

EXTREME NETWORKS INC
Form 10-Q
November 03, 2010
Table of Contents

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D. C. 20549

Form 10-Q

(Mark One)

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

For the quarterly period ended September 26, 2010

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)

Edgar Filing: EXTREME NETWORKS INC - Form 10-Q

| | |
|---|---|
| DELAWARE [State or other jurisdiction of incorporation or organization] | 77-0430270 [I.R.S Employer Identification No.] |
| 3585 Monroe Street, Santa Clara, California [Address of principal executive office] | 95051 [Zip Code] |
| Registrant's telephone number, including area code: (408) 579-2800 | |

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 229.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

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

Large accelerated filer Accelerated filer

Non-accelerated filer (Do not check if a smaller reporting company) Smaller reporting company

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

The number of shares of the Registrant's Common Stock, \$.001 par value, outstanding at October 29, 2010 was 91,049,772.

Table of Contents

EXTREME NETWORKS, INC.

FORM 10-Q

QUARTERLY PERIOD ENDED SEPTEMBER 26, 2010

INDEX

| | PAGE |
|---|-------------|
| PART I. CONDENSED CONSOLIDATED FINANCIAL INFORMATION | |
| Item 1. Condensed Consolidated Financial Statements (Unaudited): | |
| <u>Condensed Consolidated Balance Sheets as of September 26, 2010 and June 27, 2010</u> | 3 |
| <u>Condensed Consolidated Statements of Operations for the Three months ended September 26, 2010 and September 27, 2009</u> | 4 |
| <u>Condensed Consolidated Statements of Cash Flows for the Three months ended September 26, 2010 and September 27, 2009</u> | 5 |
| <u>Notes to Condensed Consolidated Financial Statements</u> | 6 |
| Item 2. <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u> | 21 |
| Item 3. <u>Quantitative and Qualitative Disclosures About Market Risk</u> | 30 |
| Item 4. <u>Controls and Procedures</u> | 32 |
| <u>PART II. OTHER INFORMATION</u> | |
| Item 1. <u>Legal Proceedings</u> | 33 |
| Item 1A. <u>Risk Factors</u> | 33 |
| Item 2. <u>Unregistered Sales of Equity Securities and Use of Proceeds</u> | 33 |
| Item 3. <u>Defaults Upon Senior Securities</u> | 33 |
| Item 4. <u>(Removed and Reserved)</u> | 33 |
| Item 5. <u>Other Information</u> | 33 |
| Item 6. <u>Exhibits</u> | 33 |
| <u>Signatures</u> | 34 |

Table of Contents

EXTREME NETWORKS, INC.
CONDENSED CONSOLIDATED BALANCE SHEETS
(In thousands, except share and per share amounts)

| | September 26, 2010 (unaudited) | June 27, 2010 (1) |
|--|--------------------------------------|-------------------------|
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 44,643 | \$ 49,004 |
| Short-term investments | 48,387 | 64,854 |
| Accounts receivable, net | 39,663 | 42,057 |
| Inventories, net | 20,496 | 21,842 |
| Deferred income taxes | 476 | 392 |
| Prepaid expenses and other current assets, net | 4,494 | 3,932 |
| Total current assets | 158,159 | 182,081 |
| Property and equipment, net | 43,397 | 43,572 |
| Marketable securities | 39,670 | 18,561 |
| Other assets, net | 16,210 | 15,731 |
| Total assets | \$ 257,436 | \$ 259,945 |
| LIABILITIES AND STOCKHOLDERS EQUITY | | |
| Current liabilities: | | |
| Accounts payable | \$ 17,329 | \$ 18,543 |
| Accrued compensation and benefits | 12,800 | 13,365 |
| Restructuring liabilities | 2,458 | 3,097 |
| Accrued warranty | 2,794 | 3,169 |
| Deferred revenue, net | 28,402 | 29,552 |
| Deferred revenue, net of cost of sales to distributors | 15,424 | 18,345 |
| Other accrued liabilities | 14,602 | 13,381 |
| Total current liabilities | 93,809 | 99,452 |
| Restructuring liabilities, less current portion | | 273 |
| Deferred revenue, less current portion | 7,610 | 7,633 |
| Deferred income taxes | 107 | 731 |
| Other long-term liabilities | 180 | 2,661 |
| Commitments and contingencies (Note 3) | | |
| Stockholders equity: | | |
| Convertible preferred stock, \$.001 par value, issuable in series, 2,000,000 shares authorized; none issued | | |
| Common stock, \$.001 par value, 750,000,000 shares authorized; 130,421,666 issued at September 26, 2010 and 129,827,715 at June 27, 2010 | 130 | 130 |
| Treasury stock, 39,625,305 at September 26, 2010 and June 27, 2010 | (149,666) | (149,666) |
| Additional paid-in-capital | 958,994 | 956,792 |
| Accumulated other comprehensive income | 2,721 | 1,100 |
| Accumulated deficit | (656,449) | (659,161) |

Edgar Filing: EXTREME NETWORKS INC - Form 10-Q

| | | |
|--|------------|------------|
| Total stockholders' equity | 155,730 | 149,195 |
| Total liabilities and stockholders' equity | \$ 257,436 | \$ 259,945 |

- (1) The information in this column is derived from the Company's consolidated balance sheet included in the Company's Annual Report on Form 10-K for the year ended June 27, 2010.
See accompanying notes to unaudited condensed consolidated financial statements.

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

| | Three Months Ended | |
|---|-------------------------------|-------------------------------|
| | September 26, 2010 | September 27, 2009 |
| Net revenues: | | |
| Product | \$ 69,213 | \$ 50,759 |
| Service | 14,624 | 15,550 |
| Total net revenues | 83,837 | 66,309 |
| Cost of revenues: | | |
| Product | 30,830 | 23,718 |
| Service | 6,170 | 5,831 |
| Total cost of revenues | 37,000 | 29,549 |
| Gross profit: | | |
| Product | 38,383 | 27,041 |
| Service | 8,454 | 9,719 |
| Total gross profit | 46,837 | 36,760 |
| Operating expenses: | | |
| Sales and marketing | 24,906 | 21,669 |
| Research and development | 12,861 | 13,610 |
| General and administrative | 6,585 | 7,245 |
| Restructuring reversal, net of charge | | (513) |
| Total operating expenses | 44,352 | 42,011 |
| Operating income (loss) | 2,485 | (5,251) |
| Interest income | 329 | 322 |
| Interest expense | (30) | (39) |
| Other expense | (277) | (78) |
| Income (loss) before income taxes | 2,507 | (5,046) |
| Provision for income taxes | (205) | 436 |
| Net income (loss) | \$ 2,712 | \$ (5,482) |
| Basic and diluted net income (loss) per share: | | |
| Net income (loss) per share - basic | \$ 0.03 | \$ (0.06) |
| Net income (loss) per share - diluted | \$ 0.03 | \$ (0.06) |

Edgar Filing: EXTREME NETWORKS INC - Form 10-Q

| | | |
|--|--------|--------|
| Shares used in per share calculation - basic | 90,305 | 88,843 |
| Shares used in per share calculation - diluted | 90,610 | 88,843 |

See accompanying notes to unaudited condensed consolidated financial statements.

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

| | Three Months Ended | |
|--|-------------------------------|-------------------------------|
| | September 26, 2010 | September 27, 2009 |
| Cash flows from operating activities: | | |
| Net income (loss) | \$ 2,712 | \$ (5,482) |
| Adjustments to reconcile net income (loss) to net cash provided by operating activities: | | |
| Depreciation and amortization | 1,539 | 1,647 |
| Change in value / loss (gain) on value of UBS option to put securities | 2,429 | (14) |
| Auction rate securities mark to market, trading (gain) loss | (2,429) | 14 |
| Provision for excess and obsolete inventory | 11 | 785 |
| Deferred income taxes | (709) | 18 |
| Stock-based compensation | 2,109 | 1,140 |
| Restructuring reversal, net of charge | | (513) |
| Changes in operating assets and liabilities, net | | |
| Accounts receivable | 2,394 | 1,580 |
| Inventories | 1,343 | (4,559) |
| Prepaid expenses and other assets | (1,041) | (2,457) |
| Accounts payable | (1,214) | 3,808 |
| Accrued compensation and benefits | (564) | (325) |
| Restructuring liabilities | (912) | (1,339) |
| Accrued warranty | (376) | 250 |
| Deferred revenue, net | (1,173) | (243) |
| Deferred revenue, net of cost of sales to distributors | (2,921) | 2,543 |
| Other accrued liabilities | 2,480 | 7,157 |
| Other long-term liabilities | (2,481) | 119 |
| Net cash provided by operating activities | 1,197 | 4,129 |
| Cash flows used in investing activities: | | |
| Capital expenditures | (1,362) | (1,227) |
| Purchases of investments | (43,541) | (13,697) |
| Proceeds from maturities of investments and marketable securities | 5,800 | 2,550 |
| Proceeds from sales of investments and marketable securities | 33,459 | 1,086 |
| Net cash used in investing activities | (5,644) | (11,288) |
| Cash flows provided by financing activities: | | |
| Proceeds from issuance of common stock | 86 | 225 |
| Net cash provided by financing activities | 86 | 225 |
| Net decrease in cash and cash equivalents | (4,361) | (6,934) |

Edgar Filing: EXTREME NETWORKS INC - Form 10-Q

| | | |
|---|------------------|------------------|
| Cash and cash equivalents at beginning of period | 49,004 | 46,195 |
| Cash and cash equivalents at end of period | \$ 44,643 | \$ 39,261 |

See accompanying notes to the unaudited condensed consolidated financial statements.

Table of Contents**EXTREME NETWORKS, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)****1. Summary of Significant Accounting Policies*****Basis of Presentation***

The unaudited condensed consolidated financial statements of Extreme Networks, Inc. (referred to as the **Company** or **Extreme Networks**) included herein have been prepared under the rules and regulations of the Securities and Exchange Commission (**SEC**). Certain information and footnote disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles have been condensed or omitted under such rules and regulations. The condensed consolidated balance sheet at June 27, 2010 was derived from audited financial statements as of that date but does not include all disclosures required by generally accepted accounting principles for complete financial statements. These interim financial statements and notes should be read in conjunction with the Company's audited consolidated financial statements and notes thereto included in the Company's Annual Report on Form 10-K for the fiscal year ended June 27, 2010. The Company has evaluated all subsequent events through the date these interim financial statements were filed with the SEC.

The unaudited condensed consolidated financial statements reflect all adjustments, consisting only of normal recurring adjustments that, in the opinion of management, are necessary for a fair presentation of the results of operations and cash flows for the interim periods presented and the financial condition of Extreme Networks at September 26, 2010. The results of operations for the first quarter of fiscal 2011 are not necessarily indicative of the results that may be expected for fiscal 2011 or any future periods.

Cash, Cash Equivalents, and Investments

The following is a summary of cash and cash equivalents, short-term investments and marketable securities (in thousands):

| | September 26, 2010 | June 27, 2010 |
|----------------------------|-------------------------------|--------------------------|
| Cash and cash equivalent | \$ 44,643 | \$ 49,004 |
| Short-term investments | 48,387 | 64,854 |
| Marketable securities | 39,670 | 18,561 |
| Total cash and investments | \$ 132,700 | \$ 132,419 |

Summary of Available-for-Sale Securities and Trading Securities

The following is a summary of available-for-sale and trading securities (in thousands):

| | September 26, 2010 | June 27, 2010 |
|---|-------------------------------|--------------------------|
| Cash equivalent | \$ 35,489 | \$ 42,544 |
| Short-term investments | 48,387 | 64,855 |
| Marketable securities | 39,670 | 18,561 |
| Total available-for-sale and trading securities | \$ 123,546 | \$ 125,960 |

Table of Contents**EXTREME NETWORKS, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) (Continued)***Available-for-Sale Securities*

The following is a summary of available-for-sale securities (in thousands):

| | Amortized Cost | Fair Value | Unrealized Holding Gains | Unrealized Holding Losses |
|-----------------------------------|-------------------|---------------|--------------------------------|---------------------------------|
| September 26, 2010: | | | | |
| Money market funds | \$ 35,489 | \$ 35,489 | \$ | \$ |
| U.S. corporate debt securities | 80,600 | 81,017 | 432 | (15) |
| U.S. government agency securities | 6,951 | 7,040 | 89 | |
| | \$ 123,040 | \$ 123,546 | \$ 521 | (\$ 15) |

Classified as:

| | | | | |
|------------------------|------------|------------|--------|---------|
| Cash equivalents | \$ 35,489 | \$ 35,489 | \$ | \$ |
| Short-term investments | 48,182 | 48,387 | 207 | (2) |
| Marketable securities | 39,369 | 39,670 | 314 | (13) |
| | \$ 123,040 | \$ 123,546 | \$ 521 | (\$ 15) |

| | Amortized Cost | Fair Value | Unrealized Holding Gains | Unrealized Holding Losses |
|-----------------------------------|-------------------|---------------|--------------------------------|---------------------------------|
| June 27, 2010: | | | | |
| Money market funds | \$ 42,544 | \$ 42,544 | \$ | \$ |
| U.S. corporate debt securities | 53,525 | 53,570 | 159 | (114) |
| U.S. government agency securities | 4,413 | 4,514 | 101 | |
| | \$ 100,482 | \$ 100,628 | \$ 260 | (\$ 114) |

Classified as:

| | | | | |
|------------------------|------------|------------|--------|----------|
| Cash equivalents | \$ 42,544 | \$ 42,544 | \$ | \$ |
| Short-term investments | 39,381 | 39,523 | 202 | (60) |
| Marketable securities | 18,557 | 18,561 | 58 | (54) |
| | \$ 100,482 | \$ 100,628 | \$ 260 | (\$ 114) |

The amortized cost and estimated fair value of available-for-sale investments in debt securities at September 26, 2010, by contractual maturity, were as follows (in thousands):

Edgar Filing: EXTREME NETWORKS INC - Form 10-Q

| | Amortized Cost | Fair Value |
|--|---------------------------|-----------------------|
| Due in 1 year or less | \$ 48,182 | \$ 48,387 |
| Due in 1-2 years | 22,716 | 22,859 |
| Due in 2-5 years | 16,653 | 16,811 |
| Due in more than 5 years | | |
| Total investments in available for sale debt securities | \$ 87,551 | \$ 88,057 |

Table of Contents**EXTREME NETWORKS, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) (Continued)**

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

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

The following table presents the Company's investments' gross unrealized losses and fair values, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position.

| | Less than 12 months | | 12 months or more | | Total | |
|--------------------------------|---------------------|-------------------|-------------------|-------------------|------------|-------------------|
| | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses |
| September 26, 2010: | | | | | | |
| U.S. corporate debt securities | \$ 7,729 | (\$ 15) | | | \$ 7,729 | (\$ 15) |

The Company determines the basis of the cost of a security sold or the amount reclassified out of accumulated other comprehensive income into earnings using the specific identification method. During the three months ended September 26, 2010, realized gains or losses recognized on the sale of investments were not significant. During the three months ended September 26, 2010 there were four investment securities that had unrealized losses. The unrealized gains / (losses) on the Company's investments were caused by interest rate fluctuations. Substantially all of the Company's available-for-sale investments are investment grade government and corporate debt securities that have maturities of less than 3 years. The Company does not intend to sell the investments and it is not more likely than not that the Company will be required to sell the investments before recovery of its amortized costs.

Fair Value of Financial Instruments

The Company's financial instruments are measured at fair value and non-financial assets and non-financial liabilities are measured at cost. Fair value is defined as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. Valuation

Edgar Filing: EXTREME NETWORKS INC - Form 10-Q

techniques used to measure fair value must maximize the use of observable inputs and minimize the use of unobservable inputs. Fair value is measured based on a fair value hierarchy following three levels of inputs, of which the first two are considered observable and the last unobservable:

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

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

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

Table of Contents**EXTREME NETWORKS, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) (Continued)**

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

| September 26, 2010: | Level 1 | Level 2 (In thousands) | Level 3 | Total |
|------------------------------------|----------------|---|----------------|--------------|
| Assets | | | | |
| Investments: | | | | |
| Federal agency notes | \$ | \$ 7,040 | \$ | \$ 7,040 |
| Money market funds | 35,489 | | | 35,489 |
| Corporate notes/bonds | | 81,017 | | 81,017 |
| Derivative instruments: | | | | |
| Foreign currency forward contracts | | 335 | | 335 |
| Total | \$ 35,489 | \$ 88,392 | \$ | \$ 123,881 |
| | | | | |
| June 27, 2010: | Level 1 | Level 2 (In thousands) | Level 3 | Total |
| Assets | | | | |
| Investments: | | | | |
| Federal agency notes | \$ | \$ 4,514 | \$ | \$ 4,514 |
| Money market funds | 42,544 | | | 42,544 |
| Corporate notes/bonds | | 53,570 | | 53,570 |
| Auction rate securities | | | 22,902 | 22,902 |
| Put Option | | | 2,429 | 2,429 |
| Derivative instruments: | | | | |
| Foreign currency forward contracts | | 109 | | 109 |
| Total | \$ 42,544 | \$ 58,193 | \$ 25,331 | \$ 126,068 |

Level 2 investment valuations are based on inputs such as quoted market prices, dealer quotations or valuations provided by alternative pricing sources supported by observable inputs. These generally include U.S. government and sovereign obligations, most government agency securities, investment-grade corporate bonds, and state, municipal and provincial obligations.

The following table provides a summary of changes in the fair value of the Company's Level 3 financial assets for the three months ended September 26, 2010 (in thousands):

| | Auction Rate Securities |
|----------------------------------|--------------------------------|
| Balance as of June 27, 2010 | \$ 22,902 |
| Sale of ARS to UBS | (22,902) |
| Balance as of September 26, 2010 | \$ |

Edgar Filing: EXTREME NETWORKS INC - Form 10-Q

| | Put Option |
|----------------------------------|-------------------|
| Balance as of June 27, 2010 | \$ 2,429 |
| Exercise of Put Option | (2,429) |
| Balance as of September 26, 2010 | \$ |

Level 3 assets consisted of ARS whose underlying assets were student loans which were substantially backed by the federal government. Since the auctions for these securities had continued to fail since February 2008, these investments were not trading and therefore did not have a readily determinable market value. Accordingly, the estimated fair value of the ARS no longer approximated par value. These ARS were held by UBS, the Company's investment provider. In November 2008, the Company accepted an offer (the Right) from UBS entitling the Company to sell at par value ARS originally purchased from UBS (approximately \$40.8 million, par value) at anytime during a two-year period from June 30, 2010 through July 2, 2012. If the Right is not exercised before July 2, 2012, it will expire and UBS will have no further rights or obligation to buy the Company's ARS. The enforceability of the Right resulted in the creation of an asset akin to a Put Option (the Company had the right to put the ARS back to UBS at some specified date for a payment equal to the par value of the ARS). The Put Option was a free standing asset separate from the ARS. The Company had valued the ARS and Put Option using a discounted cash flow model based on Level 3 assumptions. The assumptions used in valuing the ARS and the Put Option included estimates of interest rates, timing and amount of cash flows, credit and liquidity premiums, expected holding periods of the ARS and bearer risk associated with UBS's financial ability to repurchase the ARS beginning June 30, 2010. During fiscal 2010, UBS exercised its rights to call back the ARS at par for \$9.8 million and issuers sold \$5.7 million of ARS at par. On June 30, 2010, the Company sold the remaining ARS balance of \$25.3 million at par under the Rights. On July 1, 2010, the Company received \$25.3 million plus accrued interest in cash from UBS for the ARS settlement. Upon the sale of the ARS, the Company recognized a gain of \$2.4 million with an equivalent loss on the exercise of the Put Option.

Table of Contents**EXTREME NETWORKS, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) (Continued)*****Revenue Recognition***

In October 2009, the Financial Accounting Standards Board (FASB) issued a new accounting standard which excludes from the scope of software revenue guidance the revenue arrangements which include tangible products that contain software components and non-software components that function together to deliver the tangible product 's essential functionality. At the same time, the FASB also issued another accounting standard which changes the requirements for establishing separate units of accounting in a multiple element arrangement and requires the allocation of arrangement consideration to each deliverable to be based on its relative selling price. The new standards are effective prospectively for revenue arrangements entered into or materially modified in fiscal years beginning on or after June 15, 2010. The Company adopted the new standards for the first quarter of fiscal 2011, commencing on June 28, 2010. The adoption did not materially affect the Company 's results for the first quarter of fiscal 2011 and is not anticipated to have a material effect on future periods.

The Company 's networking products are tangible products that contain software and non-software components that function together to deliver the tangible product 's essential functionality. Therefore, pursuant to the guidance of the new accounting standard, for transactions initiated on or after the beginning of its fiscal year 2011, the Company now allocates the total arrangement consideration to each separable element of an arrangement based on the relative selling price of each element. Under previous applicable guidance, the Company first allocated arrangement revenue using its vendor-specific objective evidence of fair value (VSOE) for the undelivered elements of its arrangements, and then allocated the residual revenue to the delivered elements.

Under the guidance of the new accounting standard, when the Company 's sales arrangements contain multiple elements, such as products, software licenses, maintenance agreements, and/or professional services, the Company determines the relative selling price for each element based on a selling price hierarchy. The application of the new accounting standard does not change the units of accounting for the Company 's multiple element arrangements. The selling price for a deliverable is based on the Company 's vendor-specific objective evidence (VSOE), which is determined by a substantial majority of the Company 's historical standalone sales transactions for a product or service falling within a reasonable range. If VSOE is not available due to a lack of standalone sales transactions or lack of pricing within a narrow range, then third party evidence (TPE), as determined by the standalone pricing of competitive vendor products in similar markets, is used. TPE typically is difficult to establish due to the proprietary differences of competitive products and difficulty in obtaining reliable standalone pricing information. When neither VSOE nor TPE is available, the Company applies management judgment to determine the Company 's best estimate of selling price (ESP) for the stand-alone price of a product, taking into consideration such factors as sales channel, geography, gross margin objectives, and product lifecycle. The determination of ESP is made through consultation with and formal approval by the Company 's management.

When the Company 's multiple element arrangements contain non-software deliverables and elements which are considered more-than-incidental software deliverables, the Company uses the aforementioned selling price hierarchy to allocate revenue to each of the non-software and software deliverables in the arrangement. The Company continues to recognize revenue for the more-than-incidental software deliverables using the residual method pursuant to the guidance of previously applicable standard. After allocation of the relative selling price to each element of the arrangement, the Company recognizes revenue in accordance with the Company 's policies for product and service revenue recognition.

The Company derives the majority of its revenue from sales of its networking equipment, with the remaining revenue generated from service fees relating to maintenance service contracts, professional services, and training for its products. The Company generally recognizes product revenue from its value-added resellers, non-stocking distributors and end-user customers at the time of shipment, provided that persuasive evidence of an arrangement exists, delivery has occurred, the price of the product is fixed or determinable, and collection of the sales proceeds is reasonably assured. In instances where the criteria for revenue recognition are not met, revenue is deferred until all criteria have been met. Revenue from service obligations under service contracts is deferred and recognized on a straight-line basis over the contractual service period. Service contracts typically range from one to two years. The Company 's total deferred product revenue was \$0.9 million and \$1.4 million as of September 26, 2010 and June 27, 2010, respectively. The Company 's total deferred revenue for services, primarily from service contracts, was \$35.6 million as of September 26, 2010 and \$36.4 million as of June 27, 2010. Shipping costs are included in cost of product revenues.

The Company makes certain sales to partners in two distribution channels, or tiers. The first tier consists of a limited number of independent distributors that sell primarily to resellers and, on occasion, to end-user customers. The Company defers recognition of revenue on all sales to these distributors until the distributors sell the product, as evidenced by monthly sales-out reports that the distributors provide. The Company grants these distributors the right to return a portion of unsold inventory for the purpose of stock rotation. The Company also grants

Edgar Filing: EXTREME NETWORKS INC - Form 10-Q

these distributors certain price protection rights. The distributor-related deferred revenue and receivables are adjusted at the time of the stock rotation return or price reduction. The Company also provides distributors with credits for changes in selling prices, and allows distributors to participate in cooperative marketing programs. The Company maintains estimated accruals and allowances for these exposures based upon the Company's historical experience. In connection with cooperative advertising programs, the Company does not meet the criteria in its accounting policy for recognizing the expenses as marketing expenses and accordingly, the costs are recorded as a reduction to revenue in the same period that the related revenue is recorded.

Table of Contents**EXTREME NETWORKS, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) (Continued)**

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

The Company provides an allowance for sales returns based on its historical returns, analysis of credit memo data and its return policies. The allowance for sales returns was \$1.0 million as of September 26, 2010 and \$0.9 million as of June 27, 2010, respectively, for estimated future returns that were recorded as a reduction of its accounts receivable. The provision for returns is charged to net revenue in the accompanying consolidated statements of operations, and was \$0.1 million and \$0.1 million in the first quarter of fiscal 2011 and the first quarter of fiscal 2010, respectively. If the historical data that the Company uses to calculate the estimated sales returns and allowances does not properly reflect future levels of product returns, these estimates will be revised, thus resulting in an impact on future net revenues. The Company estimates and adjusts this allowance at each balance sheet date.

Inventory, Net

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

Inventories, net of write-downs for excess and obsolete inventory (which the Company determines primarily based on future demand forecasts) of \$4.5 million and \$5.2 million at September 26, 2010 and June 27, 2010 respectively, consist of (in thousands):

| | September 26, 2010 | June 27, 2010 |
|----------------|-----------------------|------------------|
| Raw materials | \$ 503 | \$ 1,346 |
| Finished goods | 19,993 | 20,496 |
| Total | \$ 20,496 | \$ 21,842 |

Deferred Revenue, Net

Deferred revenue, net represents amounts for (i) deferred services revenue (support arrangements, professional services and training), and (ii) deferred product revenue net of the related cost of revenues where the revenue recognition criteria have not been met related to sales by the Company to its resellers or directly to its end-customers. Product revenue includes shipments to end-users and value-add resellers. The following table summarizes deferred revenue, net at September 26, 2010 and June 27, 2010, respectively (in thousands):

| | September 26, 2010 | June 27, 2010 |
|-------------------|-----------------------|------------------|
| Deferred services | \$ 35,615 | \$ 36,360 |
| Deferred product | | |

Edgar Filing: EXTREME NETWORKS INC - Form 10-Q

| | | |
|-----------------------------------|----------|----------|
| Deferred revenue | 868 | 1,415 |
| Deferred cost of sales | (471) | (590) |
| Deferred product revenue, net | 397 | 825 |
| Balance at end of period | 36,012 | 37,185 |
| Less: current portion | 28,402 | 29,552 |
| Non-current deferred revenue, net | \$ 7,610 | \$ 7,633 |

Table of Contents

EXTREME NETWORKS, INC.

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

The Company offers renewable support arrangements, including extended warranty contracts, to its customers that range generally from one to five years. Deferred support revenue is included within deferred revenue, net within the Deferred services category above. The change in the Company's deferred support revenue balance in relation to these arrangements at the end of the first fiscal quarter of fiscal 2010 and 2011 was as follows (in thousands):

| | Three Months Ended | |
|--------------------------------|-----------------------|-----------------------|
| | September 26, 2010 | September 27, 2009 |
| Balance beginning of period | \$ 36,193 | \$ 36,196 |
| New support arrangements | 13,493 | 14,531 |
| Recognition of support revenue | (14,269) | (14,785) |
| Balance end of period | 35,417 | 35,942 |
| Less current portion | 27,807 | 28,917 |
| Non-current deferred revenue | \$ 7,610 | \$ 7,025 |

Deferred Revenue, Net of Cost of Sales to Distributors

At the time of shipment to distributors, the Company records a trade receivable at the contractual discount to list selling price since there is a legally enforceable obligation from the distributor to pay it currently for product delivered, the Company relieves inventory for the carrying value of goods shipped since legal title has passed to the distributor, and the Company records deferred revenue and deferred cost of sales in

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

The following table summarizes deferred revenue, net of cost of sales to distributors at September 26, 2010 and June 27, 2010, respectively (in thousands):

| | September 26, 2010 | June 27, 2010 |
|------------------------|-----------------------|------------------|
| Deferred revenue | \$ 19,874 | \$ 24,252 |
| Deferred cost of Sales | (4,450) | (5,907) |

Edgar Filing: EXTREME NETWORKS INC - Form 10-Q

| | | |
|--|-----------|-----------|
| Total deferred revenue, net of cost of sales to distributors | \$ 15,424 | \$ 18,345 |
|--|-----------|-----------|

Table of Contents**EXTREME NETWORKS, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) (Continued)*****Guarantees and Product Warranties***

The Company has standard product warranty liability. Upon issuance of the warranty, the Company discloses and recognizes a liability for the fair value of the obligation under the warranty. The following table summarizes the activity related to the Company's product warranty liability during the first three months of fiscal 2011 and fiscal 2010, respectively (in thousands):

| | Three Months Ended | |
|-----------------------------|-------------------------------|-------------------------------|
| | September 26, 2010 | September 27, 2009 |
| Balance beginning of period | \$ 3,169 | \$ 3,170 |
| New warranties issued | 1,291 | 1,357 |
| Warranty expenditures | (1,666) | (1,670) |
| Change in estimates | | 562 |
| Balance end of period | \$ 2,794 | \$ 3,419 |

The Company's standard hardware warranty period is typically 12 months from the date of shipment to end-users. For certain access products, the Company offers a lifetime hardware warranty commencing on the date of shipment from the Company and ending five (5) years following the Company's announcement of the end of sale of such product. Upon shipment of products to the Company's customers, the Company estimates expenses for the cost to repair or replace products that may be returned under warranty and accrues a liability in cost of product revenue for this amount. The determination of the Company's warranty requirements is based on actual historical experience with the product or product family, estimates of repair and replacement costs and any product warranty problems that are identified after shipment. The Company estimates and adjusts these accruals at each balance sheet date in accordance with changes in these factors.

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

Recently Issued Accounting Standards

The following standards should be read in conjunction with the standards documented in *Recently Issued Accounting Standards* under Note 2 to Notes to Consolidated Financial Statements included in the Company's Annual Report on Form 10-K for the fiscal year ended June 27, 2010.

In October 2009, the FASB issued a new accounting standard which excludes from the scope of software revenue guidance the revenue arrangements that include tangible products containing software components and non-software components that function together to deliver the tangible product's essential functionality. At the same time, the FASB also issued a new accounting standard which updates existing guidance pertaining to the separation and allocation of consideration in a multiple element arrangement. This new guidance is applicable to the Company's multiple element arrangements that include such tangible products. The new standards are effective prospectively for revenue arrangements entered into or materially modified in fiscal years beginning on or after June 15, 2010. The Company adopted this standard in the first quarter of fiscal 2011, and the adoption of this accounting standard did not have a material effect on the results for the quarter.

Table of Contents**EXTREME NETWORKS, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) (Continued)****2. Share-Based Compensation****Share Based Compensation**

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

| | Three Months Ended | |
|--|-----------------------|-----------------------|
| | September 26, 2010 | September 27, 2009 |
| Cost of product revenue | \$ 192 | \$ 72 |
| Cost of service revenue | 144 | 75 |
| Sales and marketing | 572 | 296 |
| Research and development | 611 | 375 |
| General and administrative | 590 | 322 |
| | | |
| Total share-based compensation expense | 2,109 | 1,140 |
| Share-based compensation cost capitalized in inventory | 7 | (4) |
| | | |
| Total share-based compensation cost | \$ 2,116 | \$ 1,136 |

The weighted-average grant-date per share fair value of options granted in the first quarter of fiscal 2011 and 2010 were \$1.36 and \$0.88, respectively. The weighted-average estimated per share fair value of shares purchased under the Company's 1999 Employee Stock Purchase Plan (ESPP) in the first quarter of fiscal 2011 and 2010 were \$0.93 and \$0.68, respectively.

The Company uses the straight-line method for expense attribution, and the Company estimates forfeitures and only recognizes expense for those shares expected to vest. The Company's estimated forfeiture rate in the first quarter of fiscal 2011 based on the Company's historical forfeiture experience is approximately 12%.

The fair value of each option award and ESPP 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 expected term of ESPP represents the contractual life of the ESPP purchase period. The risk-free rate based upon the estimated life of the option and ESPP is based on the U.S. Treasury yield curve in effect at the time of grant. Expected volatility is based on both the implied volatilities from traded options on the Company's stock and historical volatility on the Company's stock.

| | Stock Option Plan | | Employee Stock Purchase Plan | |
|-------------------------|-----------------------|-----------------------|------------------------------|-----------------------|
| | Three Months Ended | | Three Months Ended | |
| | September 26, 2010 | September 27, 2009 | September 26, 2010 | September 27, 2009 |
| Expected life | 4 yrs | 3 yrs | .25 yrs | 0.25 yrs |
| Risk-free interest rate | 1.11% | 1.67% | 0.17% | 0.30% |
| Volatility | 58% | 54% | 59% | 74% |

Edgar Filing: EXTREME NETWORKS INC - Form 10-Q

| | | | | |
|----------------|------|------|------|------|
| Dividend yield | 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 share-based award and stock price volatility. The assumptions listed above represent management's best estimates, but these estimates involve inherent uncertainties and the application of management judgment. As a result, if other assumptions had been used, the Company's share-based compensation cost could have been materially different from that recorded. In addition, the Company is required to estimate the expected forfeiture rate and only recognize expense for those shares expected to vest. If the Company's actual forfeiture rate is materially different from the Company's estimate, the share-based compensation expense could be materially different.

The Company issued 1,402,575 and 593,951 shares of common stock upon the exercise of stock options, ESPP stock purchase and release of restricted stock, net of repurchase in fiscal 2010 and the first quarter of fiscal 2011, respectively.

Table of Contents

EXTREME NETWORKS, INC.

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

3. Commitments, Contingencies and Leases

Purchase Commitments

The Company currently has arrangements with contract manufacturers and suppliers for the manufacture of its products. The arrangements allow them to procure long lead-time component inventory on the Company's behalf based upon a rolling production forecast provided by it. The Company is obligated to the purchase of long lead-time component inventory that its contract manufacturer procures in accordance with the forecast, unless the Company gives notice of order cancellation outside of applicable component lead-times. As of September 26, 2010, the Company had non-cancelable commitments to purchase approximately \$38.3 million of such inventory.

Legal Proceedings

The Company may from time to time be party to litigation arising in the course of its business, including, without limitation, allegations relating to commercial transactions, business relationships or intellectual property rights. Such claims, even if not meritorious, could result in the expenditure of significant financial and managerial resources. Litigation in general, and intellectual property and securities litigation in particular, can be expensive and disruptive to normal business operations. Moreover, the results of legal proceedings are difficult to predict.

Shareholder Litigation Relating to Historical Stock Option Practices

On April 25, 2007, an individual identifying herself as one of the Company's shareholders filed a derivative action in the United States District Court for the Northern District of California purporting to assert claims on behalf of and in the Company's name against various of the Company's current and former directors and officers relating to historical stock option granting from 1999 to 2002 and related accounting practices. Two similar derivative actions were filed thereafter in the same court by other individuals and the three cases were consolidated by order of the Court. After two amended complaints were filed by the lead plaintiff, the Company filed a motion to dismiss the second amended complaint, which was granted without prejudice on August 12, 2008.

On August 22, 2008, Kathleen Wheatley, an individual identifying herself as one of the Company's shareholders, filed a motion for the Court to reconsider its ruling on August 12, 2008 granting the Company's motion to dismiss. In response, the Company asked the Court to reject Ms. Wheatley's motion on various grounds, including that Ms. Wheatley is not a party to this derivative action. The Court has not yet ruled on Ms. Wheatley's motion. On September 4, 2008, Ms. Wheatley filed both a motion to intervene in the derivative action and a third amended complaint, which differs little from the first amended complaint. The third amended complaint continues to allege that various of the Company's current and former directors and officers breached their fiduciary duties and other obligations to the Company and violated state and federal securities laws in connection with its historical grants of stock options. The Company is named as a nominal defendant in the action, but it has customary indemnification agreements with the named defendants. On the Company's behalf, Ms. Wheatley seeks unspecified monetary and other relief against the named defendants. The Court has granted Ms. Wheatley's motion to intervene. On October 16, 2008, the Company, as nominal defendant, moved to dismiss the third amended complaint. On November 17, 2009, the Court denied the Company's motion to dismiss the third amended complaint, and on December 3, 2009, the Company filed a motion for reconsideration or in the alternative, a motion to certify the Order denying the Motion to Dismiss for immediate appeal. On December 30, 2009, the Court issued an Order granting us leave to file the motion for reconsideration and will rule on the Company's alternative motion to certify the Order for appeal if it denies the motion for reconsideration. On April 2, 2010, the Court denied the Company's Motion for Reconsideration and for Stay of Action and Certification and Appeal. No dates have been set for the Company's response to the Third Amended Complaint. The parties attended a mediation in August 2010. The Company intends to continue to defend the derivative action vigorously, but due to the uncertainty of litigation, the Company cannot predict the ultimate outcome of this matter at this time.

Intellectual Property Litigation

Edgar Filing: EXTREME NETWORKS INC - Form 10-Q

On April 20, 2007, the Company filed suit against Enterasys Networks in the United States District Court for the Western District of Wisconsin, Civil Action No. 07-C-0229-C. The complaint alleged willful infringement of U.S. Patents Nos. 6,104,700, 6,678,248, and 6,859,438, and sought injunctive relief against Enterasys' continuing sale of infringing goods and monetary damages. Enterasys responded to the complaint on May 30, 2007, and also filed counterclaims alleging infringement of three U.S. patents owned by Enterasys. On April 9, 2008, the Court dismissed Enterasys' counterclaims on one of its patents with prejudice. On May 5, 2008, the Court granted the Company's motion for summary judgment, finding that it does not infringe Enterasys' two remaining patents and dismissing all of Enterasys' remaining counterclaims with prejudice. On May 30, 2008, a jury found that Enterasys infringed all three of the Company's patents and awarded it damages in the amount of \$0.2 million. The Court also ruled in the Company's favor on Enterasys' challenge to the validity of the Company's patents. On October 29, 2008, the Court denied Enterasys' post-trial motion for judgment as a matter of law, and granted Extreme Network's motion for a permanent injunction against Enterasys. The injunction order permanently enjoins Enterasys from manufacturing, using, offering to sell, selling in the U.S. and importing into the U.S. the Enterasys products accused of infringing Extreme Network's three patents. On March 16, 2009, the Court also denied Enterasys' motion for a new trial, but granted Enterasys' motion for a stay of the injunction pending appeal. On April 17, 2009, Enterasys filed its notice of appeal and on May 1, 2009, the Company filed its cross appeal. On September 30, 2010, the U.S. Court of Appeals for the Federal Circuit upheld the jury verdict of infringement by Enterasys of 3 of the Company's patents and the Districts Court's summary judgment verdict of non-infringement by the Company of Enterasys' 727 patent. The U.S. Court of Appeals for the Federal Circuit reversed the finding of non-infringement by the Company of Enterasys' 181 patent, holding that the District Court Judge applied an incorrect claim construction and reversed the District Court's denial of the Company's request for attorneys' fees as premature. The Federal Circuit denied Extreme Networks' motion to dismiss Enterasys' appeal as untimely. Both Extreme Networks and Enterasys have filed petitions for rehearing. The Company is awaiting further ruling from the Federal Circuit. The Company intends to vigorously defend this law suit, but due to the inherent uncertainties of litigation, the Company cannot predict the ultimate outcome of the matter at this time.

Table of Contents

EXTREME NETWORKS, INC.

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

On June 21, 2005, Enterasys filed suit against Extreme and Foundry Networks, Inc. (**Foundry**) in the United States District Court for the District of Massachusetts, Civil Action No. 05-11298 DPW. The complaint alleges willful infringement of U.S. Patent Nos. 5,251,205; 5,390,173; 6,128,665; 6,147,995; 6,539,022; and 6,560,236, and seeks: a) a judgment that the Company willfully infringe each of the patents; (b) a permanent injunction from infringement, inducement of infringement and contributory infringement of each of the six patents; (c) damages and a reasonable royalty to be determined at trial; (d) treble damages; (e) attorneys' fees, costs and interest; and (f) equitable relief at the Court's discretion. Foundry brought a claim for reexamination of five of the patents at issue to the U.S. Patent and Trademark Office (**PTO**). The stay of the Massachusetts action was lifted on May 21, 2010, and the Court set a claims construction hearing for December 3, 2010. No trial date has been set. The Company intends to defend the lawsuit vigorously, but, due to the inherent uncertainties of litigation, it cannot predict the ultimate outcome of the matter at this time.

Other Legal Matters

Beginning on July 6, 2001, purported securities fraud class action complaints were filed in the United States District Court for the Southern District of New York. The cases were consolidated and the litigation is now captioned as In re Extreme Networks, Inc. Initial Public Offering Securities Litigation, Civ. No. 01-6143 (SAS) (S.D.N.Y.), related to In re Initial Public Offering Securities Litigation, 21 MC 92 (SAS) (S.D.N.Y.). The operative amended complaint names us as defendants; six of the Company's present and former officers and/or directors, including its former CEO and current Chairman of the Board (the **Extreme Networks Defendants**); and several investment banking firms that served as underwriters of its initial public offering and October 1999 secondary offering. The complaint alleges liability under Sections 11 and 15 of the Securities Act of 1933 and Sections 10(b) and 20(a) of the Securities Exchange Act of 1934, on the grounds that the registration statement for the offerings did not disclose that: (1) the underwriters had agreed to allow certain customers to purchase shares in the offerings in exchange for excess commissions paid to the underwriters; and (2) the underwriters had arranged for certain customers to purchase additional shares in the aftermarket at predetermined prices. Similar allegations were made in other lawsuits challenging over 300 other initial public offerings and follow-on offerings conducted in 1999 and 2000. The cases were consolidated for pretrial purposes.

Table of Contents**EXTREME NETWORKS, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) (Continued)**

The parties to the lawsuits have reached a settlement, which was approved by the Court on October 6, 2009. Extreme Networks is not required to make any cash payments in the settlement. The Court subsequently entered a final judgment of dismissal. Certain objectors have appealed the judgment. If the appeal is successful, the Company intends to defend the lawsuit vigorously, but, due to the inherent uncertainties of litigation, it cannot predict the ultimate outcome of the matter at this time.

On October 20, 2010, the Company settled a lawsuit related to certain real property leases it entered into in June 2000. As part of the settlement, the defendants will pay the Company \$5.0 million over a 12 month period.

Indemnification Obligations

Subject to certain limitations, the Company may be obligated to indemnify its current and former directors, officers and employees. These obligations arise under the terms of its certificate of incorporation, its bylaws, applicable contracts, and Delaware and California law. The obligation to indemnify, where applicable, generally means that the Company is required to pay or reimburse, and in certain circumstances the Company has paid or reimbursed, the individuals' reasonable legal expenses and possibly damages and other liabilities incurred in connection with these matters. It is not possible to estimate the maximum potential amount under these indemnification agreements due to the limited history of these claims. The cost to defend the Company and the named individuals could have a material adverse effect on its consolidated financial position, results of operations and cash flows in the future. Recovery of such costs under its directors and officers insurance coverage is uncertain.

4. Comprehensive Income (Loss) and Accumulated Other Comprehensive Income***Comprehensive Income (Loss)***

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

| | Three Months Ended | |
|---|-------------------------------|-------------------------------|
| | September 26, 2010 | September 27, 2009 |
| Net income (loss) | \$ 2,712 | \$ (5,482) |
| Other comprehensive income (loss): | | |
| Change in unrealized gain on investments: | 361 | 131 |
| Foreign currency translation adjustments | | |
| Beginning balance | 954 | 912 |
| Ending balance | 2,214 | 1,752 |
| Foreign currency translation adjustments change | 1,260 | 840 |
| Total comprehensive income (loss) | \$ 4,333 | \$ (4,511) |

Accumulated Other Comprehensive Income

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

Edgar Filing: EXTREME NETWORKS INC - Form 10-Q

| | September 26, 2010 | June 27, 2010 |
|--|-----------------------|------------------|
| Accumulated unrealized gain on investments | \$ 507 | \$ 146 |
| Accumulated foreign currency translation adjustments | 2,214 | 954 |
| Accumulated other comprehensive income | \$ 2,721 | \$ 1,100 |

5. Income Taxes

The Company recorded an income tax benefit of \$0.2 million and an income tax provision of \$0.4 million for the first quarter of fiscal 2011 and first quarter of fiscal 2010, respectively. The income tax benefit for the first quarter of fiscal 2011 consisted primarily of U.S. state income taxes, taxes on foreign income, and a reversal of previously recorded deferred tax liabilities. The income tax provision for the first quarter of fiscal 2010 consisted primarily of U.S. alternative minimum tax, taxes on foreign income and U.S. state income taxes. The income tax benefit / provisions for both quarters were calculated based on the results of operations for the three months ended September 26, 2010 and September 27, 2009, and may not reflect the annual effective tax rate. Since the Company has net operating loss carry forwards to offset U.S. taxable income, the Company is not using an annual effective tax rate to apply to the taxable income for the quarter.

Table of Contents**EXTREME NETWORKS, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) (Continued)**

The Company recognizes deferred tax assets and liabilities based on the differences between the financial statement carrying amounts and the tax bases of assets and liabilities. Significant management judgment is required in determining the Company's deferred tax assets and liabilities and any valuation allowance recorded against the Company's net deferred tax assets. The Company makes an assessment of the likelihood that the Company's net deferred tax assets will be recovered from future taxable income, and to the extent that recovery is not believed to be likely, a valuation allowance is established.

The Company has a full valuation allowance against its U.S. net deferred tax assets. The valuation allowance was calculated by assessing both negative and positive evidence when measuring the need for a valuation allowance. Evidence, such as operating results during the most recent three-year period was given more weight than our expectations of future profitability, which are inherently uncertain. Our U.S. losses during those periods represented sufficient negative evidence to require a full valuation allowance against our U.S. federal and state net deferred tax assets. This valuation allowance will be evaluated periodically and could be reversed partially or totally if business results have sufficiently improved to support realization of the Company's U.S. deferred tax assets.

The Company had unrecognized tax benefits of approximately \$23.9 million as of September 26, 2010. The future impact of the unrecognized tax benefit of \$23.9 million, if recognized, is as follows: approximately \$1.0 million would affect the effective tax rate, and approximately \$22.9 million would result in adjustments to deferred tax assets and corresponding adjustment to the valuation allowance. The Company does not anticipate any material changes to its unrecognized tax positions during the next twelve months.

Estimated interest and penalties related to the underpayment of income taxes are classified as a component of tax expense in the Condensed Consolidated Statement of Operations and totaled approximately \$7,000 for the quarter ended September 26, 2010. Accrued interest and penalties were approximately \$0.2 million and \$0.6 million as of September 26, 2010 and September 27, 2009, respectively.

In general, the Company's U.S. federal income tax returns are subject to examination by tax authorities for fiscal years 1998 forward due to net operating losses and the Company's state income tax returns are subject to examination for fiscal years 2001 forward due to net operating losses. The Company's Netherlands income tax returns are subject to examination by tax authorities for fiscal year 2005 and forward.

6. Net Income (Loss) Per Share

Basic net income (loss) per share is calculated by dividing net income (loss) by the weighted average number of common shares outstanding during the period and excludes any dilutive effects of options and stock awards. Diluted net income (loss) per share is calculated by dividing net income (loss) by the weighted average number of common shares used in the basic earnings per share calculation plus the dilutive effect of options and stock awards.

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

| | Three Months Ended | |
|---|-------------------------------|-------------------------------|
| | September 26, 2010 | September 27, 2009 |
| Net income (loss) | \$ 2,712 | (\$ 5,482) |
| Weighted-average shares used in per share calculation basic | 90,305 | 88,843 |
| Incremental shares using the treasury stock method: | | |
| Stock options | 271 | |
| Unvested restricted awards | 34 | |
| Weighted -average share used in per share calculation diluted | 90,610 | 88,843 |

Edgar Filing: EXTREME NETWORKS INC - Form 10-Q

| | | | |
|-----------------------------|---------|---------|-----------|
| Net income (loss) per share | basic | \$ 0.03 | (\$ 0.06) |
| Net income (loss) per share | diluted | \$ 0.03 | (\$ 0.06) |

Table of Contents

EXTREME NETWORKS, INC.

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

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

| | Three Months Ended | |
|---|-----------------------|-----------------------|
| | September 26, 2010 | September 27, 2009 |
| Weighted stock options outstanding: | | |
| In-the-money options | | 1,140 |
| Out-of-the-money options | 7,157 | 16,225 |
| | | |
| Total potential shares of common stock excluded from the computation of net income (loss) per share | 7,157 | 17,365 |

Weighted stock options outstanding with an exercise price lower than the Company's average stock price for the periods presented (**in-the-money options**) are excluded from the calculation of diluted net loss per share in the three months ended September 27, 2009 since the effect of including them would have been anti-dilutive due to the net loss position of the Company during the period presented.

Weighted stock options outstanding with an exercise price higher than the Company's average stock price for the periods presented (**out-of-the-money options**) are excluded from the calculation of diluted net income (loss) per share since the effect would have been anti-dilutive under the treasury stock method.

7. Restructuring Liabilities

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

As of September 27, 2010, restructuring liabilities were \$2.5 million and consisted of obligations associated with the Company's excess facilities under operating leases and termination benefits related to the reduction in the Company's workforce which occurred in the second quarter of fiscal 2010. Excess facilities were identified in the prior years from fiscal 2004 through 2009 and the Company has remaining obligations associated with these facilities. The Company did not have any restructuring charges in the first quarter of fiscal 2011. During the first quarter of fiscal 2010, the Company recorded restructuring reversals, net of \$0.5 million.

The reversals in the first quarter of fiscal 2010 were:

\$0.5 million reversal of restructuring expense due to higher projected sublease receipt from a sublease renewal arrangement.

\$0.1 million reversal of restructuring expense related to the settlement of employment termination benefits incurred in the third fiscal quarter of 2009.

Edgar Filing: EXTREME NETWORKS INC - Form 10-Q

The reversals were offset by a charge of \$0.1 million due to termination of a sublease arrangement resulting from the sublessee's bankruptcy filing.

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

| | Excess Facilities | Contract Termination | Termination Benefits | Total |
|-------------------------------|------------------------------|---------------------------------|---------------------------------|--------------|
| Balance at June 27, 2010 | \$ 3,140 | \$ 9 | \$ 221 | \$ 3,370 |
| Period payments | (737) | (9) | (166) | (912) |
| Balance at September 26, 2010 | \$ 2,403 | \$ | \$ 55 | \$ 2,458 |

Table of Contents**EXTREME NETWORKS, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) (Continued)****8. Foreign Exchange Forward Contracts**

The Company uses derivative financial instruments to manage exposures to foreign currency. The Company's objective for holding derivatives is to use the most effective methods to minimize the impact of these exposures. The Company does not enter into derivatives for speculative or trading purposes. The Company records all derivatives on the balance sheet as Other Assets, Net at fair value. Changes in the fair value of derivatives are recognized in earnings as Other Income (Expense). The Company enters into foreign exchange forward contracts to mitigate the effect of gains and losses generated by the foreign currency forecasted transactions related to certain operating expenses and remeasurement of certain assets and liabilities denominated in Japanese Yen, the Euro, the Swedish Krona, the Indian Rupee and the British Pound. These derivatives do not qualify as hedges. At September 26, 2010, these forward foreign currency contracts had a notional principal amount of \$23.1 million and fair value was \$0.3 million. These contracts have maturities of less than 60 days. Changes in the fair value of these foreign exchange forward contracts are offset largely by remeasurement of the underlying assets and liabilities.

Foreign currency transaction gains and losses from operations were a loss of \$0.3 million and a loss of \$0.1 million in the first quarter of fiscal 2011 and first quarter of fiscal 2010, respectively.

9. Disclosure about Segments of an Enterprise and Geographic Areas

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

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

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

| | Three Months Ended | | | |
|----------------------------------|-----------------------|-----------------------|--------------|-------------|
| | September 26, 2010 | September 27, 2009 | \$ Change | % Change |
| Net Revenues: | | | | |
| North America | \$ 29,471 | \$ 26,899 | \$ 2,572 | 10% |
| <i>Percentage of net revenue</i> | 35.15% | 40.57% | | |
| EMEA | 36,485 | 28,058 | 8,427 | 30% |
| <i>Percentage of net revenue</i> | 43.52% | 42.31% | | |
| APAC | 17,883 | 11,352 | 6,531 | 58% |
| <i>Percentage of net revenue</i> | 21.33% | 17.12% | | |
| Total net revenues | \$ 83,839 | \$ 66,309 | \$ 17,530 | 26% |

Two customers, Tech Data and Westcon, accounted for greater than 10% of the Company's revenue in the first quarter of fiscal 2011. Two customers, Tech Data and Ericsson AB, accounted for greater than 10% of the Company's revenue in the first quarter of fiscal 2010.

Substantially all of the Company's assets were attributable to North America operations at September 26, 2010 and September 27, 2009.

10. Proposed Sale of Corporate Campus

On September 23, 2010, the Company and Trumark Companies LLC (Trumark) entered into an Option Agreement in which the Company granted Trumark an option (the Option) to purchase half of its corporate headquarters campus (approximately eight acres) in Santa Clara, California, at a price of \$24.0 million. Provided that Trumark makes the required Option payments, Trumark will have twenty-four months to exercise the Option. If Trumark exercises the Option, the closing on the purchase of half of the corporate headquarters campus will occur thirty days after such exercise. Exercise of the Option is contingent upon the successful rezoning of the property for residential development and other requirements of the City of Santa Clara which are expected to be completed within 18 to 24 months. The Company continues to classify all of its corporate headquarters campus as an asset held for use until the purchase contingencies have been eliminated and it is probable that the sale will be concluded within 12 months.

11. Subsequent Events

On October 20, 2010, the Company settled a lawsuit related to certain real property leases it entered into in June 2000. As part of the settlement, the defendants will pay the Company \$5.0 million over a 12 month period.

Table of Contents

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

This quarterly report on Form 10-Q, including the following sections, contains forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995, including in particular, our expectations regarding market demands, customer requirements and the general economic environment, and future results of operations, and other statements that include words such as may expect or believe. These forward-looking statements involve risks and uncertainties. We caution investors that actual results may differ materially from those projected in the forward-looking statements as a result of certain risk factors identified in the section entitled Risk Factors in this Report, our Annual Report on Form 10-K for the fiscal year ended June 27, 2010, and other filings we have made with the Securities and Exchange Commission. These risk factors, include, but are not limited to: fluctuations in demand for our products and services; a highly competitive business environment for network switching equipment; our effectiveness in controlling expenses; the possibility that we might experience delays in the development or introduction of new technology and products; customer response to our new technology and products; the timing of any recovery in the global economy; risks related to pending or future litigation; and a dependency on third parties for certain components and for the manufacturing of our products.

Business Overview

We develop and sell network infrastructure equipment and offer related services to our enterprise, data center and telecommunications service provider customers. Substantially all of our revenue is derived from the sale of our networking equipment and related service contracts. In the first quarter of fiscal 2011, our revenues increased \$17.5 million, gross profit increased \$10.1 million, operating profit increased \$7.7 million and net income increased \$8.2 million as compared to the first quarter of fiscal 2010.

We believe that considering the following key developments will assist investors in understanding our operating results for the three months ended September 26, 2010.

Increasing Demand for Bandwidth

We believe that the continued increase in demand for bandwidth will over time drive future demand for high performance Ethernet solutions. Wide-spread adoption of electronic communications in all aspects of our lives, proliferation of next generation converged mobile devices and deployment of triple-play services to residences and businesses alike, continues to generate demand for greater network performance across broader geographic locations. In parallel to these transformational forces within society and the community at large, the accelerating adoption of internet and intranet cloud solutions within business enterprises is enabling organizations to offer greater business scalability to improve efficiency and through more effective operations, improve profitability. In order to realize the benefits of these developments, customers require additional bandwidth and high performance from their network infrastructure at affordable prices. As the economy continues its paced recovery, we are already seeing the initial indications that the Ethernet segment of the networking equipment market will return to growth as enterprise, data center and carrier customers continue to recognize the performance and operating cost benefits of Ethernet technology.

Industry Developments

The market for network infrastructure equipment is highly competitive and dominated by a few large companies. The current economic climate has further driven consolidation of vendors within the Ethernet networking market and with vendors from adjacent markets, including storage, security, wireless and voice applications. We believe that the underpinning technology for all of these adjacent markets is Ethernet. As a result, independent Ethernet switch vendors are being acquired or merged with larger, adjacent market vendors to enable them to deliver complete and broad solutions. As a result, we believe that, as an independent Ethernet switch vendor, we must provide products that, when combined with the products of our large strategic partners, create compelling solutions for end user customers.

Results of Operations

Our operations and financial performance have been affected by the market and competitive factors described above, and during the first quarter of fiscal 2011, we achieved the following results:

Net revenues of \$83.8 million compared to net revenues of \$66.3 million in the first quarter of fiscal 2010.

Edgar Filing: EXTREME NETWORKS INC - Form 10-Q

Total gross margin of 55.9% of net revenues, compared to 55.4% in the first quarter of fiscal 2010.

Operating income of \$2.5 million compared to operating loss of \$5.3 million in the first quarter of fiscal 2010.

Net income of \$2.7 million compared to net loss of \$5.5 million in the first quarter of fiscal 2010.

Table of Contents

Cash provided by operating activities of \$1.2 million for the three months ending September 26, 2010. Cash provided by operating activities of \$4.1 million for the three months ending September 27, 2009.

Cash and cash equivalents, short-term investments and marketable securities increased by \$0.3 million in the three months ended September 26, 2010 to \$132.7 million from \$132.4 million as of June 27, 2010, primarily as a result of cash provided by operating activities.

Net Revenues

The following table presents net product and service revenues for the three month period ended September 26, 2010 and September 27, 2009, respectively (dollars in thousands):

| | Three Months Ended | | | |
|----------------------------------|-----------------------|-----------------------|---------------|-------------|
| | September 26, 2010 | September 27, 2009 | \$ Change | % Change |
| Net Revenue: | | | | |
| Product | \$ 69,213 | \$ 50,759 | \$ 18,454 | 36.36% |
| <i>Percentage of net revenue</i> | 82.56% | 76.55% | | |
| Service | 14,624 | 15,550 | (926) | (5.96%) |
| <i>Percentage of net revenue</i> | 17.44% | 23.45% | | |
| Total net revenue | \$ 83,837 | \$ 66,309 | \$ 17,528 | 26.43% |

Product revenue increased in the first quarter of fiscal 2011 as compared to the first quarter of fiscal 2010 primarily due to improvement of the supply chain constraints which we experienced in the first quarter of fiscal 2010 along with stronger sales in EMEA and APAC, specifically Korea.

Service revenue decreased in the first quarter of fiscal 2011 as compared to the first quarter of fiscal 2010 primarily due to lower professional services and lower installed base needing service resulting in lower maintenance revenue.

We operate in three regions: North America, which includes the United States, Canada and Central America; EMEA, which includes Europe, Middle East, Africa and South America; and APAC which includes Asia Pacific, South Asia and Japan. The following table presents the total net revenue geographically for the three month period ended September 26, 2010 and September 27, 2009 (dollars in thousands):

| | Three Months Ended | | | |
|----------------------------------|-----------------------|-----------------------|---------------|-------------|
| | September 26, 2010 | September 27, 2009 | \$ Change | % Change |
| Net Revenues: | | | | |
| North America | \$ 29,471 | \$ 26,899 | \$ 2,572 | 10% |
| <i>Percentage of net revenue</i> | 35.15% | 40.57% | | |
| EMEA | 36,485 | 28,058 | 8,427 | 30% |
| <i>Percentage of net revenue</i> | 43.52% | 42.31% | | |
| APAC | 17,883 | 11,352 | 6,531 | 58% |
| <i>Percentage of net revenue</i> | 21.33% | 17.12% | | |
| Total net revenues | \$ 83,839 | \$ 66,309 | \$ 17,530 | 26% |

Edgar Filing: EXTREME NETWORKS INC - Form 10-Q

In the first quarter of fiscal 2010, we had supply chain constraints resulting from the economic slowdown during fiscal 2009. In the fourth quarter of fiscal 2009, customer orders exceeded our forecast, especially with respect to certain products. In addition, our contract manufacturers and their component suppliers had significantly reduced their capacity due to the world-wide economic slowdown, and therefore lead times significantly increased during the first fiscal quarter across our supply chain as our contract manufacturers and their component suppliers struggled to meet increasing demands. As a result, we were therefore unable to deliver products based on customer requests in the first quarter of fiscal 2010, primarily in North America and EMEA. During fiscal 2010, we improved our supply chains and therefore we did not have material supply chain constraints in the first quarter of fiscal 2011. Revenue in North America and EMEA increased in the first quarter of fiscal 2011 as compared to the first quarter of fiscal 2010 primarily due to this correction of supply chain issues that existed in the first quarter of fiscal 2010. Revenue in EMEA also increased in the first quarter of fiscal 2011 as compared to the first quarter of fiscal 2010 due to stronger service provider sales in Europe. Revenue in APAC increased in the first quarter of fiscal 2011 as compared to the first quarter of fiscal 2010 primarily due to two large strategic deals in Korea.

Table of Contents

The level of sales to any one customer may vary from period to period; however, we expect that significant customer concentration will continue for the foreseeable future. Tech Data and Westcon accounted for 13.0% and 13.7%, respectively, of the Company's revenue in the first quarter of fiscal 2011. Tech Data and Ericsson AB accounted for 13.6% and 10.5%, respectively, of the Company's revenue in the first quarter of fiscal 2010.

Cost of Revenues and Gross Profit

The following table presents the gross profit on product and service revenues and the gross profit percentage of product and service revenues for the first quarter of fiscal 2011 and first quarter of fiscal 2010 (dollars in thousands):

| | September 26, 2010 | September 27, 2009 | \$ Change | % Change |
|--------------------------------------|-----------------------|-----------------------|--------------|-------------|
| Gross profit: | | | | |
| Product | \$ 38,383 | \$ 27,041 | \$ 11,342 | 42% |
| <i>Percentage of product revenue</i> | 55.5% | 53.3% | | |
| Service | 8,454 | 9,719 | \$ (1,265) | (13%) |
| <i>Percentage of service revenue</i> | 57.8% | 62.5% | | |
| | | | | |
| Total gross profit | \$ 46,837 | \$ 36,760 | \$ 10,077 | 27% |
| | | | | |
| <i>% of Total Revenue</i> | 55.9% | 55.4% | | |

Cost of product revenue includes costs of raw materials, amounts paid to third-party contract manufacturers, costs related to warranty obligations, charges for excess and obsolete inventory, royalties under technology license agreements, and internal costs associated with manufacturing overhead, including management, manufacturing engineering, quality assurance, development of test plans, and document control. We outsource substantially all of our manufacturing and supply chain management operations, and we conduct quality assurance, manufacturing engineering, document control and distribution at our facility in Santa Clara, California. Accordingly, a significant portion of our cost of product revenue consists of payments to our primary contract manufacturers, Flextronics International, Ltd. located in Guadalajara, Mexico, Alpha Networks, located in Hsinchu, Taiwan and Benchmark Electronic, Inc, located in Huntsville, Alabama, U.S.A. In addition, we OEM our wireless product line from Motorola.

Product gross profit in the first quarter of fiscal 2011 increased as compared to the first quarter of fiscal 2010 primarily due to an increase in revenue of \$10.3 million and a \$1.1 million reduction in other cost of goods, primarily in warranty and excess and obsolescence costs, which were partially offset by strategic deals in Korea that were competitive with lower than normal gross margins.

Our cost of service revenue consists primarily of labor, overhead, repair and freight costs and the cost of spares used in providing support under customer service contracts. Service gross profit in the first quarter of fiscal 2011 decreased as compared to the first quarter of fiscal 2010 primarily due to \$0.9 million due to lower product revenue in EMEA and lower installed base needing service and services and higher return material authorization cost of \$0.5 million. In addition, service gross margin of 62.5% in the first quarter of fiscal 2010 was positively impacted by the use of written down inventory of \$0.9 million which was fully depleted in the first quarter of fiscal 2010. Service margin of 57.8% in the first quarter of fiscal 2011 is within the normalized range of 57% to 58%.

Table of Contents*Operating Expenses*

The following table presents operating expenses and operating income (loss) (in thousands, except percentages):

| | September 26, 2010 | Three Months Ended September 27, 2009 | \$ Change | % Change |
|---------------------------------------|-----------------------|---|-----------------|-------------|
| Sales and marketing | \$ 24,906 | \$ 21,669 | \$ 3,237 | 15% |
| Research and development | 12,861 | 13,610 | (749) | (6%) |
| General and administrative | 6,585 | 7,245 | (660) | (9%) |
| Restructuring charge, net of reversal | | (513) | 513 | (100%) |
| Total operating expenses | \$ 44,352 | \$ 42,011 | \$ 2,341 | 6% |
| Operating income (loss) | \$ 2,485 | \$ (5,251) | \$ 7,736 | (147%) |

The following table highlights our operating expenses and operating income (loss) as a percentage of net revenues:

| | September 26, 2010 | Three Months Ended September 27, 2009 |
|---------------------------------------|-----------------------|---|
| Sales and marketing | 29.71% | 32.68% |
| Research and development | 15.34% | 20.53% |
| General and administrative | 7.85% | 10.93% |
| Restructuring charge, net of reversal | 0.00% | (0.77%) |
| Total operating expenses | 52.90% | 63.36% |
| Operating income (loss) | 2.96% | (7.92%) |

Sales and Marketing Expenses

Sales and marketing expenses consist of salaries, commissions and related expenses for personnel engaged in marketing and sales functions, as well as trade shows and promotional expenses. Sales and marketing expenses increased in the first quarter of fiscal 2011 as compared to the first quarter of fiscal 2010 primarily due to \$1.3 million higher salary and benefits due to higher headcount, \$0.9 million increase in commission due to increased revenue, \$0.7 million increase in travel and \$0.2 million higher in share-based compensation.

Research and Development Expenses

Research and development expenses consist primarily of salaries and related personnel expenses, consultant fees and prototype expenses related to the design, development, and testing of our products. Research and development expenses decreased in the first quarter of fiscal 2011 as compared to the first quarter of fiscal 2010 primarily due to lower salary and benefits expense of \$1.3 million due to lower headcount, \$0.3 million reduction in outside services offset by \$0.8 million increase in engineering project expenses. We expense all research and development expenses as incurred.

General and Administrative Expenses

General and administrative expenses decreased in the first quarter of fiscal 2011 as compared to the first quarter of fiscal 2010 primarily due to lower litigation fees of \$0.5 million and lower salary and benefits expense of \$0.4 million due to lower headcount offset by increased

share-based compensation of \$0.3 million.

Restructuring, Net

We did not have any restructuring charges in the first quarter of fiscal 2011. During the first quarter of fiscal 2010, we recorded restructuring reversals, net of \$0.5 million.

Table of Contents

The reversals in the first quarter of fiscal 2010 were:

\$0.5 million reversal of restructuring expense due to higher projected sublease receipt from a sublease renewal arrangement.

\$0.1 million reversal of restructuring expense related to the settlement of employment termination benefits incurred in the third fiscal quarter of 2009.

The reversals were offset by a charge of \$0.1 million due to termination of a sublease arrangement resulting from the sublessee's bankruptcy filing.

Litigation Settlement

On October 20, 2010, we settled a lawsuit related to certain real property leases it entered into in June 2000. As part of the settlement, the defendants will pay us \$5.0 million over a 12 month period.

Interest Income

Interest income was linear in the first quarter of fiscal 2011 and the first quarter of fiscal 2010 at \$0.3 million as average investment balances and interest rates did not fluctuate significantly from the first quarter of fiscal 2010 to the first quarter of fiscal 2011.

Interest Expense

Interest expense was immaterial and was primarily related to interest amortization of technology agreements.

Other Income / (Expense), Net

Other income (expense) net, was expense of \$0.3 million in the first fiscal quarter of 2011 as compared to expense of \$0.1 million in the first quarter of fiscal 2010, an increase in expense of \$0.2 million. The increase in other expense was primarily due to \$0.2 million fluctuation in foreign exchange losses from \$0.1 million loss in the first quarter of fiscal 2010 to \$0.3 million loss in the first quarter of fiscal 2011 as a result of the weakening U.S. dollar as compared to other foreign currencies.

Provision (Benefit) for Income Taxes

We recorded an income tax benefit of \$0.2 million and income tax provision of \$0.4 million for the first quarter of fiscal 2011 and the first quarter of fiscal 2010, respectively. The income tax benefit for the three months ended September 26, 2010 consisted primarily of U.S. state income taxes, taxes on foreign income, and a reversal of previously recorded deferred tax liabilities. The income tax provision for the three months ended September 27, 2009 consisted primarily of U.S. alternative minimum tax, taxes on foreign income and U.S. state income taxes. The income tax benefit / provisions for both quarters were calculated based on the results of operations for the three month periods ended September 26, 2010 and September 27, 2009, and may not reflect the annual effective tax rate. Since we have net operating loss carry forwards to offset U.S. taxable income, we are not using an annual effective tax rate to apply to the taxable income for the quarter.

We have provided a full valuation allowance for our U.S. net deferred tax assets after assessing both negative and positive evidence when measuring the need for a valuation allowance. For the current quarter, evidence such as operating losses during the most recent three-year period was given more weight than our expectations of future profitability, which are inherently uncertain. Accordingly, we believe that there is sufficient negative evidence to maintain a full valuation allowance against our U.S. federal and state net deferred tax assets. This valuation allowance will be evaluated periodically and can be reversed partially or totally if business results have sufficiently improved to support realization of our U.S. deferred tax assets.

Table of Contents**Share Based Compensation**

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

| | Three Months Ended | |
|--|-------------------------------|-------------------------------|
| | September 26, 2010 | September 27, 2009 |
| Cost of product revenue | \$ 192 | \$ 72 |
| Cost of service revenue | 144 | 75 |
| Sales and marketing | 572 | 296 |
| Research and development | 611 | 375 |
| General and administrative | 590 | 322 |
| | | |
| Total share-based compensation expense | 2,109 | 1,140 |
| Share-based compensation cost capitalized in inventory | 7 | (4) |
| | | |
| Total share-based compensation cost | \$ 2,116 | \$ 1,136 |

Share-based compensation increased in the first quarter of fiscal 2011 as compared to the first quarter of fiscal 2010 primarily as a result of our decision, and the decision of our Compensation Committee to award restricted stock units (RSU) granted to employees and executives for retention and bonuses during the latter half of fiscal 2010 and in the first quarter of fiscal 2011.

Critical Accounting Policies and Estimates

Our significant accounting policies are more fully described in Note 2 of the Notes to Consolidated Financial Statements included in our Annual Report on Form 10-K for the year ended June 27, 2010. The preparation of consolidated financial statements in accordance with generally accepted accounting principles requires management to make estimates, assumptions and judgments that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the consolidated financial statements, and the reported amounts of revenue and expenses during the period reported. By their nature, these estimates, assumptions and judgments are subject to an inherent degree of uncertainty. We base our estimates, assumptions and judgments on historical experience, market trends and other factors that are believed to be reasonable under the circumstances. Estimates, assumptions and judgments are reviewed on an ongoing basis and the effects of revisions are reflected in the consolidated financial statements in the period they are determined to be necessary. Actual results may differ from these estimates under different assumptions or conditions. Our critical accounting policies have been discussed with the Audit Committee of the Board of Directors. We believe there have been no material changes to our critical accounting policies and estimates, except as discussed below, during the three months ended September 26, 2010 compared to those discussed in our Annual Report on Form 10-K for the year ended June 27, 2010.

Below is our updated accounting policy on revenue recognition:

Revenue Recognition

In October 2009, the Financial Accounting Standards Board (FASB) issued a new accounting standard which excludes from the scope of software revenue guidance the revenue arrangements which include tangible products that contain software components and non-software components that function together to deliver the tangible product's essential functionality. At the same time, the FASB also issued another accounting standard which changes the requirements for establishing separate units of accounting in a multiple element arrangement and requires the allocation of arrangement consideration to each deliverable to be based on its relative selling price. The new standards are effective prospectively for revenue arrangements entered into or materially modified in fiscal years beginning on or after June 15, 2010. We adopted the new standards for the first quarter of fiscal 2011, commencing on June 28, 2010. The adoption did not materially affect our results for the first quarter of fiscal 2011 and is not anticipated to have a material effect on future periods.

Edgar Filing: EXTREME NETWORKS INC - Form 10-Q

Our networking products are tangible products that contain software and non-software components that function together to deliver the tangible product's essential functionality. Therefore, pursuant to the guidance of the new accounting standard, for transactions initiated on or after the beginning of our fiscal year 2011, we now allocate the total arrangement consideration to each separable element of an arrangement based on the relative selling price of each element. Under previous applicable guidance, we first allocated arrangement revenue using our vendor-specific objective evidence of fair value (VSOE) for the undelivered elements of our arrangements, and then allocated the residual revenue to the delivered elements.

Table of Contents

Under the guidance of the new accounting standard, when our sales arrangements contain multiple elements, such as products, software licenses, maintenance agreements, and/or professional services, we determine the relative selling price for each element based on a selling price hierarchy. The application of the new accounting standard does not change the units of accounting for our multiple element arrangements. The selling price for a deliverable is based on our vendor-specific objective evidence (VSOE), which is determined by a substantial majority of our historical standalone sales transactions for a product or service falling within a reasonable range. If VSOE is not available due to a lack of standalone sales transactions or lack of pricing within a narrow range, then third party evidence (TPE), as determined by the standalone pricing of competitive vendor products in similar markets, is used. TPE typically is difficult to establish due to the proprietary differences of competitive products and difficulty in obtaining reliable standalone pricing information. When neither VSOE nor TPE is available, we apply management judgment to determine our best estimate of selling price (ESP) for the stand-alone price of a product, taking into consideration such factors as sales channel, geography, gross margin objectives, and product lifecycle. The determination of ESP is made through consultation with and formal approval by our management.

When our multiple element arrangements contain non-software deliverables and elements which are considered more-than-incidental software deliverables, we use the aforementioned selling price hierarchy to allocate revenue to each of the non-software and software deliverables in the arrangement. We continue to recognize revenue for the more-than-incidental software deliverables using the residual method pursuant to the guidance of previously applicable standard. After allocation of the relative selling price to each element of the arrangement, we recognize revenue in accordance with our policies for product and service revenue recognition.

We derive the majority of our revenue from sales of our networking equipment, with the remaining revenue generated from service fees relating to maintenance service contracts, professional services, and training for our products. We generally recognize product revenue from our value-added resellers, non-stocking distributors and end-user customers at the time of shipment, provided that persuasive evidence of an arrangement exists, delivery has occurred, the price of the product is fixed or determinable and collection of the sales proceeds is reasonably assured. In instances where the criteria for revenue recognition are not met, revenue is deferred until all criteria have been met. Revenue from service obligations under service contracts is deferred and recognized on a straight-line basis over the contractual service period. Our total deferred product revenue was \$0.9 million and \$1.4 million as of September 26, 2010 and June 27, 2010, respectively. Our total deferred revenue for services, primarily from service contracts, was \$35.6 million as of September 26, 2010 and \$36.4 million as of June 27, 2010. Service contracts typically range from one to two years. 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 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 for the purpose of stock rotation. We also grant these distributors certain price protection rights. The distributor-related deferred revenue and receivables are adjusted at the time of the stock rotation return or price reduction. We also provide distributors with credits for changes in selling prices, and allow distributors to participate in cooperative marketing programs. We maintain estimated accruals and allowances for these exposures based upon our contractual obligations. In connection with cooperative advertising programs, we do not meet the criteria in our accounting policy for recognizing the expenses as marketing expenses and accordingly, the costs are recorded as a reduction to revenue in the same period that the related revenue is recorded.

The second tier of the distribution channel consists of a large number of third-party value-added resellers that sell directly to end-users. For product sales to value-added resellers, we do not grant return privileges, except for defective products during the warranty period, nor do we grant pricing credits. Accordingly, we recognize revenue upon transfer of title and risk of loss to the value-added reseller, which is generally upon shipment. We reduce product revenue for cooperative marketing activities that may occur under contractual arrangements that we have with our resellers.

We provide an allowance for sales returns based on its historical returns, analysis of credit memo data and its return policies. The allowance for sales returns was \$1.0 million as of September 26, 2010 and \$0.9 million as of June 27, 2010, respectively, for estimated future returns that were recorded as a reduction of our accounts receivable. The provision for returns is charged to net revenue in the accompanying consolidated statements of operations, and was \$0.1 million and \$0.1 million in the first quarter of fiscal 2011 and the first quarter of fiscal 2010, respectively. If the historical data that we use to calculate the estimated sales returns and allowances does not properly reflect future levels of product returns, these estimates will be revised, thus resulting in an impact on future net revenues. We estimate and adjust this allowance at each balance sheet date.

Recently Issued Accounting Standards

Edgar Filing: EXTREME NETWORKS INC - Form 10-Q

In October 2009, the FASB issued a new accounting standard which excludes from the scope of software revenue guidance the revenue arrangements that include tangible products containing software components and non-software components that function together to deliver the tangible product's essential functionality. At the same time, the FASB also issued a new accounting standard which updates existing guidance pertaining to the separation and allocation of consideration in a multiple element arrangement. This new guidance is applicable to our multiple element arrangements that include such tangible products. The new standards are effective prospectively for revenue arrangements entered into or materially modified in fiscal years beginning on or after June 15, 2010. We adopted this standard in the first quarter of fiscal 2011, and the adoption of this accounting standard did not have a material effect on the results for the quarter.

Table of Contents**Liquidity and Capital Resources**

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

| | September 26, 2010 | June 27, 2010 |
|--------------------------------|-----------------------|------------------|
| Cash and cash equivalent | \$ 44,643 | \$ 49,004 |
| Short-term investments | 48,387 | 64,854 |
| Marketable securities | 39,670 | 18,561 |
| Total cash and investments | \$ 132,700 | \$ 132,419 |
| Working capital | 64,350 | \$ 82,629 |

Cash and cash equivalents decreased by \$4.4 million primarily due to cash used in investing activities offset by cash provided by operating activities. Refer to further discussions below under *Key Components of Cash Flows and Liquidity*.

Short-term investments decreased by \$16.5 million primarily due to sale of \$25.3 million of Auction Rate Securities (ARS) in the first quarter of fiscal 2011 whereby most of the proceeds from the sale were reinvested in marketable securities. Refer to further discussions below under *Item 3. Quantitative and Qualitative Disclosures About Market Risk*.

Marketable securities increased by \$21.1 million primarily due to transfers of funds from short-term investments.

The decrease in working capital of \$18.3 million was primarily due the reduction of short-term investments as funds were reinvested in marketable securities.

Key Components of Cash Flows and Liquidity

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

| | September 26, 2010 | September 27, 2009 |
|---|-----------------------|-----------------------|
| Net cash provided by operating activities | \$ 1,197 | \$ 4,129 |
| Net cash used in investing activities | (5,644) | (11,288) |
| Net cash provided by financing activities | 86 | 225 |
| Net decrease in cash and cash equivalents | \$ (4,361) | \$ (6,934) |

Cash provided by operating activities was \$1.2 million. Net income was \$2.7 million and included significant non-cash charges including depreciation of \$1.5 million and \$2.1 million in share-based compensation expense. Accounts receivable, net, decreased to \$39.7 million at September 26, 2010 from \$42.1 million at June 27, 2010. Days sales outstanding in receivables was 43 days at September 26, 2010 and 45 days at June 27, 2010 due to decreased revenue. Accounts payable decreased to \$17.3 million primarily due to decreased inventory purchases. Net inventory levels decreased to \$20.5 million at September 26, 2010 from \$21.8 million at June 27, 2010 due to decreased sales. Inventory management remains an area of focus as we balance the need to maintain safety stock inventory levels to ensure competitive lead times with the risk of inventory excess or obsolescence because of declining demand, rapidly changing technology and customer requirements. Deferred revenue, net, which consists of product and service revenue deferrals, decreased to \$36.0 million at September 26, 2010 from \$37.2 million at June 27, 2010 due to revenue recognized from previous quarters deferred product sales and also due to a seasonal reduction in sales of new service maintenance agreements. Deferred revenue, net of cost of sales to distributors, decreased \$2.9 million from \$18.3 million at June 27, 2010 to \$15.4 million at September 26, 2010. The decrease was primarily due to a combination of a long sales cycle for the sell-through of

Edgar Filing: EXTREME NETWORKS INC - Form 10-Q

inventory to a European customer and a reduction in distributor inventory, principally in the U.S.

Cash flow used in investing activities was \$5.6 million. Capital expenditures were \$1.4 million. We had a net purchase of investments of \$43.5 million in the first fiscal quarter of 2011 as we transferred short-term investments into marketable securities to take advantage of higher interest yield.

Table of Contents

Cash provided by financing activities was \$0.1 million from issuance of common stock.

As of September 26, 2010, we had letters of credit totaling \$0.2 million secured by cash. These letters of credit are primarily issued in lieu of making cash deposits with third parties.

On September 23, 2010, we entered into an Option Agreement with Trumark Companies LLC (Trumark) in which we granted Trumark an option (the Option) to purchase half of our corporate headquarters campus (approximately eight acres) in Santa Clara, California, at a price of \$24.0 million. Provided that Trumark makes the required Option payments, Trumark will have twenty-four months to exercise the Option. If Trumark exercises the Option, the closing on the purchase of half of the corporate headquarters campus will occur thirty days after such exercise. Exercise of the Option is contingent upon the successful rezoning of the property for residential development and other requirements of the City of Santa Clara which are expected to be completed within 18 to 24 months. We continue to classify all of our corporate headquarters campus as an asset held for use until the purchase contingencies have been eliminated and it is probable that the sale will be concluded within 12 months.

Contractual Obligations

The following summarizes our contractual obligations at September 26, 2010, and the effect such obligations are expected to have on our liquidity and cash flow in future periods (in thousands):

| | Total | Less Than 1 Year | 1 3 Years | 3 5 Years | More Than Five Years |
|---|------------------|-------------------------|------------------|------------------|-----------------------------|
| Contractual Obligations: | | | | | |
| Non-cancelable inventory purchase commitments | \$ 38,276 | \$ 38,276 | | | |
| Non-cancelable operating lease obligations | 9,611 | 5,968 | 2,084 | 862 | 697 |
| Other non-cancelable purchase commitments | 1,990 | 1,740 | 250 | | |
| Total contractual cash obligations | \$ 49,877 | \$ 45,984 | \$ 2,334 | \$ 862 | \$ 697 |

Non-cancelable inventory purchase commitments represent the purchase of long lead-time component inventory that our contract manufacturers procure in accordance with our forecast. Inventory purchase commitments were \$38.3 million as of September 26, 2010, a decrease of \$0.8 million from \$39.1 million as of June 27, 2010. Our current inventory balance of \$20.5 million is in-line with our average inventory balance and therefore we do not need a significant amount of inventory commitments for projected sales in the second quarter of fiscal 2011.

We did not have material commitments for capital expenditures as of September 26, 2010. Other non-cancelable purchase commitments represent OEM and technology agreements.

Off-Balance Sheet Arrangements

We did not have any off-balance sheet arrangements as of September 26, 2010.

Capital Resources and Financial Condition

As of September 26, 2010, in addition to \$44.6 million in cash and cash equivalents, we had \$48.4 million invested in short-term and \$39.7 million invested in long-term marketable investments for a total cash and cash equivalents, short-term investments and marketable securities of \$132.7 million.

In the first quarter of fiscal 2011, we sold \$25.3 million of interest bearing ARS that represented investments in pools of student loans. These ARS investments were intended to provide liquidity via an auction process that resets the applicable interest rate at predetermined calendar intervals, allowing investors to either roll over their holdings or gain immediate liquidity by selling such interests at par. The uncertainties in the credit markets had affected all of our holdings in ARS investments and auctions for our investments in these securities have failed to settle on

Edgar Filing: EXTREME NETWORKS INC - Form 10-Q

their respective settlement dates. On November 7, 2008, we accepted the UBS Rights Offer from UBS, providing us with rights related to our ARS. The Rights permitted us to require UBS to purchase our ARS at par value, which was defined as the price equal to the liquidation preference of the ARS plus accrued but unpaid dividends or interest, at any time during the period of June 30, 2010 through July 2, 2012. Conversely, UBS had the right, in its discretion, to purchase or sell our ARS at any time until July 2, 2012, so long as we receive payment at par value upon any sale or disposition. Beginning in 2010, we began to sell our ARS under the Rights. In fiscal 2010, UBS exercised its rights to call back the ARS at par for \$9.8 million and issuers sold \$5.7 million of ARS at par. On June 30, 2010, we sold the remaining ARS balance of \$25.3 million at par under the Rights. On July 1, 2010, we received \$25.3 million plus accrued interest in cash from UBS for the ARS settlement. Upon the sale of the ARS, we recognized a gain of \$2.4 million with an equivalent loss on the exercise of the Put Option.

Table of Contents

We believe that our current cash and cash equivalents, short-term investments, marketable securities and cash available from credit facilities and future operations will enable us to meet our working capital requirements for at least the next 12 months.

Item 3. Quantitative and Qualitative Disclosures About Market Risk
Interest Rate Sensitivity

The primary objective of our investment activities is to preserve principal while at the same time 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 the first quarter of fiscal 2011, we sold \$25.3 million of interest bearing ARS that represented investments in pools of student loans. These ARS investments were intended to provide liquidity via an auction process that resets the applicable interest rate at predetermined calendar intervals, allowing investors to either roll over their holdings or gain immediate liquidity by selling such interests at par. The uncertainties in the credit markets had affected all of our holdings in ARS investments and auctions for our investments in these securities have failed to settle on their respective settlement dates. On November 7, 2008, we accepted the UBS Rights Offer from UBS, providing us with rights related to our ARS. The Rights permitted us to require UBS to purchase our ARS at par value, which was defined as the price equal to the liquidation preference of the ARS plus accrued but unpaid dividends or interest, at any time during the period of June 30, 2010 through July 2, 2012. Conversely, UBS had the right, in its discretion, to purchase or sell our ARS at any time until July 2, 2012, so long as we receive payment at par value upon any sale or disposition. Beginning in 2010, we began to sell our ARS under the Rights. In fiscal 2010, UBS exercised its rights to call back the ARS at par for \$9.8 million and issuers sold \$5.7 million of ARS at par. On June 30, 2010, we sold the remaining ARS balance of \$25.3 million at par under the Rights. On July 1, 2010, we received \$25.3 million plus accrued interest in cash from UBS for the ARS settlement. Upon the sale of the ARS, we recognized a gain of \$2.4 million with an equivalent loss on the exercise of the Put Option.

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

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

The following table presents the amounts of our cash equivalents, short-term investments and marketable securities that are subject to market risk by range of expected maturity and weighted-average interest rates as of September 26, 2010. This table does not include money market funds because those funds are generally not subject to market risk.

| | Three months or less | Three months to one year | Maturing in Greater than one year (In thousands) | Total | Fair Value |
|------------------------------------|----------------------------|--------------------------------|---|-----------|---------------|
| Included in short-term investments | \$ 9,141 | \$ 39,246 | | \$ 48,387 | \$ 48,387 |
| Weighted average interest rate | 2.48% | 1.30% | | | |
| Included in marketable securities | | | \$ 39,670 | \$ 39,670 | \$ 39,670 |
| Weighted average interest rate | | | 1.49% | | |

Table of Contents

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

Exchange Rate Sensitivity

Currently, substantially all of our sales and the majority of our expenses are denominated in United States dollars and, as a result, we have experienced no significant foreign exchange gains and losses to date. While we conduct some sales transactions and incur certain operating expenses in foreign currencies and expect to continue to do so, we do not anticipate that foreign exchange gains or losses will be significant, in part because of our foreign exchange risk management process discussed below.

Foreign Exchange Forward Contracts

We record all derivatives on the balance sheet at fair value. Changes in the fair value of derivatives are recognized in earnings as Other Income (Expense). We enter into foreign exchange forward contracts to mitigate the effect of gains and losses generated by the foreign currency forecasted transactions related to certain operating expenses and remeasurement of certain assets and liabilities denominated in Japanese Yen, the Euro, the Swedish Krona, the Indian Rupee and the British Pound. These derivatives do not qualify as hedges. At September 26, 2010, these forward foreign currency contracts had a notional principal amount of \$23.1 million and fair value was \$0.3 million. These contracts have maturities of less than 60 days. Changes in the fair value of these foreign exchange forward contracts are offset largely by remeasurement of the underlying assets and liabilities.

Foreign currency transaction gains and losses from operations were a loss of \$0.3 million in the first quarter of fiscal 2011 and a loss of \$0.1 million in the first quarter of fiscal 2010.

Table of Contents

Item 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

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

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

Management's Report on Internal Control over Financial Reporting

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

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

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

Changes in Internal Control over Financial Reporting

There were no changes in our internal control over financial reporting during the quarter ended September 26, 2010 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Inherent Limitations on Effectiveness of Controls

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

Table of Contents

PART II. Other Information

Item 1. Legal Proceedings

For information regarding litigation matters that we deem significant, refer to Part I, Item 3, Legal Proceedings of our Annual Report on Form 10-K for the fiscal year ended June 27, 2010 and Note 3 to our Notes to Condensed Consolidated Financial Statements, included in Part I, Item 1 of this Report which are incorporated herein by reference.

Item 1A. Risk Factors

In addition to the other information set forth in this Report, you should carefully consider the factors discussed in Part I, Item 1A. Risk Factors in our Annual Report on Form 10-K for the fiscal year ended June 27, 2010, which to our knowledge have not materially changed. Those risks, which could materially affect our business, financial condition or future results, are not the only risks we face. Additional risks and uncertainties not currently known to us or that we currently deem to be immaterial also may adversely affect our business, financial condition and/or operating results.

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

Item 3. Defaults Upon Senior Securities Not applicable

Item 4. (Removed and Reserved)

Item 5. Other Information None

Item 6. Exhibits

(a) Exhibits:

- 10.1 Letter Agreement, dated September 3, 2010, from Extreme Networks, Inc. to Bob L. Corey
- 10.2 Option Agreement, dated September 23, 2010, between Extreme Networks, Inc. and Trumark Companies, LLC.
- 31.1 Section 302 Certification of Chief Executive Officer
- 31.2 Section 302 Certification of Chief Financial Officer
- 32.1 Section 906 Certification of Chief Executive Officer
- 32.2 Section 906 Certification of Chief Financial Officer

Table of Contents

SIGNATURES

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

EXTREME NETWORKS, INC.

(Registrant)

/s/ BOB L. COREY
BOB L. COREY

Executive Vice President and Chief Financial Officer
November 3, 2010