock.

For options granted prior to July 4, 2005, and valued in accordance with FAS 123, the expected volatility used to estimate the fair value of the options was based solely on the historical volatility on our stock; we used the graded vesting method for expense attribution; and we recognized option forfeitures as they occurred as allowed by FAS 123.

For options granted after July 3, 2005, and valued in accordance with FAS 123R, we use the straight-line method for expense attribution, and we estimate forfeitures and only recognize expense for those shares expected to vest. Our estimated forfeiture rate in the first six months of fiscal 2006, based on our historical forfeiture experience, is approximately 20%.

	Stock Option Plans		Employee Stock Purchase Plan	
	Three months ended	Six months ended	Three months ended	Six months ended

	January 1, 2006	December 26, 2004	January 1, 2006	December 26, 2004	January 1, 2006	December 26, 2004	January 1, 2006	December 26, 2004
Expected life	2.2yrs	2.5yrs	2.5yrs	2.5yrs	0.7yrs	0.6yrs	0.7yrs	0.9yrs
Risk-free interest rate	4.5%	2.8%	4.1%	2.7%	4.3%	2.3%	4.0%	1.8%
Volatility	58.0%	82.0%	61.0%	84.0%	43.0%	49.0%	44.0%	57.0%
Expected dividend yield	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%

The Black-Scholes-Merton option valuation model requires the input of highly subjective assumptions, including the expected life of the stock-based award and stock price volatility. The assumptions listed above represent management s best estimates, but these estimates involve inherent uncertainties and the application of management judgment. As a result, if other assumptions had been used, our recorded and pro forma stock-based compensation expense could have been materially different from that depicted above and below. In addition, we are required to estimate the expected forfeiture rate and only recognize expense for those shares expected to vest. If our actual forfeiture rate is materially different from our estimate, the share-based compensation expense could be materially different.

The weighted-average grant-date per share fair value of options granted in the second quarter of fiscal 2006 and fiscal 2005 was $1.69 and $2.53, respectively. The weighted-average estimated per share fair value of shares granted under the Purchase Plan in the second quarter of fiscal 2006 and fiscal 2005 was $1.41 and $1.78, respectively.

The following table illustrates the effect on net income and earnings per share if we had applied the fair value recognition provisions of FAS 123 to options granted under our stock option plans, non-vested stock awards granted and shares issued under the Purchase Plan in the three and six month periods ended December 26, 2004. For purposes of pro forma disclosures, the value of the options is estimated using a Black-Scholes-Merton option-pricing formula and amortized to expense over the options vesting periods; using the graded vested method. The following pro forma information sets forth our net income and

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net income per share assuming that we had used the FAS 123 fair value method in accounting for employee stock options and purchases during the second quarter and six months of fiscal 2005 (in thousands, except per share amounts):

	Three Months Ended December 26, 2004	Six Months Ended December 26, 2004
Net income as reported	$ 9,950	$ 14,076
Add: APB 25 stock-based employee compensation expense, as reported, net of tax	109	186
Less: Stock-based compensation expense determined under fair value based method, net of tax	(5,585)	(12,384)
Pro forma net income	$ 4,474	$ 1,878
Basic net income per share:		
As reported	$ 0.08	$ 0.12
Pro forma	$ 0.04	$ 0.02
Diluted net income per share:		
As reported	$ 0.08	$ 0.11
Pro forma	$ 0.04	$ 0.02

3. Commitments and Contingencies

Stock Repurchase Program

On October 20, 2005, our Board of Directors authorized the repurchase of up to $50 million of our common stock. This authorization will expire in October 2007. In the quarter ended January 1, 2006, we repurchased approximately 1.4 million shares for approximately $6.8 million. We expect to repurchase stock over the next twelve months, primarily through open market purchases. The repurchases will be made in compliance with the Securities and Exchange Commission s Rule 10b-18, and are subject to market conditions as well as applicable legal and other considerations.

Line of Credit

We have a revolving line of credit for $10.0 million with a major lending institution. Borrowings under this line of credit bear interest at the bank s prime rate. As of January 1, 2006, there were no outstanding borrowings under this line of credit. The line of credit contains a provision for the issuance of letters of credit not to exceed the unused balance of the line. As of January 1, 2006, we had letters of credit totaling $0.8 million. These letters of credit were primarily issued to satisfy requirements of certain of our customers for performance bonds. The line of credit requires us to maintain specified financial covenants related to tangible net worth and liquidity with which we were in compliance as of January 1, 2006. The line of credit expires on January 25, 2007.

Purchase Commitments

We currently have arrangements with one contract manufacturer and other suppliers for the manufacture of our products. Our arrangements allow them to procure long lead-time component inventory on our behalf based upon a rolling production forecast provided by us. We are obligated to the purchase of long lead-time component inventory that our contract manufacturer procures in accordance with the forecast, unless we give notice of order cancellation outside of applicable component lead-times. As of January 1, 2006, we had non-cancelable commitments to purchase approximately $18.5 million of such inventory during the third quarter of fiscal 2006.

Legal Proceedings

On December 27, 2006, Broadband Office Inc. (Broadband) served an amended complaint, adding Extreme Networks as a defendant in its lawsuit against Technology Credit Corporation (TCC) and Key Equipment Finance, Inc., seeking recovery of an alleged preferential payment in the amount of approximately $0.8 million plus interest, purportedly paid by Broadband to TCC within ninety days prior to Broadband s petition for bankruptcy protection. Extreme disputes that it owes any money to Broadband, and intends to vigorously defend against the claims.

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On June 21, 2005, Enterasys filed suit against Extreme Networks and Foundry Networks, Inc. (Foundry) in the United States District Court for the District of Delaware, Civil Action No.05-11298 DPW. The complaint alleges willful infringement of U. S. Patent Nos. 5,251,205; 5,390,173; 6,128,665; 6,147,995; 6,539,022; and 6,560, 236, and seeks a judgment: (a) determining that we have willfully infringed each of the patents; (b) permanently enjoining us from infringement, inducement of infringement and contributory infringement of each of the six patents; (c) awarding damages and a reasonable royalty to be determined at trial; (d) awarding trebled damages; (e) awarding attorneys fees, costs and interest; and (f) awarding equitable relief at the court s discretion. The Markman hearing has been scheduled for January 2007. We intend to vigorously defend against Enterasys assertions, which we believe to be without merit.

On May 27, 2003, Lucent filed suit against Extreme Networks and Foundry in the United States District Court for the District of Delaware, Civil Action No. 03-508. The complaint alleged willful infringement of U.S. Patent Nos. 4,769,810, 4,769,811, 4,914,650, 4,922,486 and 5,245,607. The judge split the case into three parts to be tried separately: phase 1 to cover infringement, willfulness and damages; phase 2 to cover invalidity; and phase 3 to cover equitable defenses and our counterclaims. On May 9, 2005, a jury in Delaware awarded us a verdict in the phase 1 trial of non-infringement on 18 out of the 19 claims asserted. The jury did award Lucent damages of approximately $275,000 on the remaining claim; which covers a feature that is not offered in our current product line. The parties each filed post-trial motions; and on August 16, 2005, the judge granted Lucent s motion for a new trial, ruling that Extreme impermissibly introduced to the jury evidence of its prior relationship with Lucent. Extreme s motion for reconsideration was denied. The new trial on phase 1 has been scheduled for September 18, 2006 and the remaining phases of the trial have not yet been scheduled. We intend to vigorously defend against Lucent s claims, which we continue to believe to be without merit.

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

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

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

We have executed a settlement agreement presented to all issuer defendants. In this settlement, plaintiffs will dismiss and release all claims against the Extreme Network Defendants, in exchange for a contingent payment by the insurance companies collectively responsible for insuring the issuers in all of the IPO cases, and for the assignment or surrender of control of certain claims we may have against the underwriters. The

Extreme Networks Defendants will not be required to make any cash payments in the settlement, unless the pro rata amount paid by the insurers in the settlement exceeds the amount of the insurance coverage, a circumstance which we do not believe will occur. The settlement will require approval of the Court, which cannot be assured. If the settlement is not approved, we cannot assure you that we will prevail in the lawsuit. Failure to prevail could have a material adverse effect on our consolidated financial position, results of operations and cash flows in the future.

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

4. Comprehensive Income

Comprehensive income was as follows (in thousands):

	Three Months Ended	Six Months Ended