

EXTREME NETWORKS INC  
Form 10-Q  
February 03, 2010  
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**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 December 27, 2009

OR

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number 000-25711

**EXTREME NETWORKS, INC.**

(Exact name of registrant as specified in its charter)

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

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 January 29, 2010 was 89,525,333.

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**EXTREME NETWORKS, INC.**

**FORM 10-Q**

**QUARTERLY PERIOD ENDED DECEMBER 27, 2009**

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(In thousands, except share and per share amounts)

|   | December 27,<br>2009<br>(unaudited) | June 28,<br>2009<br>(1) |
|---|-------------------------------------|-------------------------|
| <b>ASSETS</b>   |                                     |                         |
| Current assets:   |                                     |                         |
| Cash and cash equivalents   | \$ 50,299                           | \$ 46,195               |
| Short-term investments  | 58,663                              | 8,976                   |
| Accounts receivable, net  | 40,598                              | 37,616                  |
| Inventories, net  | 16,645                              | 12,380                  |
| Deferred income taxes   | 337                                 | 244                     |
| Prepaid expenses and other current assets, net  | 2,566                               | 4,368                   |
| Total current assets  | 169,108                             | 109,779                 |
| Property and equipment, net   | 43,848                              | 44,229                  |
| Marketable securities   | 26,463                              | 72,231                  |
| Other assets, net   | 15,538                              | 13,736                  |
| Total assets  | \$ 254,957                          | \$ 239,975              |
| <b>LIABILITIES AND STOCKHOLDERS EQUITY</b>  |                                     |                         |
| Current liabilities:  |                                     |                         |
| Accounts payable  | \$ 22,181                           | \$ 12,771               |
| Accrued compensation and benefits   | 12,028                              | 12,320                  |
| Restructuring liabilities   | 4,392                               | 3,559                   |
| Accrued warranty  | 3,229                               | 3,170                   |
| Deferred revenue, net   | 31,884                              | 30,058                  |
| Deferred revenue, net of cost of sales to distributors  | 16,186                              | 9,821                   |
| Other accrued liabilities   | 16,133                              | 14,666                  |
| Total current liabilities   | 106,033                             | 86,365                  |
| Restructuring liabilities, less current portion   | 1,775                               | 3,519                   |
| Deferred revenue, less current portion  | 6,830                               | 7,425                   |
| Deferred income taxes   | 620                                 | 564                     |
| Other long-term liabilities   | 559                                 | 592                     |
| Commitments and contingencies (Note 3)  |                                     |                         |
| Stockholders equity:  |                                     |                         |
| Convertible preferred stock, \$.001 par value, issuable in series, 2,000,000 shares authorized; none issued   |                                     |                         |
| Common stock, \$.001 par value, 750,000,000 shares authorized; 128,972,227 issued at December 27, 2009 (128,425,140 June 28, 2009) and capital in excess of par value | 129                                 | 128                     |
| Treasury stock, 39,625,305 shares at December 27, 2009 and June 28, 2009  | (149,666)                           | (149,666)               |
| Additional paid-in-capital  | 952,802                             | 949,113                 |
| Accumulated other comprehensive income  | 2,124                               | 1,323                   |
| Accumulated deficit   | (666,249)                           | (659,388)               |
| Total stockholders equity   | 139,140                             | 141,510                 |

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|  |            |            |
|--|------------|------------|
| Total liabilities and stockholders' equity | \$ 254,957 | \$ 239,975 |
|--|------------|------------|

- (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 28, 2009.

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)**

|  | <b>Three Months Ended</b>    |                              | <b>Six Months Ended</b>      |                              |
|--|------------------------------|------------------------------|------------------------------|------------------------------|
|  | <b>December 27,<br/>2009</b> | <b>December 28,<br/>2008</b> | <b>December 27,<br/>2009</b> | <b>December 28,<br/>2008</b> |
| <b>Net revenues:</b>                           |                              |                              |                              |                              |
| Product  | \$ 64,469                    | \$ 72,580                    | \$ 115,228                   | \$ 146,929                   |
| Service  | 14,928                       | 14,968                       | 30,478                       | 30,145                       |
| <b>Total net revenues</b>                      | <b>79,397</b>                | <b>87,548</b>                | <b>145,706</b>               | <b>177,074</b>               |
| <b>Cost of revenues:</b>                       |                              |                              |                              |                              |
| Product  | 27,199                       | 31,411                       | 50,917                       | 61,544                       |
| Service  | 6,426                        | 7,446                        | 12,248                       | 15,407                       |
| <b>Total cost of revenues</b>                  | <b>33,625</b>                | <b>38,857</b>                | <b>63,165</b>                | <b>76,951</b>                |
| <b>Gross profit:</b>                           |                              |                              |                              |                              |
| Product  | 37,270                       | 41,169                       | 64,311                       | 85,385                       |
| Service  | 8,502                        | 7,522                        | 18,230                       | 14,738                       |
| <b>Total gross profit</b>                      | <b>45,772</b>                | <b>48,691</b>                | <b>82,541</b>                | <b>100,123</b>               |
| <b>Operating expenses:</b>                     |                              |                              |                              |                              |
| Sales and marketing                            | 24,553                       | 25,776                       | 46,155                       | 51,633                       |
| Research and development                       | 12,422                       | 13,924                       | 26,032                       | 30,529                       |
| General and administrative                     | 6,517                        | 7,412                        | 13,755                       | 15,851                       |
| Restructuring, net                             | 4,145                        |                              | 3,633                        |                              |
| <b>Total operating expenses</b>                | <b>47,637</b>                | <b>47,112</b>                | <b>89,575</b>                | <b>98,013</b>                |
| <b>Operating (loss) income</b>                 | <b>(1,865)</b>               | <b>1,580</b>                 | <b>(7,034)</b>               | <b>2,111</b>                 |
| Interest income                                | 388                          | 870                          | 710                          | 2,293                        |
| Interest expense                               | (30)                         | (19)                         | (69)                         | (69)                         |
| Other income / (expense), net                  | (135)                        | 768                          | (295)                        | 1,316                        |
| <b>(Loss) income before income taxes</b>       | <b>(1,642)</b>               | <b>3,199</b>                 | <b>(6,688)</b>               | <b>5,651</b>                 |
| Provision for income taxes                     | (263)                        | 733                          | 173                          | 1,546                        |
| <b>Net (Loss) Income</b>                       | <b>\$ (1,379)</b>            | <b>\$ 2,466</b>              | <b>\$ (6,861)</b>            | <b>\$ 4,105</b>              |
| <b>Basic and diluted net income per share:</b> |                              |                              |                              |                              |
| Net (loss) income per share - basic            | (0.02)                       | 0.03                         | (0.08)                       | 0.04                         |
| Net (loss) income per share - diluted          | (0.02)                       | 0.03                         | (0.08)                       | 0.04                         |

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|  |        |        |        |        |
|--|--------|--------|--------|--------|
| Shares used in per share calculation - basic   | 89,059 | 88,323 | 88,951 | 99,823 |
| Shares used in per share calculation - diluted | 89,059 | 88,363 | 88,951 | 99,925 |

See accompanying notes to unaudited condensed consolidated financial statements.

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

|  | <b>Six Months Ended</b>      |                              |
|--|------------------------------|------------------------------|
|  | <b>December 27,<br/>2009</b> | <b>December 28,<br/>2008</b> |
| <b>Cash flows from operating activities:</b>   |                              |                              |
| Net (loss) income  | \$ (6,861)                   | \$ 4,105                     |
| Adjustments to reconcile net (loss) income to net cash provided by operating activities: |                              |                              |
| Depreciation and amortization  | 3,023                        | 2,745                        |
| (Gain) / loss on value of option to put securities                                       | 47                           | (6,778)                      |
| Mark to market, trading loss / (gain) on trading securities                              | (47)                         | 6,778                        |
| Provision for doubtful accounts  |                              | 56                           |
| Provision for excess and obsolete inventory  | 960                          | 819                          |
| Deferred income taxes  | (69)                         | 68                           |
| Loss on retirement of assets   | 78                           | 94                           |
| Stock-based compensation   | 3,158                        | 1,396                        |
| Restructuring, net   | 3,633                        |                              |
| Changes in operating assets and liabilities, net   |                              |                              |
| Accounts receivable  | (2,982)                      | 19,504                       |
| Inventories  | (5,216)                      | (9,157)                      |
| Prepaid expenses and other assets  | (3)                          | (928)                        |
| Accounts payable   | 9,410                        | 10,801                       |
| Accrued compensation and benefits  | (290)                        | (5,943)                      |
| Restructuring liabilities  | (4,418)                      | (1,329)                      |
| Accrued warranty   | 60                           | (1,307)                      |
| Deferred revenue, net  | 1,231                        | 200                          |
| Deferred revenue, net of cost of sales to distributors                                   | 6,365                        | 1,082                        |
| Other accrued liabilities  | 2,154                        | (4,398)                      |
| Net cash provided by operating activities  | 10,233                       | 17,808                       |
| <b>Cash flows (used in) provided by investing activities:</b>                            |                              |                              |
| Capital expenditures   | (2,720)                      | (3,334)                      |
| Purchases of investments   | (18,958)                     | (25,166)                     |
| Proceeds from maturities of investments and marketable securities                        | 8,775                        | 28,164                       |
| Proceeds from sales of investments and marketable securities                             | 6,377                        | 46,225                       |
| Net cash (used in) provided by investing activities                                      | (6,526)                      | 45,889                       |
| <b>Cash flows provided by (used in) financing activities:</b>                            |                              |                              |
| Proceeds from issuance of common stock   | 397                          | 1,614                        |
| Repurchase of common stock, including expenses   |                              | (101,363)                    |
| Net cash provided by (used in) financing activities                                      | 397                          | (99,749)                     |
| Net increase (decrease) in cash and cash equivalents                                     | 4,104                        | (36,052)                     |



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|  |           |           |
|--|-----------|-----------|
| Cash and cash equivalents at beginning of period | 46,195    | 70,370    |
| Cash and cash equivalents at end of period       | \$ 50,299 | \$ 34,318 |

See accompanying notes to 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 28, 2009 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 28, 2009. The Company has evaluated all subsequent events through February 3, 2010, the date these interim financial statements were filed with the SEC.

The unaudited condensed consolidated financial statements reflect all adjustments, consisting of normal recurring adjustments and out of period share based compensation adjustments totaling \$0.9 million 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 December 27, 2009. The results of operations for the three and six months ended December 27, 2009 are not necessarily indicative of the results that may be expected for fiscal 2010 or any future periods.

***Reclassification***

To maintain consistency and comparability, the Company reclassified certain prior-year balance sheet amounts related to transactions with the Company's distributors. To conform to the current-year presentation, the Company reclassified:

to trade receivables, \$6.7 million of contra accounts receivable at June 28, 2009, which was previously reported in accrued liabilities. The amount of contra accounts receivable related to our distributors was \$7.2 million at December 27, 2009, which is in-line with the reclassified amount of \$6.7 million at June 28, 2009. This reclassification had no effect on previously reported consolidated results of operations or stockholders equity. The consolidated statement of cash flows for the six months ended December 28, 2008 was adjusted for the reclassification.

***Cash, Cash Equivalents, and Investments******Summary of Available-for-Sale Securities and Trading Securities***

|   | <b>December 27,<br/>2009</b> | <b>June 28,<br/>2009</b> |
|---|------------------------------|--------------------------|
| Cash equivalent                                 | \$ 42,326                    | \$ 43,367                |
| Short-term investments                          | 58,663                       | 8,976                    |
| Marketable securities                           | 26,463                       | 72,231                   |
| Total available-for-sale and trading securities | \$ 127,452                   | \$ 124,574               |

**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<br>Cost | Fair Value | Unrealized<br>Holding<br>Gains | Unrealized<br>Holding<br>Losses |
|-----------------------------------|-------------------|------------|--------------------------------|---------------------------------|
| <b>December 27, 2009:</b>         |                   |            |                                |                                 |
| Money market funds                | \$ 34,326         | \$ 34,326  | \$                             | \$                              |
| U.S. corporate debt securities    | 37,764            | 38,148     | 394                            | (9)                             |
| U.S. government agency securities | 14,305            | 14,443     | 139                            | (1)                             |
|                                   | \$ 86,395         | \$ 86,917  | \$ 533                         | \$ (10)                         |

## Classified as:

|                        |           |           |        |         |
|------------------------|-----------|-----------|--------|---------|
| Cash equivalents       | \$ 42,326 | \$ 42,326 | \$     | \$      |
| Short-term investments | 17,894    | 18,128    | 235    |         |
| Marketable securities  | 26,175    | 26,463    | 298    | (10)    |
|                        | \$ 86,395 | \$ 86,917 | \$ 533 | \$ (10) |

|                                   | Amortized<br>Cost | Fair Value | Unrealized<br>Holding<br>Gains | Unrealized<br>Holding<br>Losses |
|-----------------------------------|-------------------|------------|--------------------------------|---------------------------------|
| <b>June 28, 2009:</b>             |                   |            |                                |                                 |
| Money market funds                | \$ 35,367         | \$ 35,367  | \$                             | \$                              |
| U.S. corporate debt securities    | 37,184            | 37,437     | 253                            |                                 |
| U.S. government agency securities | 10,829            | 10,987     | 158                            |                                 |
|                                   | \$ 83,380         | \$ 83,791  | \$ 411                         | \$                              |

## Classified as:

|                        |           |           |        |    |
|------------------------|-----------|-----------|--------|----|
| Cash equivalents       | \$ 43,367 | \$ 43,367 | \$     | \$ |
| Short-term investments | 8,965     | 8,976     | 11     |    |
| Marketable securities  | 31,048    | 31,448    | 400    |    |
|                        | \$ 83,380 | \$ 83,791 | \$ 411 | \$ |

The amortized cost and estimated fair value of available-for-sale investments in debt securities at December 27, 2009, by contractual maturity, were as follows (in thousands):

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|  | <b>Amortized<br/>Cost</b> | <b>Fair<br/>Value</b> |
|--|---------------------------|-----------------------|
| Due in 1 year or less  | \$ 25,893                 | \$ 26,128             |
| Due in 1-2 years   | 23,159                    | 23,444                |
| Due in 2-5 years   | 3,017                     | 3,019                 |
| Due in more than 5 years                                       |                           |                       |
| <b>Total investments in available for sale debt securities</b> | <b>\$ 52,069</b>          | <b>\$ 52,591</b>      |

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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).

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

The Company records unrealized and realized gains and losses on the Company's trading securities, net of tax, in other income (expense), net, in its statements of operations. Beginning in the second quarter of fiscal 2009, the Company classified ARS as Trading. The ARS are held with UBS and the Company accepted a Rights offer on November 7, 2008 (see discussions below). The ARS and Put Option fair value of \$40.5 million are reflected in short-term investments trading as of December 27, 2009. The reclassification to short-term investment is made based on the Company's intention to exercise the Put Option which first comes due in less than one year from balance sheet date.

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 |
| U.S. corporate debt securities    | \$ 6,115            | \$ (9)            | \$                | \$                | \$ 6,115   | \$ (9)            |
| U.S. government agency securities | 1,002               | (1)               |                   |                   | 1,002      | (1)               |
|                                   | \$ 7,117            | \$ (10)           | \$                | \$                | \$ 7,117   | \$ (10)           |

During the three and six months ended December 27, 2009, realized gains or losses recognized on the sale of investments were not significant. 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 Measurements***

The Company measures certain financial assets and liabilities at fair value on a recurring basis, including cash equivalents, available-for-sale securities, trading securities and foreign currency derivatives. 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:

| <b>December 27, 2009:</b>          | <b>Level 1</b>        | <b>Level 2</b>   | <b>Level 3</b>   | <b>Total</b>      |
|------------------------------------|-----------------------|------------------|------------------|-------------------|
|                                    | <b>(In thousands)</b> |                  |                  |                   |
| <b>Assets</b>                      |                       |                  |                  |                   |
| Investments:                       |                       |                  |                  |                   |
| Commercial paper                   | \$                    | \$ 8,000         | \$               | \$ 8,000          |
| Federal agency notes               |                       | 14,443           |                  | 14,443            |
| Money market funds                 | 34,326                |                  |                  | 34,326            |
| Corporate notes/bonds              |                       | 30,148           |                  | 30,148            |
| Auction rate securities            |                       |                  | 36,060           | 36,060            |
| Put Option                         |                       |                  | 4,473            | 4,473             |
| Derivative instruments:            |                       |                  |                  |                   |
| Foreign currency forward contracts |                       | (396)            |                  | (396)             |
| <b>Total</b>                       | <b>\$ 34,326</b>      | <b>\$ 52,195</b> | <b>\$ 40,533</b> | <b>\$ 127,054</b> |

| <b>June 28, 2009:</b>              | <b>Level 1</b>        | <b>Level 2</b>   | <b>Level 3</b>   | <b>Total</b>      |
|------------------------------------|-----------------------|------------------|------------------|-------------------|
|                                    | <b>(In thousands)</b> |                  |                  |                   |
| <b>Assets</b>                      |                       |                  |                  |                   |
| Investments:                       |                       |                  |                  |                   |
| Commercial paper                   | \$                    | \$ 8,000         | \$               | \$ 8,000          |
| Federal agency notes               |                       | 10,987           |                  | 10,987            |
| Money market funds                 | 35,367                |                  |                  | 35,367            |
| Corporate notes/bonds              |                       | 29,437           |                  | 29,437            |
| Auction rate securities            |                       |                  | 36,263           | 36,263            |
| Put Option                         |                       |                  | 4,520            | 4,520             |
| Derivative instruments:            |                       |                  |                  |                   |
| Foreign currency forward contracts |                       | (58)             |                  | (58)              |
| <b>Total</b>                       | <b>\$ 35,367</b>      | <b>\$ 48,366</b> | <b>\$ 40,783</b> | <b>\$ 124,516</b> |

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

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 December 27, 2009 (in thousands):

|  | <b>Auction Rate<br/>Securities</b> |
|--|------------------------------------|
| Balance as of June 28, 2009            | \$ 36,263                          |
| Change in interest accrued             | 25                                 |
| Change in unrealized loss              | 47                                 |
| Redemptions at par                     | (275)                              |
| <b>Balance as of December 27, 2009</b> | <b>\$ 36,060</b>                   |
|  | <b>Put Option</b>                  |
| Balance as of June 28, 2009            | \$ 4,520                           |
| Loss on Put Option                     | (47)                               |
| <b>Balance as of December 27, 2009</b> | <b>\$ 4,473</b>                    |

Level 3 assets consist of ARS whose underlying assets are student loans which are substantially backed by the federal government. Since the auctions for these securities have continued to fail since February 2008, these investments are not currently trading and therefore do not have a readily determinable market value. Accordingly, the estimated fair value of the ARS no longer approximates par value. These ARS are held by UBS AG (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 auction-rate securities originally purchased from UBS (approximately \$40.5 million, par value) at anytime during a two-year period from June 30, 2010 through July 2, 2012. Although the Company expects to sell its ARS under the Right, 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 Company has 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 include estimates of, based on data available as of December 31, 2009, 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. The Company intends to exercise the Right from UBS on June 30, 2010 and as a result has classified these ARS as short-term investments as of December 27, 2009.

**Revenue Recognition**

The Company allocates revenue to each element of multiple element arrangements that include products containing software that is more-than-incidental using the residual method based on vendor specific objective evidence of fair value of the undelivered elements. The Company determines vendor specific objective evidence of fair value based on the price charged when the item is sold separately.

The Company derives the majority of its revenue from sales of its networking equipment, with the remaining revenue generated from service fees relating to the service contracts, professional services, and training for its products. The Company generally recognizes product revenue from its value-added resellers and end-user customers at the time of shipment, provided that persuasive evidence of an arrangement exists, delivery has occurred, the price of the product is fixed or determinable, and collection of the sales proceeds is reasonably assured. In instances where the criteria for revenue recognition are not met, revenue is deferred until all criteria have been met. Revenue from service obligations under service contracts is deferred and recognized on a straight-line basis over the contractual service period. Service contracts typically range from one to two years.



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The Company makes certain sales to partners in two distribution channels, or tiers. The first tier consists of a limited number of independent distributors that sell primarily to resellers and, on occasion, to end-user customers. The Company defers recognition of revenue on all sales to these distributors until the distributors sell the product, as evidenced by monthly sales-out reports that the distributors provide. The Company grants these distributors the right to return a portion of unsold inventory for the purpose of stock rotation. The Company also grants these distributors certain price protection rights. The distributor-related deferred revenue and receivables are adjusted at the time of the stock rotation return or price reduction. The Company also provides distributors with credits for changes in selling prices, and allows distributors to participate in cooperative marketing programs. The Company maintains estimated accruals and allowances for these exposures based upon the Company's historical experience. In connection with cooperative advertising programs, the Company does not meet the criteria in 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 \$2.0 million and \$0.9 million as of December 27, 2009 and June 28, 2009, 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 \$1.0 million and \$0.1 million in the second quarter of fiscal 2010 and the second quarter of fiscal 2009, respectively. The provision for returns was \$1.1 million and \$0.6 million in the six months ended December 27, 2009 and the six months ended December 28, 2008, 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, which are net of write-downs for excess and obsolete inventory of \$5.3 million and \$4.7 million at December 27, 2009 and June 28, 2009 respectively, consist of (in thousands):

|                | December 27,<br>2009 | June 28,<br>2009 |
|----------------|----------------------|------------------|
| Raw materials  | \$ 273               | \$ 42            |
| Finished goods | 16,372               | 12,338           |
| <b>Total</b>   | <b>\$ 16,645</b>     | <b>\$ 12,380</b> |

***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 December 27, 2009 and June 28, 2009, respectively (in thousands):

|                        | December 27,<br>2009 | June 28,<br>2009 |
|------------------------|----------------------|------------------|
| Deferred services      | \$ 37,785            | \$ 36,690        |
| Deferred product       |                      |                  |
| Deferred revenue       | 2,647                | 1,315            |
| Deferred cost of sales | (1,718)              | (522)            |

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|                                   |          |          |
|-----------------------------------|----------|----------|
| Deferred product revenue, net     | 929      | 793      |
| Balance at end of period          | 38,714   | 37,483   |
| Less: current portion             | 31,884   | 30,058   |
| Non-current deferred revenue, net | \$ 6,830 | \$ 7,425 |

**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 was as follows (in thousands):

|                                | Three Months Ended   |                      | Six Months Ended     |                      |
|--------------------------------|----------------------|----------------------|----------------------|----------------------|
|                                | December 27,<br>2009 | December 28,<br>2008 | December 27,<br>2009 | December 28,<br>2008 |
| Balance beginning of period    | \$ 35,942            | \$ 39,057            | \$ 36,196            | \$ 38,778            |
| New support arrangements       | 15,522               | 12,923               | 30,053               | 27,472               |
| Recognition of support revenue | (13,886)             | (14,050)             | (28,671)             | (28,320)             |
| Balance end of period          | 37,578               | 37,930               | 37,578               | 37,930               |
| Less current portion           | 30,748               | 29,851               | 30,748               | 29,851               |
| Non-current deferred revenue   | \$ 6,830             | \$ 8,079             | \$ 6,830             | \$ 8,079             |

***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 the Company has a legally enforceable obligation for current payment from the distributor upon product delivery, 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 accounts receivable 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 December 27, 2009 and June 28, 2009, respectively (in thousands):

|  | December 27,<br>2009 | June 28,<br>2009 |
|--|----------------------|------------------|
| Deferred revenue   | \$ 21,613            | \$ 13,644        |
| Deferred cost of Sales                                       | (5,427)              | (3,823)          |
| Total deferred revenue, net of cost of sales to distributors | \$ 16,186            | \$ 9,821         |



**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 six months of fiscal 2010 and fiscal 2009, respectively (in thousands):

|                             | Six months ended     |                      |
|-----------------------------|----------------------|----------------------|
|                             | December 27,<br>2009 | December 28,<br>2008 |
| Balance beginning of period | \$ 3,170             | \$ 4,824             |
| New warranties issued       | 3,039                | 3,532                |
| Warranty expenditures       | (3,543)              | (2,594)              |
| Change in estimates         | 563                  | (2,246)              |
| Balance end of period       | \$ 3,229             | \$ 3,516             |

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. For the six months ended December 27, 2009, the Company recorded \$0.6 million for a change in estimate resulting from losses identified related to a failure in one of its products.

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 28, 2009.

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 will be 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 is currently evaluating the impact that the adoption of the new accounting standards may have on its consolidated results of operations and financial condition.



**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   |                      | Six Months Ended     |                      |
|--|----------------------|----------------------|----------------------|----------------------|
|  | December 27,<br>2009 | December 28,<br>2008 | December 27,<br>2009 | December 28,<br>2008 |
| Cost of product revenue                                | \$ 143               | \$ 56                | \$ 215               | \$ 16                |
| Cost of service revenue                                | 146                  | 61                   | 221                  | 93                   |
| Sales and marketing                                    | 683                  | 328                  | 979                  | 503                  |
| Research and development                               | 611                  | 311                  | 986                  | 462                  |
| General and administrative                             | 435                  | 228                  | 757                  | 322                  |
| Total share-based compensation expense                 | 2018                 | 984                  | 3158                 | 1396                 |
| Share-based compensation cost capitalized in inventory | 12                   | 20                   | 8                    | (6)                  |
| Total share-based compensation cost                    | \$ 2,030             | \$ 1,004             | \$ 3,166             | \$ 1,390             |

The weighted-average grant-date per share fair value of options granted in the second quarter of fiscal 2010 and 2009 were \$0.87 and \$0.54, respectively. The weighted-average estimated per share fair value of shares purchased under ESPP was \$0.64 in both the second quarter of fiscal 2010 and 2009.

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 second quarter of fiscal 2010 based on the Company's historical forfeiture experience is approximately 9%.

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

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  
Three Months Ended**

**Employee Stock Purchase Plan  
Three Months Ended**

**Stock Option Plan  
Six Months Ended**

**Employee Stock Purchase Plan  
Six Months Ended**



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|                         | December 27,<br>2009 | December 28,<br>2008 | December 27,<br>2009 | December 28,<br>2008 | December 27,<br>2009 | December 28,<br>2008 | December 27,<br>2009 | December 28,<br>2008 |
|-------------------------|----------------------|----------------------|----------------------|----------------------|----------------------|----------------------|----------------------|----------------------|
| Expected life           | 3 yrs                | 2.5 yrs              | 0.25 yrs             | 0.25 yrs             | 3 yrs                | 2.5 yrs              | 0.25 yrs             | 0.25 yrs             |
| Risk-free interest rate | 1.33%                | 1.33%                | 0.16%                | 0.26%                | 1.35%                | 1.33%                | 0.23%                | 1.11%                |
| Volatility              | 58%                  | 41%                  | 86%                  | 93%                  | 58%                  | 41%                  | 81%                  | 66%                  |
| Dividend yield          | N/A                  | N/A                  | N/A                  | N/A                  | N/A                  | N/A                  | N/A                  | N/A                  |

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.

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**Table of Contents****EXTREME NETWORKS, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) (Continued)*****Adjustments to Share-Based Compensation Expense During the Three and Six Months Ended December 27, 2009***

The Company was notified by its third party software provider that it had made certain changes to how its software program calculates stock-based compensation expense. Specifically, the prior version of this software that the Company had been using calculated stock-based compensation expense by incorrectly applying a weighted average forfeiture rate to the vested portion of stock option awards until the grant's final vest date, rather than calculating stock-based compensation expense based upon the actual vested portion of the grant date fair value, resulting in an understatement of stock-based compensation expense in certain periods prior to the grant's final vest date. Consequently, the Company identified errors in the calculation of stock-based compensation expense for fiscal years ended June 29, 2008, July 1, 2007 and July 2, 2006. The errors identified relate only to the timing of stock-based compensation expense recognition.

The Company determined that the cumulative error from the understatement of stock-based compensation expense related to the periods discussed above totaled \$0.9 million through June 29, 2008. The impact of the errors on the fiscal years ended June 29, 2008, July 1, 2007 and July 2, 2006, is to decrease net income by \$0.3 million for each year.

Management has determined that the impact of this error is not material to the previously issued annual and interim financial statements. Accordingly, the unaudited condensed consolidated financial statements for the three and six months ended December 27, 2009 include the cumulative adjustment to increase stock-based compensation expense by \$0.9 million (or \$0.01 per share) to correct these errors. The Company does not believe the correction of these errors is material to the condensed consolidated financial statements for the three and six months ended December 27, 2009 and does not believe that it will be material to the annual consolidated financial statements for the fiscal year ending June 27, 2010.

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

The Company has a revolving line of credit for \$10.0 million with a major lending institution which expires on January 22, 2010. The Company is not intending to renew the line of credit upon expiration. Borrowings under this line of credit bear interest at the bank's prime rate. As of December 27, 2009, there were no outstanding borrowings under this line of credit. The line of credit contains a provision for the issuance of letters of credit not to exceed the unused balance of the line. As of December 27, 2009, the Company had outstanding letters of credit totaling \$0.2 million. These letters of credit were primarily issued to satisfy requirements of certain of the Company's customers for performance bonds. The line of credit requires the Company to maintain specified financial covenants related to tangible net worth and liquidity with which the Company was in compliance as of December 27, 2009.

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

***Purchase Commitments***

The Company currently has arrangements with three contract manufacturers and other suppliers for the manufacture of the Company's products. The Company's arrangements allow it to procure long lead-time component inventory on the Company's behalf based upon a rolling production forecast provided by us. The Company is obligated for the purchase of long lead-time component inventory that the Company's contract manufacturers procure in accordance with the forecast, unless the Company gives notice of order cancellation outside of applicable component lead-times. As of December 27, 2009, the Company had non-cancelable commitments to purchase approximately \$36.0 million of such inventory.

***Legal Proceedings***

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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.

***Other Legal Matters***

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 name of the Company against various of its 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.

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

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 the Company's historical grants of stock options. The Company is named as a nominal defendant in the action, but the Company has customary indemnification agreements with the named defendants. On behalf of the Company, 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 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 the Company 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. The motion for reconsideration and alternative motion to certify an appeal are fully briefed and awaiting decision by the Court. 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.

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

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

|   | Three Months Ended   |                      | Six Months Ended     |                      |
|---|----------------------|----------------------|----------------------|----------------------|
|   | December 27,<br>2009 | December 28,<br>2008 | December 27,<br>2009 | December 28,<br>2008 |
| Net (loss) income                                   | \$ (1,379)           | \$ 2,466             | \$ (6,861)           | \$ 4,105             |
| Other comprehensive (loss) income:                  |                      |                      |                      |                      |
| Change in unrealized gain on investments:           |                      |                      |                      |                      |
| Net unrealized gain on ARS recorded to other income |                      | 3,547                |                      | 2,517                |
| Net unrealized (loss) gain on other investments     | (20)                 | 653                  | 111                  | 606                  |
| Net unrealized (loss) gain on investments           | (20)                 | 4,200                | 111                  | 3,123                |
| Net unrealized loss on derivatives                  |                      | (5)                  |                      | (7)                  |
| Foreign currency translation adjustments            |                      |                      |                      |                      |
| Beginning balance                                   | 1,752                | 1,387                | 912                  | 2,025                |
| Ending balance                                      | 1,602                | 999                  | 1,602                | 999                  |

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|   |            |          |            |          |
|---|------------|----------|------------|----------|
| Foreign currency translation adjustments change | (150)      | (388)    | 690        | (1,026)  |
| Total comprehensive (loss) income               | \$ (1,549) | \$ 6,273 | \$ (6,060) | \$ 6,195 |

*Accumulated Other Comprehensive Income*

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

|  | December 27,<br>2009 | June 28,<br>2009 |
|--|----------------------|------------------|
| Accumulated unrealized gain on investments           | \$ 522               | \$ 411           |
| Accumulated foreign currency translation adjustments | 1,602                | 912              |
| Accumulated other comprehensive income               | \$ 2,124             | \$ 1,323         |

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**EXTREME NETWORKS, INC.**

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

**5. Income Taxes**

The Company recorded an income tax benefit of \$0.3 million and an income tax provision of \$0.7 million for the second quarter of fiscal 2010 and second quarter of fiscal 2009, respectively. The reduction in tax expense is related to reduced U.S. alternative minimum tax for fiscal years 2009 and 2010, and benefits from recently enacted legislation that allows for refunds of prior period federal tax payments. The income tax provision for the three months ended December 27, 2009 and December 28, 2008 consisted primarily of taxes on foreign income and U.S. state income taxes. The income tax provisions for both quarters were calculated based on the results of operations for the three months ended December 27, 2009 and December 28, 2008, and may not reflect the annual effective 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.

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

During fiscal 2003, the Company established a full valuation allowance for the Company's US net deferred tax assets. The valuation allowance was calculated 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 is given more weight than the Company's expectations of future profitability, which are inherently uncertain. The Company's most recent three year history of losses represented sufficient negative evidence to require a full valuation allowance against the Company's U.S. 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 the Company's U.S. deferred tax assets.

The Company had unrecognized tax benefits of approximately \$22.6 million as of December 27, 2009. The future impact of the unrecognized tax benefit of \$22.6 million, if recognized, is as follows: approximately \$2.0 million would affect the effective tax rate, and approximately \$20.6 million would result in adjustments to deferred tax assets and corresponding adjustment to the valuation allowance. It is reasonably possible that the amount of unrealized tax benefits including accrued interest could decrease by approximately \$1.4 million during the next 12 months due to the expiration of the statute of limitations in certain foreign jurisdictions.

Estimated interest and penalties related to the underpayment of income taxes are classified as a component of tax expense in the Condensed Consolidated Statement of Operations and totaled approximately \$29,000 for the quarter ended December 27, 2009. Accrued interest and penalties were approximately \$0.6 million and \$0.5 million as of December 27, 2009 and December 28, 2008, respectively.

In general, the Company's U.S. federal income tax returns are subject to examination by tax authorities for fiscal years 2006 forward, the Company's state income tax returns are subject to examination for fiscal years 2005 forward, and the Company's Netherlands income tax returns are subject to examination for fiscal years 2003 forward.

**6. Net Income Per Share**

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

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## EXTREME NETWORKS, INC.

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

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

|  | Three Months Ended   |                      | Six Months Ended     |                      |
|--|----------------------|----------------------|----------------------|----------------------|
|  | December 27,<br>2009 | December 28,<br>2008 | December 27,<br>2009 | December 28,<br>2008 |
| Net (loss) income  | \$ (1,379)           | \$ 2,466             | \$ (6,861)           | \$ 4,105             |
| Weighted-average shares used in per share calculation basic  | 89,059               | 88,323               | 88,951               | 99,823               |
| Incremental shares using the treasury stock method:          |                      |                      |                      |                      |
| Stock options  |                      | 6                    |                      | 23                   |
| Unvested restricted awards                                   |                      | 34                   |                      | 79                   |
| Weighted-average share used in per share calculation diluted | 89,059               | 88,363               | 88,951               | 99,925               |
| Net (loss) income per share basic                            | \$ (0.02)            | \$ 0.03              | \$ (0.08)            | \$ 0.04              |
| Net (loss) income per share diluted                          | \$ (0.02)            | \$ 0.03              | \$ (0.08)            | \$ 0.04              |

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

|  | Three Months Ended   |                      | Six Months Ended     |                      |
|--|----------------------|----------------------|----------------------|----------------------|
|  | December 27,<br>2009 | December 28,<br>2008 | December 27,<br>2009 | December 28,<br>2008 |
| Stock options outstanding:   |                      |                      |                      |                      |
| In-the-money options   | 2,460                |                      | 2,478                |                      |
| Out-of-the-money options   | 14,247               | 18,485               | 14,558               | 18,278               |
| Total potential shares of common stock excluded from the computation of earnings per share | 16,707               | 18,485               | 17,036               | 18,278               |

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 and six months ended December 27, 2009 since the effect of including them would have been anti-dilutive due to the net loss position of the Company during the periods 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 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.



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As of December 27, 2009, restructuring liabilities were \$6.2 million and consisted of obligations associated with the Company's excess facilities under operating leases and termination benefits incurred in the current quarter. Excess facilities were identified in prior years from fiscal 2004 through 2009 and the Company has remaining obligations associated with these facilities. During the current quarter, the Company restructured the organization, including restructuring from a business unit organization to a functional organization. In connection with the restructuring, the Company had a reduction in force ( RIF ) and terminated 8% of its workforce. Total termination benefits were \$3.6 million. In addition, the Company eliminated certain redundant engineering projects in conjunction with the reorganization. The Company incurred \$0.5 million related to the discontinued engineering projects.

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

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

|   | Excess<br>Facilities | Asset<br>Impairment | Contract<br>Termination | Severance | Acceleration<br>of Stock<br>Awards | Total    |
|---|----------------------|---------------------|-------------------------|-----------|------------------------------------|----------|
| Balance June 28, 2009   | \$ 6,337             | \$                  | \$ 77                   | \$ 741    | \$ 126                             | \$ 7,078 |
| Period charges  | 74                   | 449                 | 77                      | 3,504     | 126                                | 4,230    |
| Period reversals  | (529)                |                     |                         | (94)      |                                    | (623)    |
| Write-off   |                      | (65)                |                         |           | (126)                              | (191)    |
| Period payments   | (1,377)              | (384)               | (77)                    | (2,489)   |                                    | (4,327)  |
| Balance December 27, 2009   | 4,505                |                     |                         | 1,662     |                                    | 6,167    |
| Less: current portion   | 2,730                |                     |                         | 1,662     |                                    | 4,392    |
| Restructuring liabilities at December 27, 2009, less<br>current portion | \$ 1,775             | \$                  | \$                      | \$        | \$                                 | \$ 1,775 |

**8. Foreign Currency Hedging**

The Company records all derivatives on the balance sheet at fair value. Changes in the fair value of derivatives that do not qualify, or are not effective as hedges, are recognized in earnings. Accordingly, the Company records the forward contracts used to manage foreign exchange exposures in prepaid expenses and other current assets on the consolidated balance sheets at fair value.

*Foreign Exchange Exposure. Management* The Company denominates substantially all global sales in U.S. dollars. International sales subsidiaries generate operating expenses in foreign currencies. The Company has a program of hedging forecasted and actual foreign currency risk with forward contracts to eliminate, reduce or transfer selected foreign currency risks that can be confidently identified and quantified. Hedges of anticipated transactions are designated and documented at inception as cash flow hedges and are evaluated for effectiveness at least quarterly. As the critical terms of the forward contract and the underlying are matched at inception, forward contract effectiveness is calculated by comparing the cumulative change in the contract (on a forward to forward basis) to the change in fair value of the anticipated expense, with the effective portion of the hedge recorded in accumulated other comprehensive income (OCI). Values accumulated in OCI are subsequently reclassified into the consolidated statement of operations line item to which the hedged transaction relates in the period the anticipated expense is recognized in income. Any ineffectiveness is recognized immediately in other expense. No ineffectiveness was recognized in other expense in the second quarter of fiscal 2010 and the second quarter of fiscal 2009. At December 27, 2009, these forward foreign currency contracts had a notional principal amount of \$6.4 million and fair value is insignificant. These contracts have maturities of less than 60 days.

Forward contracts are used to hedge the remeasurement of non-functional currency monetary assets and liabilities in order to mitigate reported foreign exchange gains and losses. Gains and losses in the forward contracts are recognized in other income (expense), net. At December 27, 2009, the Company held foreign currency forward contracts with a notional principal amount and fair value of \$16.6 million and \$0.4 million. These contracts have maturities of less than 45 days. Changes in the fair value of these foreign exchange forward contracts are offset largely by remeasurement of the underlying assets and liabilities.

The Company does not enter into foreign exchange forward contracts for speculative or trading purposes. Foreign currency transaction gains and losses from operations, including the impact of hedging, were a loss of \$0.1 million in the second quarter of fiscal 2010 and gain of \$0.1 million in the second quarter of fiscal 2009. Foreign currency transaction gains and losses from operations, including the impact of hedging, were a loss of \$0.2 million in the first six months of fiscal 2010 and gain of \$0.6 million in the first six months of fiscal 2009.

**9. Disclosure about Segments of an Enterprise and Geographic Areas**

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

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

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

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

|                    | Three months ended<br>December 27, 2009 |                      | Three months ended<br>December 28, 2008 |                      | Six months ended<br>December 27, 2009 |                      | Six months ended<br>December 28, 2008 |                      |
|--------------------|---|----------------------|---|----------------------|---------------------------------------|----------------------|---------------------------------------|----------------------|
|                    | \$                                      | % of Net<br>Revenues | \$                                      | % of Net<br>Revenues | \$                                    | % of Net<br>Revenues | \$                                    | % of Net<br>Revenues |
| Net Revenues:      |   |                      |   |                      |                                       |                      |                                       |                      |
| North America      | \$ 27,458                               | 34.58%               | \$ 33,445                               | 38.20%               | \$ 54,356                             | 37.31%               | \$ 69,101                             | 39.02%               |
| EMEA               | 37,842                                  | 47.66%               | 42,195                                  | 48.20%               | 65,900                                | 45.22%               | 83,771                                | 47.31%               |
| APAC               | 14,097                                  | 17.76%               | 11,908                                  | 13.60%               | 25,450                                | 17.47%               | 24,202                                | 13.67%               |
| Total net revenues | \$ 79,397                               | 100.00%              | \$ 87,548                               | 100.00%              | \$ 145,706                            | 100.00%              | \$ 177,074                            | 100.00%              |

Two customers, Tech Data and Westcon, accounted for greater than 10% of the Company's revenue in the second quarter of fiscal 2010. One customer, Tech Data, accounted for greater than 10% of the Company's revenue in the second quarter of fiscal 2009.

Tech Data accounted for greater than 10% of the Company's revenue in the first six months of fiscal 2010. Two customers, Tech Data and Ericsson AB, accounted for greater than 10% of the Company's revenue in the first six months of fiscal 2009.

Substantially all of the Company's assets were attributable to North America operations at December 27, 2009 and December 28, 2008.

**10. Employee Stock Option Exchange Program**

On December 23, 2009, our stockholders approved a voluntary program ( Exchange Program ) that will permit eligible employees to exchange certain outstanding stock options that are underwater for a lesser number of shares of restricted stock units to be granted under the Extreme Networks, Inc. 2005 Equity Incentive Plan (the 2005 Plan ) and to exchange certain other stock options that are more substantially underwater for a cash payment. If commenced, exchange program will be open to all of our United States employees, except for members of our Board of Directors and our executive officers. The exchange program is expected to commence in February 2010 and end 20 days after the commencement date. We do not believe the incremental stock compensation charge related to the Exchange program will be material to the annual consolidated financial statements for the fiscal year ending June 27, 2010.

**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, particularly, our expectations regarding results of operations, the general economic environment, our ability to expand our market penetration, our ability to expand our distribution channels, customer acceptance of our products, our ability to meet the expectations of our customers, product demand and revenue, cash flows, product gross profits, our expectations to continue to develop new products and enhance existing products, our expectations regarding the amount of our research and development expenses, our expectations relating to our selling, general and administrative expenses, our efforts to achieve additional operating efficiencies and to review and improve our business systems and cost structure, our expectations to continue investing in technology, resources and infrastructure, our expectations concerning the availability of products from suppliers and contract manufacturers, anticipated product costs and sales prices, our expectations that we have sufficient capital to meet our requirements for at least the next twelve months, our expectations regarding the rationalization of our workforce and facilities, and our expectations regarding materials and inventory management. These forward-looking statements involve risks and uncertainties. We caution investors that actual results may differ materially from those projected in the forward-looking statements as a result of certain risk factors identified in the section entitled "Risk Factors" in this Report, our Quarterly Report on Form 10-Q for the first quarter of fiscal 2010, our Annual Report on Form 10-K for the fiscal year ended June 28, 2009, and other filings we have made with the Securities and Exchange Commission. These risk factors, include, but are not limited to: fluctuations in demand for our products and services; a highly competitive business environment for network switching equipment; our effectiveness in controlling expenses; the possibility that we might experience delays in the development of new technology and products; customer response to our new technology and products; the timing of any recovery in the global economy; risks related to pending or future litigation; and a dependency on third parties for certain components and for the manufacturing of our products.*

**Business Overview**

We develop and sell network infrastructure equipment and offer related services contracts for extended warranty and maintenance to our enterprise, data center and metropolitan telecommunications service provider customers. Substantially all of our revenue is derived from the sale of our networking equipment and related service contracts. In the second quarter of fiscal 2010, our revenues decreased \$8.2 million, gross profit decreased \$2.9 million, operating profit decreased \$3.4 million and net loss increased \$3.8 million as compared to the second quarter of fiscal 2009. In the six months ended December 27, 2009, our revenues decreased \$31.4 million, gross profit decreased \$17.6 million, operating profit decreased \$9.1 million and net loss decreased \$11.0 million as compared to the six months ended December 28, 2008.

We believe that considering the following key developments will assist investors in understanding our operating results for the three and six months ended December 27, 2009.

**Supply Chain Constraints**

We use our forecast of expected demand to determine our material requirements. Lead times for materials and components we order vary significantly, and depend on factors such as the specific supplier, contract terms and demand for a component at a given time. 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 unable to deliver products based on customer requests. This adversely affected our revenue and sales for the first quarter of fiscal 2010 since we were unable to deliver products in that quarter in a timely manner and certain customers cancelled orders or chose other vendors based on product availability. We have made substantial progress with our suppliers to improve timely delivery of our products to meet customers' demands in the second quarter of fiscal 2010. We continue to work to manage our forecast and supply chain in light of our customers' demands as accurately as possible. As a result of improvements in the supply chain, cost controls and increased revenue, our financial results improved from the first to the second quarter of fiscal 2010.

**Impact of the Global Economic Developments**

In addition to issues with our supply chain, we believe that the credit market crisis, global recession and other challenges affecting economic conditions in the United States and other parts of the world were the significant drivers of our financial performance during the first six months of fiscal 2010. Sales in the United States and Eastern Europe were most impacted as a result of the weak US economy and the global credit crisis in the financial market, while sales in Asia were only minimally impacted by global economic developments and grew during the period. We believe that limited access to credit, conservative purchasing patterns and delays or cancellation of IT infrastructure plans in the face of continued uncertainty regarding the global economy, will continue to negatively impact overall demand for networking solutions, including Ethernet equipment.



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### *Increasing Demand for Bandwidth*

While economic conditions have limited demand for networking equipment, we believe that the continued increase in demand for bandwidth will 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, deployment of triple-play services to residences and the rapidly growing adoption of internet cloud solutions offer our customers the opportunity to reduce expenses, improve efficiency and/or increase revenue. 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 recovers, we believe that the Ethernet segment of the networking equipment market will resume growth as enterprise, data center and carrier customers continue to recognize the performance and operating cost benefits of Ethernet technology.

### *Increased Product Breadth*

We believe that continued success in our marketplace will depend on our ability to develop new and enhanced products employing leading-edge technology.

### *Industry Developments*

The market for network infrastructure equipment is highly competitive and dominated by a few large companies. The difficult 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.

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

### *Restructuring*

On October 22, 2009, we restructured the organization, including restructuring from a business unit organization to a functional organization. In connection with the restructuring, we had a reduction in force ( RIF ), terminated 8% of our workforce and eliminated certain redundant engineering projects. Total restructuring charges in the second quarter of fiscal 2010 was \$4.1 million.

### *Results of Operations*

Our operations and financial performance have been affected by the economic factors described above. During the second quarter of fiscal 2010, we experienced the following results:

Net revenues of \$79.4 million, compared to net revenues of \$87.5 million in the second quarter of fiscal 2009.

Total gross profit of 58% of net revenues, compared to 56% in the second quarter of fiscal 2009.

Operating loss of \$1.9 million compared to operating income of \$1.6 million in the second quarter of fiscal 2009.

Net loss of \$1.4 million, compared to net income of \$2.5 million in the second quarter of fiscal 2009.  
During the six months ended December 27, 2009, we experienced the following results:

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Net revenues of \$145.7 million, compared to net revenues of \$177.1 million for the six months ended December 28, 2008.

Total gross profit of 57% of net revenues, compared to total gross profit of 57% of net revenues for the six months ended December 28, 2008.

Operating loss of \$7.0 million compared to operating income of \$2.1 million for the six months ended December 28, 2008.

Net loss of \$6.8 million, compared to net income of \$4.1 million for the six months ended December 28, 2008.

Operating cash flow was \$10.2 million positive for the six months ending December 27, 2009. Cash and cash equivalents, short-term investments and marketable securities increased by \$8.0 million in the six months ended December 27, 2009 to \$135.4 million, primarily as a result of cash flow from operations for the six months ended December 27, 2009.



**Table of Contents****Net Revenues**

The following table presents net product and service revenues for the three month and six month period ended December 27, 2009 and December 28, 2008, respectively (dollars in thousands):

|                           | Three months ended<br>December 27, 2009 |                      | Three months ended<br>December 28, 2008 |                      | Six months ended<br>December 27, 2009 |                      | Six months ended<br>December 28, 2008 |                      |
|---------------------------|---|----------------------|---|----------------------|---------------------------------------|----------------------|---------------------------------------|----------------------|
|                           | \$                                      | % of Net<br>Revenues | \$                                      | % of Net<br>Revenues | \$                                    | % of Net<br>Revenues | \$                                    | % of Net<br>Revenues |
| <b>Net Revenues:</b>      |   |                      |   |                      |                                       |                      |                                       |                      |
| Product                   | \$ 64,469                               | 81.20%               | \$ 72,580                               | 82.90%               | \$ 115,228                            | 79.08%               | \$ 146,929                            | 82.98%               |
| Service                   | 14,928                                  | 18.80%               | 14,968                                  | 17.10%               | 30,478                                | 20.92%               | 30,145                                | 17.02%               |
| <b>Total net revenues</b> | <b>\$ 79,397</b>                        | <b>100.00%</b>       | <b>\$ 87,548</b>                        | <b>100.00%</b>       | <b>\$ 145,706</b>                     | <b>100.00%</b>       | <b>\$ 177,074</b>                     | <b>100.00%</b>       |

Net revenues were \$79.4 million in the second quarter of fiscal 2010 and \$87.5 million in the second quarter of fiscal 2009, representing a decrease of \$8.1 million or 9% in the second quarter of fiscal 2010 from the second quarter of fiscal 2009. Net revenues for the first six months of fiscal 2010 were \$145.7 million, which is a decrease of \$31.4 million or 18% from net revenues of \$177.1 million in the first six months of fiscal 2009.

Product revenue was \$64.4 million for the second quarter of fiscal 2010 compared to \$72.6 million for the second quarter of fiscal 2009, a decline of \$8.1 million, or 11%. Product revenue was \$115.2 million for the first six months of fiscal 2010, compared to \$146.9 million for the first six months of fiscal 2009, a decrease of \$31.7 million or 22%.

Service revenue was effectively flat from the three and six months ended December 27, 2009 as compared to the three and six months ended fiscal 2009.

We operate in three regions: North America, which includes the United States, Canada and Central America; EMEA, which includes Europe, Middle East, Africa and South America; and APAC which includes Asia Pacific and Japan. The following table presents the total net revenue geographically for the three month period ended December 27, 2009 and December 28, 2008 (dollars in thousands):

|                           | Three months ended<br>December 27, 2009 |                      | Three months ended<br>December 28, 2008 |                      | Six months ended<br>December 27, 2009 |                      | Six months ended<br>December 28, 2008 |                      |
|---------------------------|---|----------------------|---|----------------------|---------------------------------------|----------------------|---------------------------------------|----------------------|
|                           | \$                                      | % of Net<br>Revenues | \$                                      | % of Net<br>Revenues | \$                                    | % of Net<br>Revenues | \$                                    | % of Net<br>Revenues |
| <b>Net Revenues:</b>      |   |                      |   |                      |                                       |                      |                                       |                      |
| North America             | \$ 27,458                               | 34.58%               | \$ 33,445                               | 38.20%               | \$ 54,356                             | 37.31%               | \$ 69,101                             | 39.02%               |
| EMEA                      | 37,842                                  | 47.66%               | 42,195                                  | 48.20%               | 65,900                                | 45.22%               | 83,771                                | 47.31%               |
| APAC                      | 14,097                                  | 17.76%               | 11,908                                  | 13.60%               | 25,450                                | 17.47%               | 24,202                                | 13.67%               |
| <b>Total net revenues</b> | <b>\$ 79,397</b>                        | <b>100.00%</b>       | <b>\$ 87,548</b>                        | <b>100.00%</b>       | <b>\$ 145,706</b>                     | <b>100.00%</b>       | <b>\$ 177,074</b>                     | <b>100.00%</b>       |

In the second quarter of fiscal 2010, North America revenue was \$27.5 million, a decrease of \$6.0 million, or 18% from the second quarter of fiscal 2009. Product revenues decreased \$6.2 million or 25% and service revenue increased \$0.2 million or 2% compared to a year ago quarter. In the first six months of fiscal 2010, North America revenues were \$54.4 million which represented a decrease of \$14.7 million or 21% from the first six months of fiscal 2009. Product revenues decreased \$15.1 million or 30% and service revenue increased \$0.4 million or 2% from the first six months of fiscal 2009. The decrease in the North America revenues compared to the second quarter of fiscal 2009 and the first six months of fiscal 2009 was primarily the result of weakness in the U.S. economy as well as competition. The decrease in the first six months of fiscal 2009 was also due to supply chain constraints in the first quarter of fiscal 2010.

In the second quarter of fiscal 2010, EMEA revenues were \$37.8 million, a decrease of \$4.4 million, or 10%, from the second quarter of fiscal 2009. Product revenue decreased \$4.5 million or 12% and service revenue increased \$0.1 million or 3% compared to a year ago quarter. In the

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first six months of fiscal 2010, EMEA revenues were \$65.9 million which represented a decrease of \$17.9 million or 21% from the first six months of fiscal 2009. Product revenues decreased \$18.4 million or 25% and service revenue increased \$0.5 million or 6% from the first six months of fiscal 2009. The decrease in EMEA revenues compared to the first three and six months of fiscal 2009 was primarily due to weakness in the EMEA economy and a slowdown in the service provider business in Eastern Europe as our customer base is in the process of deploying previous purchases.

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In the second quarter of fiscal 2010, APAC revenues were \$14.1 million, an increase of \$2.2 million or 18% from the second quarter of fiscal 2009. Product revenues increased \$2.5 million or 24% and service revenue decreased \$0.3 million or 22% compared to a year ago quarter. In the first six months of fiscal 2010, APAC revenues were \$25.5 million which represented an increase of \$1.2 million or 5% from the first six months of fiscal 2009. Product revenue increased \$1.8 million or 9% and service revenue decreased \$0.6 million or 19%. The increase in APAC revenues compared to the second quarter of fiscal 2009 and the first six months of fiscal 2009 was primarily driven by stronger management execution contributing to improved performance in China.

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 10.4% and 16.5%, respectively, of the Company's revenue in the second quarter of fiscal 2010. Tech Data accounted for 10.2% of the Company's revenue in the second quarter of fiscal 2009.

Tech Data accounted for 11.8% of the Company's revenue in the first six months of fiscal 2010. Tech Data and Ericsson AB accounted for 10.9% and 10.2% of the Company's revenue in the first six months of fiscal 2009.

**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 2010 and first quarter of fiscal 2009 (dollars in thousands):

|                    | Three months ended<br>December 27, 2009 |        | Three months ended<br>December 28, 2008 |        | Six months ended<br>December 27, 2009 |        | Six months ended<br>December 28, 2008 |        |
|--------------------|---|--------|---|--------|---------------------------------------|--------|---------------------------------------|--------|
|                    | Gross<br>Margin                         |        | Gross<br>Margin                         |        | Gross<br>Margin                       |        | Gross<br>Margin                       |        |
|                    | \$                                      | %      | \$                                      | %      | \$                                    | %      | \$                                    | %      |
| Gross profit:      |   |        |   |        |                                       |        |                                       |        |
| Product            | \$ 37,270                               | 57.81% | \$ 41,169                               | 56.72% | \$ 64,311                             | 55.81% | \$ 85,385                             | 58.11% |
| Service            | 8,502                                   | 56.95% | 7,522                                   | 50.25% | 18,230                                | 59.81% | 14,738                                | 48.89% |
| Total gross profit | \$ 45,772                               | 57.65% | \$ 48,691                               | 55.62% | \$ 82,540                             | 56.65% | \$ 100,123                            | 56.54% |

Gross profit was \$45.8 million in the second quarter of fiscal 2010, a decrease of \$2.9 million or 6% as compared to \$48.7 million in the second quarter of fiscal 2009.

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 Electronics, Inc, located in Huntsville, Alabama, U.S.A.

Product gross profit in the second quarter of fiscal 2010 was \$37.3 million, representing a decrease of \$3.9 million or 10% from the second quarter of fiscal 2009. As a percentage of revenue, product gross margin increased one percentage point. The decrease in product gross profit was primarily driven by lower sales volume of \$6.1 million, offset by \$2.7 million favorability in product mix.

Product gross profit for the first six months of fiscal 2010 was \$64.3 million, a decrease of \$21.1 million or 25% from \$85.3 million in the first six months of fiscal 2009. The decrease in product gross profit was primarily driven by lower sales volume of \$13.3 million and \$8.3 million in competitive pricing and mix, offset by \$1.0 million decrease in distribution expense.

Our cost of service revenues consists primarily of labor, overhead, repair and freight costs and the cost of spares used in providing support under customer service contracts. Service gross profit was \$8.5 million in the second quarter of fiscal 2010, an increase of \$1.0 million or 13% from \$7.5 million in the second quarter of fiscal 2009. The increase in service gross profit in the second quarter of fiscal 2010 was primarily due to increased cost savings such as \$0.7 million in lower repair costs and \$0.4 million in lower professional services.



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Service gross profit was \$18.2 million for the first six months of fiscal 2010, an increase of \$3.5 million or 24% from \$14.7 million in the first six months of fiscal 2009. The increase in service gross profit is primarily due to increased cost savings such as \$2.4 million in lower repair costs and \$0.8 million in lower labor costs.

***Sales and Marketing Expenses***

Sales and marketing expenses consist of salaries, commissions and related expenses for personnel engaged in marketing and sales functions, as well as trade shows and promotional expenses. Sales and marketing expenses decreased to \$24.6 million for the second quarter of fiscal 2010 from \$25.8 million for the second quarter of fiscal 2009, a decrease of \$1.2 million, or 5%. This decrease was primarily driven by lower commission expense of \$0.4 million due to lower sales volume, \$0.5 million of favorable foreign exchange impact, and lower general sales and marketing expenses of \$0.6 million due to cost controls.

Sales and marketing expenses decreased to \$46.2 million for the first six months of fiscal 2010 from \$51.6 million for the first six months of fiscal 2009, a decrease of \$5.5 million or 11%. The decrease was primarily due to lower commissions expense of \$1.9 million due to lower sales volume, lower salaries and benefits of \$1.1 million due to lower headcount, \$0.7 million of favorable foreign exchange impact, lower travel and entertainment expense of \$0.4 million, lower contract labor and marketing fees of \$0.3 million, lower general sales expense of \$0.8 million due to cost control, lower purchases of internal demo hardware of \$0.3 million, and lower sales office fees of \$0.3 million.

***Research and Development Expenses***

Research and development expenses consist principally of salaries and related personnel expenses, consultant fees and prototype expenses related to the design, development and testing of our products. Research and development expenses decreased to \$12.4 million for the second quarter of fiscal 2010 from \$13.9 million for the second quarter of fiscal 2009, a decrease of \$1.5 million or 11%. The decrease was due to lower salaries and benefits of \$0.6 million primarily driven by lower headcount and lower spending of \$1.4 million on engineering projects as a result of the reduction in force and discontinued engineering projects due to the business reorganization in the second quarter of fiscal 2010, offset by \$0.3M of higher expenses due mainly to amortization of additional intangible assets.

Research and development expenses decreased to \$26.0 million for the first six months of fiscal 2010 from \$30.5 million for the first six months of fiscal 2009, a decrease of \$4.5 million or 15%. The decrease was primarily due to lower salaries and benefits of \$2.6 million driven by lower headcount and lower spending of \$2.4 million on engineering projects as a result of the reduction in force and discontinued engineering projects due to the business reorganization in the second quarter of fiscal 2010. We expense all research and development costs as incurred.

***General and Administrative Expenses***

General and administrative expenses consist primarily of salaries and related expenses for executive, finance and administrative personnel, legal fees, professional fees and other general corporate expenses. General and administrative expenses decreased to \$6.5 million for the second quarter of fiscal 2010 from \$7.4 million for the second quarter of fiscal 2009, a decrease of \$0.9 million, or 12%. This decrease was primarily due to \$1.3 million lower professional fees in litigation and financial consulting.

General and administrative expenses decreased to \$13.8 million for the first six months of fiscal 2010 from \$15.8 million for the first six months of fiscal 2009, a decrease of \$2.1 million or 13%. The decrease was primarily due to \$0.4 million of lower litigation fees and \$1.9 million of lower contract labor and professional fees.

***Restructuring, Net***

During the second quarter of fiscal 2010, we restructured the organization, including restructuring from a business unit organization to a functional organization. In connection with the restructuring, we had a reduction in force ( RIF ) and terminated 8% of our workforce. Total termination benefits were \$3.6 million. In addition, we eliminated redundant engineering projects in conjunction with the reorganization. We incurred \$0.5 million related to the discontinued engineering projects.

***Adjustments to Share Based Compensation Expense During the Three and Six Months Ended December 27, 2009***

We were notified by our third party software provider that it had made certain changes to how its software program calculates stock-based compensation expense. Specifically, the prior version of this software that we had been using calculated stock-based compensation expense by incorrectly applying a weighted average forfeiture rate to the vested portion of stock option awards until the grant's final vest date, rather than calculating stock-based compensation expense based upon the actual vested portion of the grant date fair value, resulting in an understatement of

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stock-based compensation expense in certain periods prior to the grant's final vest date. Consequently, we identified errors in the calculation of stock-based compensation expense for fiscal years ended June 29, 2008, July 1, 2007 and July 2, 2006. The errors identified relate only to the timing of stock-based compensation expense recognition.

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We determined that the cumulative error from the understatement of stock-based compensation expense related to the periods discussed above totaled \$0.9 million through June 29, 2008. The impact of the errors on the fiscal years ended June 29, 2008, July 1, 2007 and July 2, 2006, is to decrease net income by \$0.3 million for each year.

Management has determined that the impact of this error is not material to the previously issued annual and interim financial statements. Accordingly, the unaudited condensed consolidated financial statements for the three and six months ended December 27, 2009 include the cumulative adjustment to increase stock-based compensation expense by \$0.9 million (or \$0.01 per share) to correct these errors. We do not believe the correction of these errors is material to the condensed consolidated financial statements for the three and six months ended December 27, 2009 and do not believe that it will be material to the annual consolidated financial statements for the fiscal year ending June 27, 2010.

***Interest Income***

Interest income was \$0.4 million in the second quarter of fiscal 2010 as compared to \$0.9 million in the second quarter of fiscal 2009, a decrease of \$0.5 million. The decrease was due to decreased funds available for investments and decreased interest rates earned on investments. Cash, cash equivalents and investments were \$135.4 million as of December 27, 2009, a decrease of \$8.1 million as compared to \$143.5 million as of December 28, 2008. Average interest yield in the second quarter of fiscal 2010 was 1.6% as compared to 2.7% in second quarter of fiscal 2009.

***Interest Expense***

Interest expense in the second quarter of fiscal 2010 and second quarter of fiscal 2009 was immaterial and was primarily related to interest amortization of technology agreements.

***Other Income / (Expense), Net***

Other income (expense) net, was expense of \$0.1 million in the second quarter of fiscal 2010 as compared to income of \$0.8 million in the second fiscal quarter of 2009, a decrease in income of \$0.9 million. The decrease in income in other income (expense), net was primarily due to decreased foreign exchange gain as a result of the weakening dollar against other currencies. Foreign exchange loss was \$0.2 million in the second quarter of fiscal 2010 as compared to a gain of \$0.8 million in the second quarter of fiscal 2009.

Other income (expense), net also includes an unrealized loss of \$4.5 million resulting from the transfer of our ARS from available-for-sale to trading securities offset by \$4.5 million gain in fair value of the Put Option related to our acceptance of the UBS Rights offer to repurchase our ARS in the second quarter of fiscal 2009.

***Provision for Income Taxes***

We recorded income tax benefit of \$0.3 million and a tax provision of \$0.7 million for the second quarter of fiscal 2010 and the second quarter of fiscal 2009, respectively. The reduction in tax expense is related to reduced U.S. alternative minimum tax for fiscal years 2009 and 2010, and benefits from recently enacted legislation that allows for refunds of prior period federal tax payments. The income tax provisions for the three months ended December 27, 2009 and December 28, 2008 consisted primarily of taxes on foreign income and U.S. state income taxes. The income tax provisions for both quarters were calculated based on the results of operations for the three month periods ended December 27, 2009 and December 28, 2008, and may not reflect the annual effective 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. We initially recorded this charge during fiscal 2003 which places greater weight on previous cumulative losses than the outlook for future profitability when determining whether U.S. net deferred tax assets can be realized. Based upon our most recent three-year history of losses as of the date of determining the charge, we determined that it was appropriate to retain the full valuation allowance against our U.S. 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. net deferred tax assets.

***Critical Accounting Policies and Estimates***

Our significant accounting policies are more fully described in Note 2 of the Notes to Consolidated Financial Statements included in our Annual Report on Form 10-K for the year ended June 28, 2009. 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

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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



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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 compared to those discussed in our Annual Report on Form 10-K for the year ended June 28, 2009.

**Recently Issued Accounting Standards**

The following standards should be read in conjunction with the standards documented in *New Accounting Pronouncements* under Item 7A in our Annual Report on Form 10-K for the fiscal year ended June 28, 2009.

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 will be 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 are currently evaluating the impact that the adoption of the new accounting standards may have on our consolidated results of operations and financial condition.

**Liquidity and Capital Resources**

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

|  | As of                |                  |
|--|----------------------|------------------|
|  | December 27,<br>2009 | June 28,<br>2009 |
| Cash, cash equivalents, short-term investments and marketable securities | \$ 135,424           | \$ 127,403       |
| Working capital  | \$ 63,075            | \$ 23,414        |

The increase in cash, investments and working capital is primarily a result of \$10.2 million cash provided by operating activities, \$0.4 million cash received from issuance of common stock, offset by \$2.7 million in capital expenditures. Refer to further discussions below under *Key Components of Cash Flows and Liquidity*.

**Key Components of Cash Flows and Liquidity**

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

|   | Six months ended     |                      |
|---|----------------------|----------------------|
|   | December 27,<br>2009 | December 28,<br>2008 |
| Net cash provided by operating activities           | \$ 10,233            | \$ 17,808            |
| Net cash (used in) provided by investing activities | \$ (6,526)           | \$ 45,889            |
| Net cash provided by (used in) financing activities | \$ 397               | \$ (99,749)          |

|  |          |             |
|--|----------|-------------|
| Net increase (decrease) in cash and cash equivalents | \$ 4,104 | \$ (36,052) |
|--|----------|-------------|

Cash provided by operating activities was \$10.2 million. Net loss was \$6.9 million and included significant non-cash charges including depreciation of \$3.0 million, \$3.2 million in share-based compensation expense, \$1.0 million in the provision for excess and obsolete inventory and restructuring expense of \$3.6 million. Accounts receivable, net, increased to \$40.6 million at December 27, 2009 from \$37.6 million at June 28, 2009. Days sales outstanding in receivables was 46 days at December 27, 2009 and 42 days at June 28, 2009 due to increased collections. Accounts payable increased to \$22.2 million primarily due to increased inventory purchases at quarter end. Net inventory levels normalized to \$16.6 million at December 27, 2009 from \$12.4 million at June 28, 2009. Inventory balance of \$12.4 million at June 28, 2009 was lower than the normal inventory balance between \$16.0 million to \$18.0 million due to decreased inventory forecast demand from decreased

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revenue in the fourth quarter of fiscal 2009. 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, increased to \$38.7 million at December 27, 2009 from \$37.5 million at June 28, 2009. The increase was primarily due to increased maintenance renewal activities in December 2009 and increased product deferral due to partial shipments. Deferred revenue, net of cost of sales to distributors, increased \$6.4 million from \$9.8 million at June 28, 2009 to \$16.2 million at December 27, 2009. The increase was primarily due to inventory stocking for backlog.

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Cash flow used in investing activities was \$6.5 million. Capital expenditures were \$2.7 million. We had a net purchase of investments of \$10.2 million in the first six months of 2010 as we transferred cash and cash equivalents into longer term securities to take advantage of higher interest yield.

Cash provided by financing activities was \$0.4 million from issuance of common stock.

We have a revolving line of credit for \$10.0 million with a major lending institution which expires on January 22, 2010. We are not intending to renew the line of credit upon expiration. Borrowings under this line of credit bear interest at the bank's prime rate. As of December 27, 2009, there were no outstanding borrowings under this facility. The line of credit contains a provision for the issuance of letters of credit not to exceed the unused balance of the line. As of December 27, 2009, we had letters of credit totaling \$0.2 million. These letters of credit were primarily issued to satisfy requirements of certain of our customers for performance bonds. The line of credit requires us to maintain specified financial covenants related to tangible net worth and liquidity with which we were in compliance as of December 27, 2009.

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

*Employee Stock Option Exchange Program*

On December 23, 2009, our stockholders approved a voluntary program ( Exchange Program ) that will permit eligible employees to exchange certain outstanding stock options that are underwater for a lesser number of shares of restricted stock units to be granted under the Extreme Networks, Inc. 2005 Equity Incentive Plan (the 2005 Plan ) and to exchange certain other stock options that are more substantially underwater for a cash payment. If commenced, the exchange program will be open to all of our United States employees, except for members of our Board of Directors and our executive officers. The exchange program is expected to commence in February 2010 and end 20 days after the commencement date. We do not believe the incremental stock compensation charge related to the Exchange program will be material to the annual consolidated financial statements for the fiscal year ending June 27, 2010.

*Contractual Obligations*

The following summarizes our contractual obligations at December 27, 2009, and the effect such obligations are expected to have on our liquidity and cash flow in future periods (in thousands):

|   |                  | Less             |                 |               |                         |
|---|------------------|------------------|-----------------|---------------|-------------------------|
|   | Total            | Than 1<br>Year   | 1 3<br>Years    | 3 5<br>Years  | More Than<br>Five Years |
| <b>Contractual Obligations:</b>               |                  |                  |                 |               |                         |
| Non-cancelable inventory purchase commitments | \$ 36,048        | \$ 36,048        | \$              | \$            | \$                      |
| Non-cancelable operating lease obligations    | 12,042           | 6,678            | 4,463           | 901           |                         |
| Other non-cancelable purchase commitments     | 2,734            | 1,244            | 1,490           |               |                         |
| <b>Total contractual cash obligations</b>     | <b>\$ 50,824</b> | <b>\$ 43,970</b> | <b>\$ 5,953</b> | <b>\$ 901</b> | <b>\$</b>               |

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 \$36.0 million as of December 27, 2009, an increase of \$16.1 million from \$19.9 million as of June 28, 2009. The increase was primarily due to increased demand forecast and the reinstatement of safety stock given the supply chain constraints in the first six months of fiscal 2010.

We did not have material commitments for capital expenditures as of December 27, 2009. 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 December 27, 2009.

**Table of Contents***Capital Resources and Financial Condition*

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

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

The primary objective of our investment activities is to preserve principal while at the same time maximizing the income we receive from our investments without significantly increasing risk. Some of the securities that we have invested in may be subject to market risk. This means that a change in prevailing interest rates may cause the principal amount of the investment to fluctuate. For example, if we hold a security that was issued with a fixed interest rate at the then-prevailing rate and the prevailing interest rate later rises, the principal amount of our investment will probably decline. To minimize this risk, we maintain our portfolio of cash equivalents and short-term investments in a variety of securities, including commercial paper, other non-government debt securities and money market funds.

We hold a variety of interest bearing ARS that represent investments in pools of student loans. These ARS investments are intended to provide liquidity via an auction process that resets the applicable interest rate at predetermined calendar intervals, allowing investors to either roll over their holdings or gain immediate liquidity by selling such interests at par. The recent uncertainties in the credit markets have affected all of our holdings in ARS investments and auctions for our investments in these securities have failed to settle on their respective settlement dates. On November 7, 2008, we accepted the UBS Rights Offer from UBS, providing us with rights related to our ARS. The Rights permit us to require UBS to purchase our ARS at par value, which is defined as the price equal to the liquidation preference of the ARS plus accrued but unpaid dividends or interest, at any time during the period of June 30, 2010 through July 2, 2012. Conversely, UBS has the right, in its discretion, to purchase or sell our ARS at any time until July 2, 2012, so long as we receive payment at par value upon any sale or disposition. We expect to sell our ARS under the Rights in the period beginning in 2010. However, if the Rights are not exercised before July 2, 2012 they will expire and UBS will have no further rights or obligation to buy our ARS. So long as we hold our ARS, they will continue to accrue interest as determined by the auction process or the terms of the ARS if the auction process fails. During the first quarter of fiscal 2010, we reclassified our entire balance of ARS from marketable securities to short-term securities in our consolidated balance sheet. The reclassification is a result of the securities underlying the Put Option being due within less than one year from balance sheet date.

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 December 27, 2009. This table does not include money market funds because those funds are generally not subject to market risk. Included within short-terms investments within this table, is our ARS portfolio held at UBS.

|                                       | Three<br>months<br>or less | Three<br>months to<br>one year | Maturing in<br>Greater<br>than one<br>year | Total     | Fair<br>Value |
|---------------------------------------|----------------------------|--------------------------------|--|-----------|---------------|
| Included in cash and cash equivalents | \$ 8,000                   |                                |  | \$ 8,000  | \$ 8,000      |
| Weighted average interest rate        | 0.07%                      |                                |  |           |               |
| Included in short-term investments    | \$ 1,320                   | \$ 57,343                      |  | \$ 58,663 | \$ 58,663     |
| Weighted average interest rate        | 2.31%                      | 1.99%                          |  |           |               |
| Included in marketable securities     |                            |                                | \$ 26,463                                  | \$ 26,463 | \$ 26,463     |
| Weighted average interest rate        |                            |                                | 1.96%                                      |           |               |



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### ***Exchange Rate Sensitivity***

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

### ***Foreign Exchange Forward Contracts***

We enter into foreign exchange forward contracts to hedge foreign currency forecasted transactions related to certain operating expenses, denominated in Japanese Yen, the Euro, the Swedish Krona, the Indian Rupee and the British Pound. These derivatives are designated as cash flow hedges. At December 27, 2009, these forward foreign currency contracts had a notional principal amount of \$6.4 million and fair value is insignificant. These contracts have maturities of less than 60 days.

Additionally, we enter into foreign exchange forward contracts to mitigate the effect of gains and losses generated by the remeasurement of certain assets and liabilities denominated in Japanese Yen, the Euro, the Swedish Krona, Indian Rupee and the British Pound. These derivatives are not designated as hedges. At December 27, 2009, we held foreign currency forward contracts with a notional principal amount and fair value of \$16.6 million and \$0.4 million, respectively. These contracts have maturities of less than 45 days. Changes in the fair value of these foreign exchange forward contracts are offset largely by remeasurement of the underlying assets and liabilities.

We do not enter into foreign exchange forward contracts for speculative or trading purposes. Foreign currency transaction gains and losses from operations, including the impact of hedging, were a loss of \$0.1 million in the second quarter of fiscal 2010 and gain of \$0.1 million in the second quarter of fiscal 2009. Foreign currency transaction gains and losses from operations, including the impact of hedging, were a loss of \$0.2 million in the first six months of fiscal 2010 and gain of \$0.6 million in the first six months of fiscal 2009.

## **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 Acting President and Chief Executive Officer, and Chief Financial Officer ( Acting CEO and CFO ), as appropriate to allow timely decisions regarding required disclosure.

Under the supervision and with the participation of our management, including our Acting 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 Acting 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.

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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 December 27, 2009 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

### ***Inherent Limitations on Effectiveness of Controls***

Our management, including the Acting 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 Acting 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 Acting 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 28, 2009 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 28, 2009 and Part II, Item 1A, Risk Factors in our Quarterly Report on Form 10-Q for the quarter ended September 27, 2009, which to our knowledge have not materially changed. Those risks, which could materially affect our business, financial condition or future results, are not the only risks we face. Additional risks and uncertainties not currently known to us or that we currently deem to be immaterial also may adversely affect our business, financial condition and/or operating results.

**Item 2. Unregistered Sales of Equity Securities and Use of Proceeds Not applicable****Item 3. Defaults Upon Senior Securities Not applicable****Item 4. Submission of Matters to a Vote of Security Holders**

On December 23, 2009, Extreme Networks, Inc. held its annual meeting of stockholders (the *Annual Meeting*). Four proposals were considered and approved by the stockholders. Approximately 89.4% percent of outstanding shares were represented at the meeting.

***Proposal #1 Election of Directors Including Director Exceptions.***

John H. Kispert, Edward B. Meyercord III, and Harry Silverglide, the directors nominated as Class II directors to hold office for a three-year term until the annual meeting of stockholders in 2012 and until their successors are elected and qualified or until their earlier resignation or removal, were each elected to our Board of Directors as Class II directors.

|                         | For        | % of Voted | Withheld   | % of Voted |
|-------------------------|------------|------------|------------|------------|
| John H. Kispert         | 70,227,124 | 87.97%     | 9,604,432  | 12.03%     |
| Edward B. Meyercord III | 70,223,471 | 87.97%     | 9,608,085  | 12.03%     |
| Harry Silverglide       | 69,222,378 | 86.72%     | 10,609,178 | 13.28%     |

***Proposal #2 Appointment of the Company's Independent Auditors.***

Our stockholders ratified the appointment of Ernst & Young LLP as our independent registered public accountants for the fiscal year ending June 27, 2010.

|            | For        | Against | Abstain   | Broker Non-Votes |
|------------|------------|---------|-----------|------------------|
| Votes      | 77,917,276 | 364,872 | 1,549,408 | 0                |
| % of Voted | 97.60%     | 0.45%   | 1.94%     |                  |

***Proposal #3 Approval of Voluntary Exchange Program.***

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Our stockholders approved a voluntary program that will permit eligible employees to exchange certain outstanding stock options that are underwater for a lesser number of shares of restricted stock units to be granted under the Extreme Networks, Inc. 2005 Equity Incentive Plan (the *2005 Plan*) and to exchange certain other stock options that are more substantially underwater for a cash payment.

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|                   | <b>For</b> | <b>Against</b> | <b>Abstain</b> | <b>Broker Non-Votes</b> |
|-------------------|------------|----------------|----------------|-------------------------|
| <b>Votes</b>      | 50,327,931 | 3,691,397      | 3,001,359      | 22,810,869              |
| <b>% of Voted</b> | 88.26%     | 6.47%          | 5.26%          |                         |

***Proposal #4 Amendment to 2005 Plan to Increase Shares.***

Our stockholders approved an amendment to the 2005 Plan to increase by 4,000,000 the maximum number of shares of our common stock that may be issued under the 2005 Plan.

|                   | <b>For</b> | <b>Against</b> | <b>Abstain</b> | <b>Broker Non-Votes</b> |
|-------------------|------------|----------------|----------------|-------------------------|
| <b>Votes</b>      | 41,858,302 | 15,069,598     | 92,788         | 22,810,868              |
| <b>% of Voted</b> | 73.40%     | 26.42%         | 0.16%          |                         |

**Item 5. Other Information** None

**Item 6. Exhibits**

*(a) Exhibits:*

31.1 Section 302 Certification of Acting Chief Executive Officer, and Chief Financial Officer

32.1 Section 906 Certification of Acting Chief Executive Officer, and Chief Financial Officer

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**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**

**Acting President and Chief Executive Officer**

**Senior Vice President and Chief Financial Officer**

February 3, 2010