

NetApp, Inc.  
Form 10-Q  
August 30, 2012  
Table of Contents

**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**Form 10-Q**

(Mark One)

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

For the quarterly period ended July 27, 2012

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 000-27130

**NetApp, Inc.**

*(Exact name of registrant as specified in its charter)*

**Delaware**  
*(State or other jurisdiction of  
incorporation or organization)*

**77-0307520**  
*(I.R.S. Employer  
Identification No.)*

**495 East Java Drive,  
Sunnyvale, California 94089**

*(Address of principal executive offices, including zip code)*

# Edgar Filing: NetApp, Inc. - Form 10-Q

(408) 822-6000

*(Registrant's telephone number, including area code)*

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 (§232.405 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  Smaller reporting company   
(Do not check if a 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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

As of August 20, 2012, there were 363,314,960 shares of the registrant's common stock, \$0.001 par value, outstanding.

**Table of Contents****TABLE OF CONTENTS****PART I FINANCIAL INFORMATION**

Item 1	<u>Condensed Consolidated Financial Statements (Unaudited)</u>	3
	<u>Condensed Consolidated Balance Sheets as of July 27, 2012 and April 27, 2012</u>	3
	<u>Condensed Consolidated Statements of Operations for the Three Months Ended July 27, 2012 and July 29, 2011</u>	4
	<u>Condensed Consolidated Statements of Comprehensive Income for the Three Months Ended July 27, 2012 and July 29, 2011</u>	5
	<u>Condensed Consolidated Statements of Cash Flows for the Three Months Ended July 27, 2012 and July 29, 2011</u>	6
	<u>Notes to Condensed Consolidated Financial Statements</u>	7
Item 2	<u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	22
Item 3	<u>Quantitative and Qualitative Disclosures About Market Risk</u>	35
Item 4	<u>Controls and Procedures</u>	37

**PART II OTHER INFORMATION**

Item 1	<u>Legal Proceedings</u>	38
Item 1A	<u>Risk Factors</u>	38
Item 2	<u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	57
Item 3	<u>Defaults upon Senior Securities</u>	57
Item 4	<u>Mine Safety Disclosures</u>	57
Item 5	<u>Other Information</u>	57
Item 6	<u>Exhibits</u>	57
	<u>SIGNATURE</u>	58

**TRADEMARKS**

© 2012 NetApp, Inc. All rights reserved. No portions of this document may be reproduced without prior written consent of NetApp, Inc. Specifications are subject to change without notice. NetApp, the NetApp logo, Go further, faster, DataFabric, Data ONTAP, FilerView, FlexCache, FlexClone, FlexPod, FlexShare, FlexVol, MetroCluster, MultiStore, NearStore, Network Appliance, OnCommand, RAID-DP, SecureShare, SnapDrive, SnapLock, SnapManager, SnapMirror, SnapProtect, SnapRestore, Snapshot, SnapVault, StorageGRID, and WAFL are trademarks or registered trademarks of NetApp, Inc. in the United States and/or other countries. Microsoft and Windows are registered trademarks of Microsoft Corporation. Symantec is a trademark of Symantec Corporation. UNIX is a registered trademark of The Open Group. All other brands or products are trademarks or registered trademarks of their respective holders and should be treated as such.

**Table of Contents****PART I FINANCIAL INFORMATION****Item 1. Condensed Consolidated Financial Statements (Unaudited)****NETAPP, INC.****CONDENSED CONSOLIDATED BALANCE SHEETS****(In millions)****(Unaudited)**

	<b>July 27, 2012</b>	<b>April 27, 2012</b>
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 1,529.4	\$ 1,549.8
Short-term investments	3,911.7	3,848.7
Accounts receivable, net of allowance of \$0.7 million and \$0.4 million as of July 27, 2012 and April 27, 2012, respectively	584.2	830.9
Inventories	203.7	161.5
Other current assets	511.8	435.6
<b>Total current assets</b>	<b>6,740.8</b>	<b>6,826.5</b>
Property and equipment, net	1,139.1	1,137.2
Goodwill	905.2	905.2
Other intangible assets, net	214.6	236.0
Other non-current assets	406.3	427.4
<b>Total assets</b>	<b>\$ 9,406.0</b>	<b>\$ 9,532.3</b>
<b>LIABILITIES AND STOCKHOLDERS EQUITY</b>		
Current liabilities:		
Accounts payable	\$ 275.6	\$ 233.1
Accrued compensation and related benefits	217.2	340.3
Other current liabilities	346.9	377.6
1.75% Convertible Senior Notes Due 2013	1,215.8	1,202.3
Short-term deferred revenue	1,404.4	1,366.5
<b>Total current liabilities</b>	<b>3,459.9</b>	<b>3,519.8</b>
Other long-term liabilities	207.3	206.9
Long-term deferred revenue	1,363.1	1,449.4
<b>Total liabilities</b>	<b>5,030.3</b>	<b>5,176.1</b>
Commitments and contingencies (Note 15)		
1.75% Convertible Senior Notes Due 2013	0.0	62.6

## Edgar Filing: NetApp, Inc. - Form 10-Q

<b>Stockholders' equity:</b>		
Common stock (467.5 and 468.9 shares issued as of July 27, 2012 and April 27, 2012, respectively)	0.5	0.5
Additional paid-in capital	4,531.7	4,410.3
Treasury stock, at cost (104.3 shares as of July 27, 2012 and April 27, 2012)	(2,927.4)	(2,927.4)
Retained earnings	2,765.7	2,805.3
Accumulated other comprehensive income	5.2	4.9
<b>Total stockholders' equity</b>	<b>4,375.7</b>	<b>4,293.6</b>
 <b>Total liabilities and stockholders' equity</b>	 <b>\$ 9,406.0</b>	 <b>\$ 9,532.3</b>

See accompanying notes to condensed consolidated financial statements.

**Table of Contents****NETAPP, INC.****CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS**

(In millions, except per share amounts)

(Unaudited)

	<b>Three Months Ended</b>	
	<b>July 27, 2012</b>	<b>July 29, 2011</b>
<b>Revenues:</b>		
Product	\$ 898.0	\$ 965.7
Software entitlements and maintenance	218.5	198.2
Service	328.1	294.3
<b>Net revenues</b>	<b>1,444.6</b>	<b>1,458.2</b>
<b>Cost of revenues:</b>		
Cost of product	452.2	437.4
Cost of software entitlements and maintenance	6.6	5.3
Cost of service	135.7	118.6
<b>Total cost of revenues</b>	<b>594.5</b>	<b>561.3</b>
<b>Gross profit</b>	<b>850.1</b>	<b>896.9</b>
<b>Operating expenses:</b>		
Sales and marketing	482.9	454.8
Research and development	221.4	198.6
General and administrative	65.6	65.1
Acquisition-related expense	0.0	2.2
<b>Total operating expenses</b>	<b>769.9</b>	<b>720.7</b>
<b>Income from operations</b>	<b>80.2</b>	<b>176.2</b>
<b>Other expense, net:</b>		
Interest income	10.8	10.6
Interest expense	(19.9)	(19.4)
Other income (expense), net	3.1	(0.3)
<b>Total other expense, net</b>	<b>(6.0)</b>	<b>(9.1)</b>
<b>Income before income taxes</b>	<b>74.2</b>	<b>167.1</b>
Provision for income taxes	10.4	27.6
<b>Net income</b>	<b>\$ 63.8</b>	<b>\$ 139.5</b>
<b>Net income per share:</b>		
Basic	\$ 0.17	\$ 0.38

Edgar Filing: NetApp, Inc. - Form 10-Q

Diluted	\$ 0.17	\$ 0.34
<b>Shares used in net income per share calculations:</b>		
Basic	366.1	370.3
Diluted	371.2	405.5

See accompanying notes to condensed consolidated financial statements.

**Table of Contents****NETAPP, INC.****CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME****(In millions)****(Unaudited)**

	<b>Three Months Ended</b>	
	<b>July 27, 2012</b>	<b>July 29, 2011</b>
<b>Net income</b>	<b>\$ 63.8</b>	<b>\$ 139.5</b>
<b>Other comprehensive income:</b>		
Foreign currency translation adjustments	(5.2)	(1.0)
Defined benefit obligation adjustments	0.1	0.0
Unrealized gains on available-for-sale securities:		
Unrealized holding gains arising during the period	4.1	1.0
Income tax effect on unrealized holding gains	(0.5)	0.3
Reclassification adjustments for gains included in net income	(0.1)	(0.5)
Unrealized gains on cash flow hedges:		
Unrealized holding gains arising during the period	6.4	4.4
Reclassification adjustments for gains included in net income	(4.5)	(1.8)
<b>Other comprehensive income</b>	<b>0.3</b>	<b>2.4</b>
<b>Comprehensive income</b>	<b>\$ 64.1</b>	<b>\$ 141.9</b>

See accompanying notes to condensed consolidated financial statements.



**Table of Contents****NETAPP, INC.****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS****(In millions)****(Unaudited)**

	<b>Three Months Ended</b>	
	<b>July 27, 2012</b>	<b>July 29, 2011</b>
<b>Cash flows from operating activities:</b>		
Net income	\$ 63.8	\$ 139.5
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	82.4	68.5
Stock-based compensation	79.2	58.1
Accretion of discount and issuance costs on Notes	14.3	13.7
Deferred income taxes	(18.0)	(23.4)
Tax benefit (charge) from stock-based compensation	(8.8)	28.7
Excess tax benefit from stock-based compensation	(4.9)	(32.1)
Other non-cash items, net	(6.0)	(7.2)
Changes in assets and liabilities, net of acquisition of business:		
Accounts receivable	244.2	145.0
Inventories	(42.2)	6.8
Other operating assets	(27.1)	(10.4)
Accounts payable	41.9	22.8
Accrued compensation and other current liabilities	(146.7)	(248.3)
Deferred revenue	(47.0)	66.7
Other operating liabilities	4.1	12.2
<b>Net cash provided by operating activities</b>	<b>229.2</b>	<b>240.6</b>
<b>Cash flows from investing activities:</b>		
Purchases of investments	(628.0)	(564.9)
Redemptions of investments	561.9	810.7
Purchases of property and equipment	(61.9)	(98.3)
Acquisition of business	0.0	(480.0)
Other investing activities, net	1.3	1.7
<b>Net cash used in investing activities</b>	<b>(126.7)</b>	<b>(330.8)</b>
<b>Cash flows from financing activities:</b>		
Issuance of common stock	35.0	46.6
Repurchase and retirement of common stock	(150.0)	(200.0)
Excess tax benefit from stock-based compensation	4.9	32.1
Other financing activities, net	(2.0)	0.3
<b>Net cash used in financing activities</b>	<b>(112.1)</b>	<b>(121.0)</b>
<b>Effect of exchange rate changes on cash and cash equivalents</b>	<b>(10.8)</b>	<b>(2.9)</b>
<b>Net decrease in cash and cash equivalents</b>	<b>(20.4)</b>	<b>(214.1)</b>
<b>Cash and cash equivalents:</b>		
Beginning of period	1,549.8	2,757.3

End of period

\$ 1,529.4 \$ 2,543.2

See accompanying notes to condensed consolidated financial statements.

---

**Table of Contents**

**NETAPP, INC.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**(Unaudited)**

**1. The Company**

Headquartered in Sunnyvale, California, NetApp, Inc. (we, us, or the Company) is a supplier of enterprise storage and data management software and hardware products and services. Our solutions help global enterprises meet major information technology challenges such as managing storage growth, assuring secure and timely information access, protecting data and controlling costs by providing innovative solutions that simplify the complexity associated with managing corporate data.

**2. Condensed Consolidated Financial Statements**

*Fiscal Year* Our fiscal year is reported on a 52- or 53-week year ending on the last Friday in April. The first quarters of fiscal 2013 and 2012 were each 13-week periods.

*Basis of Presentation* The accompanying unaudited condensed consolidated financial statements have been prepared by the Company, and reflect all adjustments, consisting only of normal recurring adjustments that are, in the opinion of management, necessary for the fair presentation of our financial position, results of operations, and cash flows for the interim periods presented. The statements have been prepared in accordance with accounting principles generally accepted in the United States of America (GAAP) for interim financial information and in accordance with the instructions to Form 10-Q and Rule 10-01 of Regulation S-X. Accordingly, these statements do not include all information and footnotes required by GAAP for annual consolidated financial statements, and should be read in conjunction with our audited consolidated financial statements as of and for the fiscal year ended April 27, 2012 contained in our Annual Report on Form 10-K filed with the Securities and Exchange Commission on June 19, 2012. The results of operations for the three months ended July 27, 2012 are not necessarily indicative of the operating results to be expected for the full fiscal year or future operating periods.

**3. Significant Accounting Policies**

There have been no significant changes in our significant accounting policies as of and for the three months ended July 27, 2012, as compared to the significant accounting policies described in our Annual Report on Form 10-K for the fiscal year ended April 27, 2012.

*Recent Accounting Standards Not Yet Effective*

In September 2011, the FASB issued a revised accounting standard intended to simplify how an entity tests goodwill for impairment. The revised standard will allow an entity to first assess qualitative factors to determine whether it is necessary to perform the two-step quantitative goodwill impairment test. An entity will no longer be required to calculate the fair value of a reporting unit unless it determines, based on a qualitative assessment, that it is more likely than not that its fair value is less than its carrying amount. This guidance is effective for us beginning in our fourth quarter of fiscal 2013. We do not expect this guidance to have a material impact on our consolidated financial statements.

In December 2011, the Financial Accounting Standards Board issued new guidance that will require us to disclose information about offsetting arrangements associated with financial and derivative instruments to enable users of our financial statements to understand the effect of those arrangements on our financial position. This guidance is effective for us beginning in our first quarter of fiscal 2014, at which time we will include the applicable disclosures required by this accounting standard update.

*Use of Estimates*

The preparation of the condensed consolidated financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting periods. Such estimates include, but are not limited to, revenue recognition, reserves and allowances; inventory valuation and purchase order accruals; valuation of goodwill and intangibles; restructuring reserves; product warranties; employee benefit accruals; stock-based compensation; loss contingencies; investment impairments; income taxes, and fair value measurements. Actual results could differ materially from those estimates.



**Table of Contents****4. Statements of Cash Flows**

Non-cash investing and financing activities and supplemental cash flow information are as follows (in millions):

	<b>Three Months Ended</b>	
	<b>July 27, 2012</b>	<b>July 29, 2011</b>
<b>Non-cash Investing and Financing Activities:</b>		
Reclassification of equity component of convertible debt	\$ 62.6	\$ 12.6
Acquisition of property and equipment on account	\$ 27.4	\$ 33.7
<b>Supplemental Cash Flow Information:</b>		
Income taxes paid, net of refunds	\$ 16.2	\$ 13.1
Interest paid, net of capitalized interest	\$ 11.2	\$ 11.2

**5. Business Combination**

On May 6, 2011, we completed the acquisition of certain assets related to the Engenio external storage systems business (Engenio) of LSI Corporation (LSI). We paid LSI \$480.0 million in cash and also assumed certain liabilities related to Engenio. During the three years following the acquisition, LSI will pay us a total of \$13.0 million to service certain LSI customer warranties. This acquisition enables us to address growing customer requirements in the areas of high bandwidth and intensive analytics workloads such as video, including full-motion video capture and digital video surveillance, as well as high-performance computing applications, such as genomics sequencing and scientific research.

The purchase price was allocated to Engenio's net tangible and intangible assets as of the date of acquisition based on various fair value estimates and analyses, including work performed by third-party valuation specialists.

The following are the estimated fair value of assets acquired and liabilities assumed as of the closing date (in millions):

Current assets	\$ 49.8
Property and equipment	33.3
Identified intangible assets	272.1
Goodwill	143.7
Other assets	9.3
<b>Total assets acquired</b>	<b>508.2</b>
Current liabilities	(20.9)
Other liabilities	(7.3)
<b>Total purchase price</b>	<b>\$ 480.0</b>

As this was an asset acquisition, U.S. goodwill is deductible for income tax purposes. The goodwill is comprised of expected synergies in utilizing Engenio's technology in our products and channels (and vice versa), reduction in future combined research and development expenses, and intangible assets, such as acquired workforce, that do not qualify for separate recognition.

**6. Other Intangible Assets, Net**

Other intangible assets, net consist of acquired finite-lived intangibles, as summarized below (in millions):

July 27, 2012	Other	April 27, 2012	Other
---------------	-------	----------------	-------

Edgar Filing: NetApp, Inc. - Form 10-Q

	<b>Gross Carrying Amount</b>	<b>Accumulated Amortization</b>	<b>Intangible Assets, Net</b>	<b>Gross Carrying Amount</b>	<b>Accumulated Amortization</b>	<b>Intangible Assets, Net</b>
Developed technology	\$ 282.1	\$ (92.9)	\$ 189.2	\$ 282.1	\$ (79.0)	\$ 203.1
Customer contracts/relationships	54.6	(34.2)	20.4	59.4	(32.7)	26.7
Trademarks and trade names	9.9	(5.9)	4.0	14.7	(9.7)	5.0
Covenants not to compete	2.2	(1.2)	1.0	2.2	(1.0)	1.2
<b>Total other intangible assets</b>	<b>\$ 348.8</b>	<b>\$ (134.2)</b>	<b>\$ 214.6</b>	<b>\$ 358.4</b>	<b>\$ (122.4)</b>	<b>\$ 236.0</b>

**Table of Contents**

Amortization expense for finite-lived intangible assets is summarized below (in millions):

	Three Months Ended		Statements of Operations Classifications
	July 27, 2012	July 29, 2011	
Developed technology	\$ 13.9	\$ 13.9	Cost of product revenues
Customer contracts/relationships	6.3	9.0	Sales and marketing
Trademarks and trade names	1.0	1.2	Sales and marketing
Covenants not to compete	0.2	0.2	Sales and marketing
	\$ 21.4	\$ 24.3	

As of July 27, 2012, future amortization expense related to finite-lived intangible assets is as follows (in millions):

Fiscal Year	Amount
Remainder of 2013	\$ 62.8
2014	52.0
2015	50.6
2016	46.9
2017	2.3
Total	\$ 214.6

**7. Balance Sheet Details**

*Cash and cash equivalents (in millions):*

	July 27, 2012	April 27, 2012
Cash	\$ 843.5	\$ 649.8
Cash equivalents	685.9	900.0
Cash and cash equivalents	\$ 1,529.4	\$ 1,549.8

*Inventories (in millions):*

	July 27, 2012	April 27, 2012
Purchased components	\$ 65.2	\$ 30.9
Finished goods	138.5	130.6
Inventories	\$ 203.7	\$ 161.5

*Other current assets (in millions):*

Edgar Filing: NetApp, Inc. - Form 10-Q

	July 27, 2012	April 27, 2012
Deferred tax assets, net	\$ 228.0	\$ 201.6
Prepaid expenses and other current assets	275.9	225.4
Short-term restricted cash	7.9	8.6
Other current assets	\$ 511.8	\$ 435.6

*Property and equipment, net (in millions):*

	July 27, 2012	April 27, 2012
Land	\$ 247.6	\$ 247.6
Buildings and building improvements	444.0	417.9
Leasehold improvements	100.0	96.5
Computer, production, engineering and other equipment	669.7	638.1
Software	391.9	381.6
Furniture and fixtures	73.1	71.7
Construction-in-progress	90.3	107.1
	2,016.6	1,960.5
Accumulated depreciation and amortization	(877.5)	(823.3)
Property and equipment, net	\$ 1,139.1	\$ 1,137.2



**Table of Contents**

Software includes capitalized internal-use software development costs. The net book value of such is as follows (in millions):

	July 27, 2012	April 27, 2012
Computer software	\$ 151.8	\$ 160.1

**Other non-current assets (in millions):**

	July 27, 2012	April 27, 2012
Auction rate securities	\$ 46.3	\$ 51.0
Restricted cash	2.4	2.6
Deferred tax assets, net	179.6	203.8
Other assets	178.0	170.0
Other non-current assets	\$ 406.3	\$ 427.4

**Short-term and long-term deferred revenue (in millions):**

	July 27, 2012	April 27, 2012
Product	\$ 25.3	\$ 25.7
SEM and service	2,742.2	2,790.2
Total	\$ 2,767.5	\$ 2,815.9

## Reported as:

	July 27, 2012	April 27, 2012
Short-term	\$ 1,404.4	\$ 1,366.5
Long-term	1,363.1	1,449.4
Total	\$ 2,767.5	\$ 2,815.9

**Accumulated other comprehensive income (in millions):**

The components of accumulated other comprehensive income (AOCI), net of related immaterial tax effects, were as follows:

	July 27, 2012	April 27, 2012
Accumulated foreign currency translation adjustments	\$ (0.3)	\$ 4.9
Accumulated defined benefit obligation adjustments	(4.3)	(4.4)

## Edgar Filing: NetApp, Inc. - Form 10-Q

Accumulated unrealized gains on available-for-sale securities	8.4	4.9
Accumulated unrealized gains (losses) on derivatives instruments	1.4	(0.5)
Total accumulated other comprehensive income	\$ 5.2	\$ 4.9

### 8. Financial Instruments and Fair Value

The accounting guidance for fair value measurements provides a framework for measuring fair value on either a recurring or nonrecurring basis whereby the inputs used in valuation techniques are assigned a hierarchical level. The following are the three levels of inputs to measure fair value:

*Level 1:* Observable inputs that reflect quoted prices (unadjusted) for identical assets or liabilities in active markets.

*Level 2:* Inputs that reflect quoted prices for identical assets or liabilities in less active markets; quoted prices for similar assets or liabilities in active markets; inputs other than quoted prices that are observable for the assets or liabilities; or inputs that are derived principally from or corroborated by observable market data by correlation or other means.

*Level 3:* Unobservable inputs that reflect our own assumptions incorporated in valuation techniques used to measure fair value. These assumptions are required to be consistent with market participant assumptions that are reasonably available.

We consider an active market to be one in which transactions for the asset or liability occur with sufficient frequency and volume to provide pricing information on an on-going basis, and consider an inactive market to be one in which there are infrequent or few transactions for the asset or liability, the prices are not current, or price quotations vary substantially either over time or among market makers. Where appropriate, our own or the counterparty's non-performance risk is considered in measuring the fair values of liabilities and assets, respectively.

**Table of Contents****Investments**

The following is a summary of our investments (in millions):

	July 27, 2012 Gross Unrealized				April 27, 2012 Gross Unrealized			
	Cost or Amortized Cost	Gains	Losses	Estimated Fair Value	Cost or Amortized Cost	Gains	Losses	Estimated Fair Value
Corporate bonds	\$ 2,968.3	\$ 12.4	\$ (0.6)	\$ 2,980.1	\$ 2,665.2	\$ 9.5	\$ (1.4)	\$ 2,673.3
U.S. Treasury and government debt securities	620.0	1.2	0.0	621.2	836.7	1.2	(0.1)	837.8
Commercial paper	207.4	0.0	0.0	207.4	164.6	0.0	0.0	164.6
Certificates of deposit	306.7	0.3	0.0	307.0	347.7	0.5	0.0	348.2
Money market funds	481.9	0.0	0.0	481.9	724.8	0.0	0.0	724.8
Auction rate securities	49.1	0.8	(3.6)	46.3	54.1	0.9	(4.0)	51.0
Equity funds	26.4	0.0	0.0	26.4	25.5	0.0	0.0	25.5
Total debt and equity securities	\$ 4,659.8	\$ 14.7	\$ (4.2)	\$ 4,670.3	\$ 4,818.6	\$ 12.1	\$ (5.5)	\$ 4,825.2

The following table presents the contractual maturities of our debt investments as of July 27, 2012 (in millions):

	Amortized Cost	Fair Value
Due in one year or less	\$ 1,655.4	\$ 1,658.8
Due in one through five years	2,243.0	2,252.9
Due after ten years*	49.1	46.3
	\$ 3,947.5	\$ 3,958.0

\* Consists of auction rate securities which have contractual maturities of greater than 10 years.

**Fair Value of Financial Instruments**

The following table summarizes our financial assets and liabilities measured at fair value on a recurring basis as of July 27, 2012 (in millions):

	Total	Fair Value Measurements at Reporting Date Using Quoted Prices		
		in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
<b>Assets</b>				
Corporate bonds	\$ 2,980.1	\$ 0.0	\$ 2,980.1	\$ 0.0
U.S. Treasury and government debt securities	621.2	224.9	396.3	0.0
Commercial paper	207.4	0.0	207.4	0.0
Certificates of deposit	307.0	0.0	307.0	0.0
Money market funds	481.9	481.9	0.0	0.0

Edgar Filing: NetApp, Inc. - Form 10-Q

Auction rate securities	46.3	0.0	0.0	46.3
Equity funds	26.4	26.4	0.0	0.0
Foreign currency contracts	8.9	0.0	8.9	0.0
Total	\$ 4,679.2	\$ 733.2	\$ 3,899.7	\$ 46.3
<b>Liabilities</b>				
Foreign currency contracts	\$ 0.4	\$ 0.0	\$ 0.4	\$ 0.0

**Table of Contents**

Reported as (in millions):

	Fair Value Measurements at Reporting Date Using			
	Total	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
<b>Assets</b>				
Cash equivalents	\$ 685.9	\$ 481.9	\$ 204.0	\$ 0.0
Short-term investments	3,911.7	224.9	3,686.8	0.0
Other current assets	15.1	6.2	8.9	0.0
Other non-current assets	66.5	20.2	0.0	46.3
Total	\$ 4,679.2	\$ 733.2	\$ 3,899.7	\$ 46.3
<b>Liabilities</b>				
Other current liabilities	\$ 0.4	\$ 0.0	\$ 0.4	\$ 0.0

Level 2 investments are held by a custodian who prices some of the investments themselves using standard inputs in various asset price models or obtains investment prices from a third party pricing provider that incorporates standard inputs in various asset price models. We review Level 2 inputs and fair value for reasonableness and the values may be further validated by comparison to multiple independent pricing sources. In addition, we review third-party pricing provider models, key inputs and assumptions and understand the pricing processes at our third-party providers in determining the overall reasonableness of the fair value of our Level 2 financial instruments. As of July 27, 2012 and April 27, 2012, we have not made any adjustments to the prices obtained from our third party pricing providers.

The unrealized losses on our available-for-sale investments in corporate bonds were caused by market value declines as a result of the economic environment, as well as fluctuations in market interest rates. Because the decline in market value is attributable to changes in market conditions and not credit quality, and because we have concluded currently that we neither intend to sell nor is it more likely than not that we will be required to sell these investments prior to a recovery of par value, we do not consider these investments to be other-than temporarily impaired as of July 27, 2012.

Quantitative information about our Level 3 fair value measurements is as follows (fair value in millions):

	Fair Value at July 27, 2012	Valuation Techniques	Unobservable Inputs	Range (Weighted average)
ARSs	\$ 46.3	Discounted cash flow	Time-to-economic maturity	6.7 yrs 11.8 yrs (8.7 yrs)
			Liquidity risk premium, market credit spread and other factors	1.7% - 2.4% (2.0%)
			Coupon rate	0.0% - 2.8% (1.4%)
		Market comparable securities	Discount rate	6.0% - 17.0% (12.7%)

All of our ARSs are classified as other non-current assets and are backed by pools of student loans guaranteed by the U.S. Department of Education. We estimate the fair value of each individual ARS using an income (discounted cash flow) and market approach that incorporate both observable and unobservable inputs. Key inputs into the discounted cash flow analysis include the time-to-economic maturity, liquidity risk premium, market credit spread and other factors and a coupon rate. The key input into the market approach is a discount rate. A significant increase (decrease) in the time-to-economic maturity, liquidity risk premium, market credit spread and other factors, coupon rate or discount rate could result in a significantly lower (higher) fair value estimate. We review the fair value of our Level 3 financial instruments for overall

## Edgar Filing: NetApp, Inc. - Form 10-Q

reasonableness by reviewing service provider pricing methodologies, key inputs and assumptions and by understanding the processes used by our third-party service providers. Based on our ability to access our cash and short-term investments, our expected operating cash flows, and our other sources of cash, we do not intend to sell these investments prior to recovery of value. We will continue to monitor our ARS investments in light of the debt market environment and evaluate these investments for impairment and classification.

The table below provides a reconciliation of the beginning and ending balance of our Level 3 auction rate securities measured at fair value on a recurring basis using significant unobservable inputs (in millions):

	Three Months Ended	
	July 27, 2012	July 29, 2011
Balance at beginning of period	\$ 51.0	\$ 65.1
Total unrealized gains, net included in other comprehensive income	0.3	0.9
Settlements	(5.0)	(9.7)
Balance at end of period	\$ 46.3	\$ 56.3

**Table of Contents****9. Financing Arrangements*****1.75% Convertible Senior Notes Due 2013***

On June 10, 2008, we issued \$1,265.0 million aggregate principal amount of 1.75% Convertible Senior Notes due 2013 (the Notes). The Notes are unsecured, unsubordinated obligations of the Company, which pay interest in cash semi-annually at a rate of 1.75% per annum. The Notes will mature on June 1, 2013 unless earlier repurchased or converted in accordance with their terms prior to such date. The Notes may be converted, under the conditions specified below, based on an initial conversion rate of 31.40 shares of common stock per \$1,000 principal amount of Notes (which represents an initial effective conversion price of the Notes of \$31.85 per share), subject to adjustment as described in the indenture governing the Notes.

The Notes are not redeemable by us prior to the maturity date. In the event of a fundamental change (as defined in the indenture for the Notes), holders of the Notes may require us to repurchase all or a portion of their Notes at a repurchase price equal to 100% of the principal amount of the Notes plus accrued and unpaid interest, if any, to, but excluding, the fundamental change repurchase date.

The holders of the Notes may convert their Notes until the close of business on the scheduled trading day immediately preceding the maturity date if any of the following conditions are met: (1) during the five business day period after any five consecutive trading day period (the measurement period) in which the trading price of the Notes for each day in the measurement period was less than 98% of an amount equal to (i) the last reported sale price of our common stock multiplied by (ii) the conversion rate for the Notes on each such day; (2) during any calendar quarter (and only during such calendar quarter) if the last reported sale price of our common stock for 20 or more trading days in a period of 30 consecutive trading days ending on the last trading day of the immediately preceding calendar quarter exceeds 130% of the applicable conversion price in effect for the Notes on the last trading day of such immediately preceding calendar quarter; or (3) upon the occurrence of specified corporate transactions set forth in the indenture for the Notes. On or after March 1, 2013, until the scheduled trading day immediately preceding the maturity date, holders of the Notes may convert their Notes regardless of the foregoing conditions. Upon conversion, a holder will receive cash in an amount equal to the lesser of the conversion value and the principal amount of the Notes, and shares of our common stock for any conversion value in excess of the principal amount of the Notes, if any. Holders of the Notes who convert their Notes in connection with a fundamental change will, under certain circumstances, be entitled to a make-whole premium in the form of an increase in the conversion rate.

Our common stock price did not exceed the conversion threshold price of \$41.41 per share set forth for the Notes for at least 20 trading days during the 30 consecutive trading days ended June 30, 2012, and accordingly, as of July 27, 2012, the Notes were not convertible at the option of the holder. Since the Notes were not convertible, the difference between the principal amount and the carrying value of the Notes was reflected as equity on our condensed consolidated balance sheet as of July 27, 2012.

The determination of whether or not the Notes are convertible must continue to be performed quarterly. Consequently, the Notes may be convertible in future quarters prior to March 1, 2013 at which time they become unconditionally convertible. If the Notes become convertible at the option of the holder, the difference between the principal amount and the carrying value of the Notes would be reflected as convertible debt in mezzanine on our condensed consolidated balance sheets.

Upon conversion of the Notes, we deliver cash up to the principal amount of the Notes and, with respect to any excess conversion value greater than the principal amount of the Notes, shares of our common stock. As of July 27, 2012, shares issued related to the Notes were minimal. Based on the closing price of our common stock of \$32.91 on July 27, 2012, the if-converted value of our Notes exceeded their principal amount by approximately \$42.2 million.

We separately account for the liability and equity components of the Notes. The initial debt component of the Notes was valued at \$1,017.0 million based on the contractual cash flows discounted at an appropriate comparable market non-convertible debt borrowing rate at the date of issuance of 6.31%, with the equity component representing the residual amount of the proceeds of \$248.0 million which was recorded as a debt discount. Issuance costs were allocated pro-rata based on the relative initial carrying amounts of the debt and equity components. As a result, \$5.2 million of the issuance costs was allocated to the equity component of the Notes, and \$21.4 million of the issuance costs remained classified as other non-current assets. The debt discount and the issuance costs allocated to the debt component are amortized as additional interest expense over the term of the Notes using the effective interest method and an effective interest rate of 6.31% for all periods presented.

The following table reflects the carrying value of the Notes (in millions):

Edgar Filing: NetApp, Inc. - Form 10-Q

	July 27, 2012	April 27, 2012
1.75% Convertible Senior Notes Due 2013	\$ 1,264.9	\$ 1,264.9
Less: Unamortized discount	(49.1)	(62.6)
Net carrying amount of Notes	\$ 1,215.8	\$ 1,202.3



**Table of Contents**

The following table presents the amount of interest expense recognized related to the Notes (in millions):

	Three Months Ended	
	July 27, 2012	July 29, 2011
Contractual coupon interest expense	\$ 5.5	\$ 5.5
Amortization of debt discount	13.5	12.6
Amortization of debt issuance costs	1.2	1.1
Less capitalized interest	(0.5)	0.0
<b>Total interest expense related to Notes</b>	<b>\$ 19.7</b>	<b>\$ 19.2</b>

The following table reflects the remaining debt discount and issuance costs as of July 27, 2012 (in millions):

Remaining debt discount	\$ 49.1
Remaining issuance costs	4.2
Remaining life of the Notes (years)	0.8

**Note Hedges and Warrants**

Concurrent with the issuance of the Notes, we purchased Note hedges and sold warrants. The separate Note hedge and warrant transactions are structured to reduce the potential future economic dilution associated with the conversion of the Notes.

**Note Hedges:** As of July 27, 2012 and April 27, 2012, we had arrangements with counterparties to buy up to approximately 31.8 million shares, subject to anti-dilution adjustments, of our common stock at a price of \$31.85 per share, subject to adjustment. The Note hedge transactions will expire at the earlier of (1) the last day on which any Notes remain outstanding or (2) the scheduled trading day immediately preceding the maturity date of the Notes. Upon exercise of the Note hedges, we have the option to receive cash or shares of our common stock equal to the difference between the then market price and the strike price of the hedges.

**Warrants:** As of July 27, 2012 and April 27, 2012, we had outstanding warrants for others to acquire, subject to anti-dilution adjustments, 39.7 million shares of our common stock at an exercise price of \$41.28 per share, subject to adjustment, on a series of days commencing on September 3, 2013. Upon exercise of the warrants, we have the option to deliver cash or shares of our common stock equal to the difference between the then market price and the strike price of the warrants.

As of July 27, 2012, we were subject to potential dilution on the approximately 20% unhedged portion of our Notes upon conversion, if on the date of conversion, the per-share market price of our common stock exceeds the conversion price of \$31.85.

As of July 27, 2012, we received a minimal number of shares related to the Note hedge transactions and no cash or shares were delivered related to the warrant transactions.

**Fair Value of Notes**

As of July 27, 2012, the approximate fair value of the principal amount of the Notes, which includes the debt and equity components, was approximately \$1,476.0 million, or 116.7% of the face value of the Notes, based upon quoted market information provided by third party pricing providers (Level 1).

**Other Long-Term Financing Arrangements**

The following presents the amounts due under other long-term financing arrangements (in millions):

Edgar Filing: NetApp, Inc. - Form 10-Q

	July 27, 2012	April 27, 2012
Current portion of other long-term financing arrangements	\$ 7.9	\$ 9.1
Non-current portion of other long-term financing arrangements	2.7	3.5
Total	\$ 10.6	\$ 12.6

**Table of Contents****10. Stockholders Equity****Stock Options**

A summary of the activity under our stock option plans and agreements is as follows (in millions, except for the exercise price):

	Number of Shares	Weighted- Average Exercise Price	Weighted- Average Remaining Contractual Term (Years)	Aggregate Intrinsic Value
Outstanding at April 27, 2012	20.6	\$ 29.98		
Options granted	2.0	29.82		
Options exercised	(0.4)	17.16		
Options forfeitures and cancellations	(0.3)	39.45		
Outstanding at July 27, 2012	21.9	30.04	3.82	\$ 142.3
Options vested and expected to vest as of July 27, 2012	21.1	29.75	3.75	140.7
Exercisable at July 27, 2012	14.7	26.92	3.03	119.0

The aggregate intrinsic value represents the pre-tax difference between the exercise price of stock options and the quoted market price of our stock on that day for all in-the-money options. As of July 27, 2012, the total unrecognized compensation expense related to stock options was \$77.8 million, which is expected to be recognized on a straight-line basis over a weighted-average remaining service period of 2.4 years.

Additional information related to our stock options is summarized below (in millions, except per share information):

	Three Months Ended	
	July 27, 2012	July 29, 2011
Weighted-average fair value per share granted	\$ 10.71	\$ 17.24
Intrinsic value of options exercised	\$ 5.4	\$ 43.8
Proceeds received from the exercise of stock options	\$ 6.7	\$ 35.0
Fair value of options vested	\$ 14.4	\$ 18.4

**Restricted Stock Units**

The following table summarizes activity related to our restricted stock units (RSUs) (in millions, except for fair value):

	Number of Shares	Weighted- Average Grant Date Fair Value
Outstanding at April 27, 2012	12.0	\$ 43.28
RSUs granted	4.5	29.03
RSUs vested	(2.0)	39.85
RSUs forfeitures and cancellations	(0.4)	42.10
Outstanding at July 27, 2012	14.1	39.29

## Edgar Filing: NetApp, Inc. - Form 10-Q

RSUs are converted into common stock upon vesting. Upon the vesting of RSUs, we primarily use the net share settlement approach, where a portion of the shares are withheld and retired as settlement of statutory employee withholding taxes, which decreases the shares issued to the employee by a corresponding value. The number and value of the shares netted for employee taxes are summarized in the table below (in millions):

	<b>Three Months Ended</b>	
	<b>July 27, 2012</b>	<b>July 29, 2011</b>
Shares withheld for taxes	0.7	0.5
Fair value of shares withheld and retired	\$ 19.8	\$ 25.3

As of July 27, 2012, the total unrecognized compensation expense related to RSUs was \$410.7 million, which is expected to be recognized on a straight-line basis over a weighted-average remaining service period of 3.0 years.

**Table of Contents*****Employee Stock Purchase Plan***

Under the Employee Stock Purchase Plan (ESPP), employees who elect to participate are granted options that include a purchase price adjustment provision under which the employees may purchase common stock at a 15% discount from the market value of the common stock at certain specified dates within a two-year offering period. Additional information related to the purchase rights issued under the ESPP is provided below (in millions, except per share information):

	<b>Three Months Ended</b>	
	<b>July 27, 2012</b>	<b>July 29, 2011</b>
Weighted-average fair value per right granted	\$ 10.25	\$ 15.88
Shares issued under the ESPP	1.9	1.1
Weighted-average price per share issued	\$ 25.30	\$ 39.17

As of July 27, 2012, the total unrecognized compensation expense related to the ESPP was \$73.8 million, which is expected to be recognized on a straight-line basis over a weighted-average remaining service period of 1.8 years.

***Stock-Based Compensation Expense***

Stock-based compensation expense included in the condensed consolidated statements of operations is as follows (in millions):

	<b>Three Months Ended</b>	
	<b>July 27, 2012</b>	<b>July 29, 2011</b>
Cost of product revenues	\$ 1.8	\$ 1.1
Cost of service revenues	5.6	3.9
Sales and marketing	39.0	28.6
Research and development	23.7	16.0
General and administrative	9.1	8.5
Total stock-based compensation expense	\$ 79.2	\$ 58.1

The following table summarizes stock-based compensation associated with each type of award (in millions):

	<b>Three Months Ended</b>	
	<b>July 27, 2012</b>	<b>July 29, 2011</b>
Employee stock options	\$ 12.0	\$ 14.5
RSUs	44.5	34.4
ESPP	22.7	9.2
Total stock-based compensation expense	\$ 79.2	\$ 58.1

Stock-based compensation for the three months ended July 27, 2012 includes a charge of \$12.8 million related to the purchase price adjustment provision under the ESPP.

Total income tax benefit (charge) associated with employee stock transactions and recognized in stockholders' equity was as follows (in millions):

**Three Months Ended**

Edgar Filing: NetApp, Inc. - Form 10-Q

	July 27, 2012	July 29, 2011
Income tax benefit (charge) associated with employee stock transactions	\$ (8.8)	\$ 28.7

**Valuation Assumptions**

The fair value of each award is estimated on the grant date using the Black-Scholes option pricing model, assuming no expected dividends and the following weighted-average assumptions:

	<b>Stock Options</b>	
	<b>Three Months Ended</b>	
	July 27, 2012	July 29, 2011
Expected term in years	4.8	4.8
Risk-free interest rate	0.63%	1.60%
Volatility	41%	35%

	<b>ESPP</b>	
	<b>Three Months Ended</b>	
	July 27, 2012	July 29, 2011
Expected term in years	1.2	1.2
Risk-free interest rate	0.18%	0.25%
Volatility	38%	35%

**Table of Contents****Stock Repurchase Program**

During the three months ended July 27, 2012, we repurchased and retired 4.9 million shares of our common stock at an average price of \$30.31 per share, for an aggregate purchase price of \$150.0 million, of which \$46.6 million and \$103.4 million was allocated to additional paid-in capital and retained earnings, respectively. Since the May 13, 2003 inception of our stock repurchase program through July 27, 2012, we repurchased a total of 123.9 million shares of our common stock at an average price of \$29.68 per share, for an aggregate purchase price of \$3.7 billion.

As of July 27, 2012, our Board of Directors had authorized the repurchase of up to \$4.0 billion of our common stock under our stock repurchase program. As of July 27, 2012, the remaining authorized amount for stock repurchases under this program was \$0.3 billion with no termination date. The stock repurchase program may be suspended or discontinued at any time.

**11. Derivatives and Hedging Activities**

We use derivative instruments to manage exposures to foreign currency risk. The maximum length of time over which forecasted foreign currency denominated revenues are hedged is six months. The notional value of our outstanding foreign currency forward purchase contracts that were entered into to hedge forecasted foreign denominated sales and our foreign currency denominated monetary asset and liability exposures consisted of the following (in millions):

	July 27, 2012	April 27, 2012
<b>Cash Flow Hedges</b>		
Euro	\$ 103.5	\$ 96.9
British Pound Sterling	29.3	29.8
<b>Balance Sheet Contracts</b>		
Euro	188.0	267.4
British Pound Sterling	55.4	86.4
Australian Dollar	73.9	38.5
Canadian Dollar	20.7	54.3
Israeli Shekel	23.2	17.2
Other	59.2	51.3

The fair value of our short-term foreign currency contracts was not material as of July 27, 2012 and April 27, 2012. We did not recognize any gains and losses in earnings due to hedge ineffectiveness for any period presented.

The effect of derivative instruments designated as cash flow hedges recognized in net revenues on our condensed consolidated statements of operations was as follows (in millions):

	Three Months Ended July 27, 2012		Three Months Ended July 29, 2011	
	Gain Recognized in AOCI	Gain Reclassified from AOCI into Income	Gain Recognized in AOCI	Gain Reclassified from AOCI into Income
<b>Derivatives in Cash Flow Hedging Relationships</b>				
Foreign exchange forward purchase contracts	\$ 6.4	\$ 4.5	\$ 4.4	\$ 1.8

The effect of derivative instruments not designated as hedges recognized in other expense, net on our condensed consolidated statements of operations was as follows (in millions):

Three Months Ended

Edgar Filing: NetApp, Inc. - Form 10-Q

<b>Derivatives Not Designated as Hedging Instruments</b>	<b>July 27, 2012</b>	<b>July 29, 2011</b>
	<b>Gain Recognized into Income</b>	
Foreign exchange forward contracts	\$ 15.9	\$ 6.0

**12. Income Taxes**

Our effective tax rates for the periods presented were as follows:

	<b>Three Months Ended</b>	
	<b>July 27, 2012</b>	<b>July 29, 2011</b>
Effective tax rates	14.0%	16.5%



**Table of Contents**

Our effective tax rates reflect the impact of a significant amount of our earnings being taxed in foreign jurisdictions at rates below the U.S. statutory tax rate. As of July 27, 2012, we had \$162.8 million of unrecognized tax benefits, of which \$107.5 million has been recorded in other long-term liabilities and \$96.0 million, including penalties and interest, would affect our provision for income taxes if recognized.

On March 26, 2012, we received a Revenue Agent's Report from the IRS for our fiscal 2005 through 2007 tax returns. On April 25, 2012, we filed a protest related to transfer pricing matters comparable to similar matters that were resolved in our favor in our last audit cycle. In February 2012, the IRS commenced an examination of our fiscal 2008 through fiscal 2010 income tax returns. We are also under audit by the California Franchise Tax Board for our fiscal 2007 and 2008 California income tax returns. Our open years in U.S. federal jurisdictions are fiscal 2005 and later years. In addition, we are effectively subject to federal tax examination adjustments for tax years ended on or after fiscal year 2000, in that we have tax attribute carryforwards from these years that could be subject to adjustments, if and when utilized.

On September 17, 2010, the Danish Tax Authorities issued a decision concluding that distributions declared in 2005 and 2006 from our Danish subsidiary were subject to Danish at-source dividend withholding tax. We do not believe that our Danish subsidiary is liable for withholding tax and filed an appeal with the Danish Tax Tribunal to that effect. On December 19, 2011, the Danish Tax Tribunal issued a ruling that our Danish subsidiary was not liable for Danish withholding tax. The Danish tax examination agency appealed to the Danish High Court in March 2012.

We are in various stages of the examination and appeals process in connection with tax audits worldwide and it is difficult to determine when these examinations will be settled. It is reasonably possible that over the next twelve-month period, we may experience an increase or decrease in unrecognized tax benefits. It is not possible to determine either the magnitude or the range of any increase or decrease at this time.

In April 2010 our Dutch subsidiary received a favorable tax ruling from the Dutch tax authorities effective May 1, 2010 that replaces the previous Dutch tax ruling that expired on April 30, 2010. This ruling results in both a lower level of earnings subject to tax in the Netherlands and an extension of the expiration date to April 30, 2015.

**13. Net Income per Share**

The following is a calculation of basic and diluted net income per share (in millions):

	<b>Three Months Ended</b>	
	<b>July 27, 2012</b>	<b>July 29, 2011</b>
<b>Numerator:</b>		
Net income	\$ 63.8	\$ 139.5
<b>Denominator:</b>		
Shares used in basic computation	366.1	370.3
Dilutive potential shares related to employee equity award plans	4.9	11.8
Dilutive impact of assumed conversion of Notes	0.2	15.4
Dilutive impact of warrants	0.0	8.0
Shares used in diluted computation	371.2	405.5
<b>Net Income per Share:</b>		
Basic	\$ 0.17	\$ 0.38
Diluted	\$ 0.17	\$ 0.34

The following potential weighted-average shares of common stock have been excluded from the diluted net income per share calculations, as their effect would have been anti-dilutive (in millions):

**Three Months Ended**

Edgar Filing: NetApp, Inc. - Form 10-Q

	July 27, 2012	July 29, 2011
Options and RSUs	17.7	3.6

Dilutive shares outstanding during the three months ended July 27, 2012 do not include any effect resulting from warrants, as their impact would have been anti-dilutive. The Note hedges are not included in the calculation of earnings per share for any period as their effect would have been anti-dilutive. The Note hedges, if exercised upon conversion of the Notes, are expected to reduce approximately 80% of the dilutive effect of the Notes when our stock price is above \$31.85 per share.

**Table of Contents****14. Segment, Geographic, and Significant Customer Information**

We operate in one reportable industry segment: the design, manufacturing, marketing, and technical support of high-performance networked storage solutions. We conduct business globally, and our sales and support activities are managed on a geographic basis. Our management reviews financial information presented on a consolidated basis, accompanied by disaggregated information it receives from its internal management system about revenues by geographic region, based on the location from which the customer relationship is managed, for purposes of allocating resources and evaluating financial performance. We do not allocate costs of revenues, research and development, sales and marketing, or general and administrative expenses to our geographic regions in this internal management system because management does not review operations or operating results, or make planning decisions, below the consolidated entity level.

Summarized revenues by geographic region from our internal management system and utilized by our Chief Executive Officer, who is considered our Chief Operating Decision Maker, is as follows (in millions):

	<b>Three Months Ended</b>	
	<b>July 27, 2012</b>	<b>July 29, 2011</b>
Americas (United States, Canada and Latin America)*	\$ 801.1	\$ 813.4
Europe, Middle East and Africa	439.3	456.7
Asia Pacific and Japan	204.2	188.1
Net revenues	\$ 1,444.6	\$ 1,458.2

\* Americas revenues consist of Americas commercial and U.S. public sector markets. Sales to customers inside the United States comprised \$711.4 million and \$689.3 million of Americas net revenues during the three months ended July 27, 2012 and July 29, 2011, respectively. The majority of our assets, excluding cash, cash equivalents, restricted cash, short-term investments and accounts receivable, were attributable to our domestic operations. The following table presents cash, cash equivalents and short-term investments held in the United States and internationally in various foreign subsidiaries (in millions):

	<b>July 27, 2012</b>	<b>April 27, 2012</b>
United States	\$ 2,568.4	\$ 2,697.6
International	2,872.7	2,763.8
Total	\$ 5,441.1	\$ 5,461.4

Property and equipment information is based on the physical location of the assets. The following table presents property and equipment information for geographic areas (in millions):

	<b>July 27, 2012</b>	<b>April 27, 2012</b>
United States	\$ 1,041.2	\$ 1,038.9
International	97.9	98.3
Total	\$ 1,139.1	\$ 1,137.2

No more than ten percent of property and equipment was located in any single foreign country.

## Edgar Filing: NetApp, Inc. - Form 10-Q

International sales to a single foreign country that accounted for ten percent or more of net revenues are as follows (in millions):

	<b>Three Months Ended</b>	
	<b>July 27, 2012</b>	<b>July 29, 2011</b>
Germany	\$ 146.7	\$ 147.8

The following customers, each of which is a distributor, accounted for ten percent or more of our net revenues (in millions):

	<b>Three Months Ended</b>	
	<b>July 27, 2012</b>	<b>July 29, 2011</b>
Arrow Electronics, Inc.	\$ 229.5	\$ 212.9
Avnet, Inc.	198.3	159.1

**Table of Contents**

The following customer accounted for ten percent or more of net accounts receivable (in millions):

	July 27, 2012	April 27, 2012
Avnet, Inc.	\$ 63.1	\$ 92.5

**15. Commitments and Contingencies*****Lease Commitments***

As of July 27, 2012, future annual minimum lease payments under all non-cancelable facilities and equipment operating leases with an initial term in excess of one year totaled \$325.7 million.

As of July 27, 2012, we have three leasing arrangements with BNP Paribas LLC (BNPPLC), one of which require us to lease certain of our land to BNPPLC for a period of 99 years and all of which require us to lease approximately 0.3 million square feet of office space from BNPPLC for our headquarters in Sunnyvale, California, which had an original cost of \$69.6 million. Under these leasing arrangements, we pay BNPPLC minimum lease payments, which vary based on a fixed rate on the costs of the facilities on the respective lease commencement dates. We make payments for each of the leases for a term of five years. We have the option to renew each of the leases for two consecutive five-year periods upon approval by BNPPLC. The initial lease terms expire in December 2012 and January 2013. Upon expiration (or upon any earlier termination) of the lease terms, we must elect one of the following options: (i) purchase the buildings from BNPPLC at cost; (ii) if certain conditions are met, arrange for the sale of the buildings by BNPPLC to a third-party, and be liable for any deficiency between the net proceeds received from the third-party and BNPPLC's cost, up to 85% of cost (residual guarantee); or (iii) pay BNPPLC supplemental payments for an amount equal to the difference between BNPPLC's cost and fair value, up to the residual guarantee, in which event we may recoup some or all of such payments by arranging for a sale of each or all buildings by BNPPLC during the ensuing two-year period.

These leases require us to maintain specified financial covenants with which we were in compliance as of July 27, 2012. Such financial covenants include a maximum ratio of Total Debt to Earnings before Interest, Taxes, Depreciation and Amortization of less than 3:1 and a minimum amount of Unencumbered Cash and Short-Term Investments of \$300.0 million.

***Purchase Orders and Other Commitments***

In the normal course of business we make commitments to our third-party contract manufacturers, to manage manufacturer lead times and meet product forecasts, and to other parties, to purchase various key components used in the manufacture of our products. We establish accruals for estimated losses on purchased components to the extent we believe it is probable that such components will not be utilized in future operations. To the extent that such forecasts are not achieved, our commitments and associated accruals may change. We had \$281.0 million in non-cancelable purchase commitments with our contract manufacturers as of July 27, 2012. In addition, we recorded a liability for firm, non-cancelable and unconditional purchase commitments with contract manufacturers for quantities in excess of our future demand forecasts through a charge to product cost of sales. As of July 27, 2012 and April 27, 2012, such liability amounted to \$7.2 million and \$3.3 million, respectively, and is included in other current liabilities in the condensed consolidated balance sheets.

In addition to commitments with contract manufacturers and component suppliers, we have open purchase orders and contractual obligations associated with our ordinary course business for which we have not received goods or services. As of July 27, 2012, we had \$50.3 million in capital purchase commitments and \$200.6 million in other purchase commitments.

***Product Warranties***

We provide customers a warranty on software of ninety days to five years and a warranty on hardware of one to five years. The following table summarizes our warranty reserves (in millions):

Three Months Ended	
July 27, 2012	July 29, 2011

Edgar Filing: NetApp, Inc. - Form 10-Q

Beginning balance	\$ 83.1	\$ 40.5
Liability assumed in acquisition	0.0	17.5
Expense accrued during the period	23.7	11.7
Warranty costs incurred	(10.3)	(10.2)
Ending balance	\$ 96.5	\$ 59.5

**Table of Contents*****Financing Guarantees***

Some of our customers have entered into recourse and nonrecourse financing leasing arrangements using third-party financing companies. Under the terms of recourse leases, which are generally three years or less, we remain liable for the aggregate unpaid remaining lease payments to the third-party leasing companies in the event of end-user customer default. These arrangements are generally collateralized by a security interest in the underlying assets. Under the terms of the nonrecourse leases, we do not have any continuing obligations or liabilities to the third-party financing companies. Where we provide a guarantee for recourse leases, we defer revenues subject to the industry-specific software revenue recognition guidance, and recognize revenues for non-software deliverables in accordance with our multiple deliverable revenue arrangement policy.

The aggregate amount of financing guarantees representing the total maximum potential future payments under financing arrangements with third parties, and the related deferred revenue are summarized as follows (in millions):

	July 27, 2012	April 27, 2012
Maximum guaranteed payment contingencies	\$ 161.4	\$ 169.0
Deferred revenue associated with financing guarantees	(151.3)	(149.9)
Maximum potential future payments relating to financing guarantees, net of associated deferred revenue	\$ 10.1	\$ 19.1

To date, we have not experienced material losses under our lease financing programs or other financing arrangements.

***Legal Contingencies***

When a loss is considered probable and reasonably estimable, we record a liability in the amount of our best estimate for the ultimate loss. However, the likelihood of a loss with respect to a particular contingency is often difficult to predict and determining a meaningful estimate of the loss or a range of loss may not be practicable based on the information available and the potential effect of future events and decisions by third parties that will determine the ultimate resolution of the contingency.

We are subject to various legal proceedings and claims that arise in the normal course of business. No material accrual has been recorded as of July 27, 2012 related to such matters.

**Table of Contents**

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

**Forward-Looking Statements**

This Quarterly Report on Form 10-Q contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended (the Exchange Act), and is subject to the safe harbor provisions set forth in the Exchange Act. Forward-looking statements usually contain the words estimate, intend, plan, predict, seek, may, will, would, could, anticipate, expect, believe, or similar expressions and variations or negatives of these words or expressions. In addition, statements that refer to expectations, projections, or other characterizations of future events or circumstances, including any underlying assumptions, are forward-looking statements. All forward-looking statements, including but not limited to, statements about:

our future financial and operating results;

our business strategies;

management's plans, beliefs and objectives for future operations, research and development;

economic and industry trends or trend analysis;

product introductions, development, enhancements and acceptance;

acquisitions and joint ventures, growth opportunities, investments and legal proceedings;

competitive positions;

future cash flows and cash deployment strategies;

short-term and long-term cash requirements, including anticipated capital expenditures;

our anticipated tax rate;

the dilutive effect of our 1.75% Convertible Senior Notes due June 2013 (the Notes) and associated warrants on our earnings per share;

the conversion, maturation or repurchase of the Notes;

compliance with laws, regulations and debt covenants; and



## Edgar Filing: NetApp, Inc. - Form 10-Q

the continuation of our stock repurchase program are inherently uncertain as they are based on management's current expectations and assumptions concerning future events, and are subject to numerous known and unknown risks and uncertainties. Therefore, our actual results may differ materially from the forward-looking statements contained herein. Factors that could cause actual results to differ materially from those described herein include, but are not limited to:

acceptance of, and demand for, our products, including our recent product introductions;

our ability to increase our customer base, market share and revenue;

general economic and market conditions, particularly the continuing fiscal challenges in the United States and the Eurozone;

the amount of orders received in future periods;

our ability to ship our products in a timely manner;

our ability to achieve anticipated pricing, cost, and gross margins levels;

**Table of Contents**

- our ability to successfully manage our backlog and increase revenue;
- our ability to successfully execute on our strategies;
- our ability to effectively integrate acquired products and technologies;
- our ability to successfully introduce new products and forecast demand for those products;
- our ability to maintain the quality of our hardware, software and services offerings;
- our ability to adapt to changes in market demand;
- demand for our services and support and the growth of the storage markets generally;
- our ability to identify and respond to significant market trends and emerging standards;
- the impact of industry consolidation;
- our ability to successfully manage our investment in people, process, and systems;
- our ability to maintain our partner, supplier and contract manufacturer relationships;
- the ability of our suppliers and contract manufacturers to meet our requirements;
- the ability of our competitors to introduce new products that compete successfully with our products;
- our ability to grow direct and indirect sales and to efficiently utilize global service and support;
- variability in our gross margins;
- our ability to sustain and/or improve our cash and overall financial position;
- our cash requirements and terms and availability of financing;

valuation and liquidity of our investment portfolio;

our ability to finance business acquisitions, construction projects and capital expenditures through cash from operations and/or financing;

the results of our ongoing litigation, tax audits, government audits, inquiries and investigations; and

those factors discussed under the heading **Risk Factors** elsewhere in this Quarterly Report on Form 10-Q.

Readers are cautioned not to place undue reliance on these forward-looking statements, which speak only as of the date hereof and are based upon information available to us at this time. These statements are not guarantees of future performance. We disclaim any obligation to update information in any forward-looking statement. Actual results could vary from our forward-looking statements due to foregoing factors as well as other important factors, including those described in the Risk Factors included in Part II Item 1A.

**Critical Accounting Estimates and Policies**

Our discussion and analysis of financial condition and results of operations are based upon our condensed consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America. The preparation of such statements requires us to make estimates and assumptions that affect the reported amounts of revenues and expenses during the reporting periods and the reported amounts of assets, liabilities and equity as of the date of the financial statements. Our estimates are based on historical experience and other assumptions that we consider to be appropriate under the circumstances. However, future results may vary from our estimates.

**Table of Contents**

We believe the accounting policies discussed under Item 7, Management's Discussion and Analysis of Financial Condition and Results of Operations in our Annual Report on Form 10-K for the fiscal year ended April 27, 2012 are significantly affected by critical accounting estimates and that they are both highly important to the portrayal of our financial condition and results of operations and require difficult management judgments and assumptions about matters that are inherently uncertain. There have been no material changes to the critical accounting policies and estimates as filed in such report.

**New Accounting Standards**

See Note 3 of the accompanying condensed consolidated financial statements for a full description of new accounting pronouncements, including the respective expected dates of adoption and effects on results of operations and financial condition.

**Results of Operations**

The following table sets forth certain Condensed Consolidated Statements of Operations data as a percentage of net revenues for the periods indicated:

	<b>Three Months Ended</b>	
	<b>July 27, 2012</b>	<b>July 29, 2011</b>
<b>Revenues:</b>		
Product	62.2%	66.2%
Software entitlements and maintenance	15.1	13.6
Service	22.7	20.2
Net revenues	100.0	100.0
<b>Cost of revenues:</b>		
Cost of product	31.3	30.0
Cost of software entitlements and maintenance	0.5	0.4
Cost of service	9.4	8.1
<b>Gross profit</b>	<b>58.8</b>	<b>61.5</b>
<b>Operating expenses:</b>		
Sales and marketing	33.4	31.2
Research and development	15.3	13.6
General and administrative	4.5	4.4
Acquisition-related expense		0.2
Total operating expenses	53.2	49.4
<b>Income from operations</b>	<b>5.6</b>	<b>12.1</b>
<b>Other expense, net</b>	<b>(0.5)</b>	<b>(0.6)</b>
<b>Income before income taxes</b>	<b>5.1</b>	<b>11.5</b>
Provision for income taxes	0.7	1.9
<b>Net income</b>	<b>4.4%</b>	<b>9.6%</b>

**Discussion and Analysis of Results of Operations***Overview*

## Edgar Filing: NetApp, Inc. - Form 10-Q

Net revenues for the three months ended July 27, 2012 were \$1,444.6 million, down \$13.6 million, or 1%, compared to the prior year. The decrease in revenues was due to a decrease in product revenues, primarily due to changes in product and customer mix and unfavorable foreign currency rates, partially offset by higher volume. The product revenue decrease was partially offset by increases in hardware maintenance contract and software entitlements and maintenance (SEM) revenues.

Gross margin percentage decreased during the three months ended July 27, 2012 compared to the prior year, primarily due to changes in mix and a higher percentage of product sales derived from Original Equipment Manufacturer (OEM) revenues. In addition, gross margin was negatively impacted by unfavorable exchange rates.

Sales and marketing, research and development, and general and administrative expenses for the three months ended July 27, 2012 totaled \$769.9 million, up 7%, compared to the prior year. This increase was primarily due to a 13% increase in the average headcount during the three months ended July 27, 2012, compared to the prior year, partially offset by lower compensation cost per headcount. In addition, exchange rates had a favorable impact on expenses.

***Net Revenues (in millions, except percentages):***

	Three Months Ended		
	July 27, 2012	July 29, 2011	% Change
Net revenues	\$ 1,444.6	\$ 1,458.2	(1)%

**Table of Contents**

Net revenues decreased by \$13.6 million, or 1%, for the three months ended July 27, 2012, compared to the prior year. The decrease in our net revenues was due to a decrease in product revenues, which comprised 62% of net revenues for the three months ended July 27, 2012, compared to 66% for the three months ended July 29, 2011, partially offset by increases in both SEM and service revenues.

Sales through our indirect channels represented 78% and 76% of net revenues for the three months ended July 27, 2012 and July 29, 2011, respectively. Included in indirect channel sales during the three months ended July 27, 2012 and July 29, 2011 is \$208.9 million and \$213.4 million of OEM revenue, respectively.

The following customers, each of which is a distributor, accounted for 10% or more of net revenues (in millions, except percentages):

	Three Months Ended		% of Net Revenues
	July 27, 2012	July 29, 2011	
Arrow Electronics, Inc.	\$ 229.5	\$ 212.9	15%
Avnet, Inc.	\$ 198.3	\$ 159.1	11%

**Product Revenues (in millions, except percentages):**

	Three Months Ended		% Change
	July 27, 2012	July 29, 2011	
Product revenues	\$ 898.0	\$ 965.7	(7)%

Product revenues decreased by \$67.7 million, or 7%, for the three months ended July 27, 2012 compared to the prior year. Product revenues consist of configured systems, which include bundled hardware and software products, and non-configured products, which consist primarily of add-on storage, OEM products and add-on hardware and software products.

Total configured system revenues of \$462.2 million decreased by \$47.9 million, or 9%, during the three months ended July 27, 2012, compared to the prior year, primarily due to a decrease in the 3000 series systems, partially offset by an increase in the 2000 series systems. Configured systems unit volume increased by 10% during the three months ended July 27, 2012, compared to the same period in the prior year. Unit volume of the 2000 series increased and unit volume of the 3000 series systems decreased, reflecting a shift in customer demand from certain 3000 series systems to the recently introduced 2000 series systems. The average selling prices (ASPs) of total configured systems decreased during the three months ended July 27, 2012, compared to the prior year, due to a shift in sales from higher priced 3000 series systems to lower priced 2000 series systems, as well as product mix within the various series and customer mix. In addition, ASPs decreased due to unfavorable foreign currency rates.

Non-configured product revenues of \$435.8 million decreased \$19.8 million, or 4%, during the three months ended July 27, 2012, compared to the prior year. This decrease was primarily due to lower revenue from add-on storage. In addition, our revenues from OEM products declined 2% during the period. Non-configured product revenues were unfavorably impacted by product and customer mix.

Our systems are highly configurable to respond to customer requirements in the open systems storage markets that we serve. This can cause a wide variation in product configurations that can significantly impact revenues, cost of revenues and gross profit performance. Pricing changes, discounting practices, product competition, foreign currency, unit volumes, customer mix, natural disasters and product material costs can also impact revenues, cost of revenues and/or gross profit performance. Disks are a significant component of our storage systems. Industry disk pricing has fallen every year; however, when supplies are constrained, disk prices may increase. To the extent that disk prices increase or decrease, we intend to pass along those price increases or decreases to our customers while working to maintain relatively constant profit margins on our disk drives. As our sales price per terabyte continues to decline, improved system performance, increased capacity and software to manage this increased capacity have an offsetting impact on product revenues.

**Software Entitlements and Maintenance Revenues (in millions, except percentages):**

Edgar Filing: NetApp, Inc. - Form 10-Q

	Three Months Ended		
	July 27, 2012	July 29, 2011	% Change
Software entitlements and maintenance revenues	\$ 218.5	\$ 198.2	10%

**Table of Contents**

SEM revenues increased by \$20.3 million, or 10%, during the three months ended July 27, 2012 compared to the prior year. This increase was due to an increase in the aggregate contract value of the installed base under SEM contracts, which is recognized as revenue ratably over the terms of the underlying contracts.

**Service Revenues (in millions, except percentages):**

	Three Months Ended		
	July 27, 2012	July 29, 2011	% Change
Service revenues	\$ 328.1	\$ 294.3	11%

Service revenues include hardware maintenance, professional services and educational and training services. Service revenues increased by \$33.8 million, or 11%, during the three months ended July 27, 2012 compared to the prior year.

Hardware maintenance contract revenues constituted approximately 71% and 70% of our service revenues for the three months ended July 27, 2012 and July 29, 2011, respectively. Such revenues increased \$29.6 million, or 14%, during the three months ended July 27, 2012 compared to the prior year, as a result of an increase in the installed base under service contracts. Professional services and educational and training services constituted approximately 29% and 30% of our service revenues for the three months ended July 27, 2012 and July 29, 2011, respectively.

**Revenues by Geographic Area (in millions, except percentages):**

	Three Months Ended		
	July 27, 2012	July 29, 2011	% Change
Americas (United States, Canada and Latin America)	\$ 801.1	\$ 813.4	(2)%
Europe, Middle East and Africa (EMEA)	439.3	456.7	(4)%
Asia Pacific and Japan (APAC)	204.2	188.1	9%
Net revenues	\$ 1,444.6	\$ 1,458.2	

Americas revenues consist of Americas commercial and U.S. public sector markets.

Sales to customers inside the United States comprised 89% and 85% of America's net revenues during the three months ended July 27, 2012 and July 29, 2011, respectively. EMEA revenues were negatively impacted by the general macroeconomic conditions in the region, as well as unfavorable foreign currency rates. Sales to Germany accounted for 10% of net revenues during each of the three months ended July 27, 2012 and July 29, 2011. No other single foreign country accounted for 10% or more of net revenues in any of the periods presented.

**Cost of Revenues**

Our cost of revenues consists of three elements: (1) cost of product revenues, which includes the costs of manufacturing and shipping of our storage products, amortization of purchased intangible assets, inventory write-downs, and warranty costs; (2) cost of SEM, which includes the costs of providing SEM and third-party royalty costs and (3) cost of service revenues, which reflects costs associated with providing support activities for hardware, global support partnership programs, professional services and educational and training services.

Our gross profit is impacted by a variety of factors, including pricing changes, discounting practices, foreign currency, product configuration, unit volumes, customer mix, revenue mix, natural disasters and product material costs. Service gross profit is typically impacted by factors such as changes in the size of our installed base of products, as well as the timing of support service initiations and renewals, and incremental investments in our customer support infrastructure. If any of these factors that impact our gross profit are adversely affected, whether by economic uncertainties or for other reasons, our gross profit could decline.





**Table of Contents****Cost of Product Revenues (in millions, except percentages):**

	Three Months Ended		
	July 27, 2012	July 29, 2011	% Change
Cost of product revenues	\$ 452.2	\$ 437.4	3%

Cost of product revenues increased by \$14.8 million, or 3%, during the three months ended July 27, 2012, compared to the prior year. The changes were comprised of the following elements (in percentage points of the total change):

	Three Months Ended Fiscal 2013 to Fiscal 2012	
	Percentage Change Points	
Materials cost		
Warranty		3
Excess and obsolete inventory		2
Other		(2)
<b>Total change</b>		<b>3</b>

Material costs represent 81% and 83% of product costs for the three months ended July 27, 2012 and July 29, 2011, respectively, and increased only \$1.5 million from the prior period primarily due to a 10% unit volume increase in configured systems that was offset by unit material cost reductions reflecting a change in mix towards lower cost 2000 series systems and OEM products. Other product costs of sales included a \$12.1 million increase in hardware related warranty expense and a \$7.0 million increase in inventory write-downs.

Cost of product revenues represented 50% of product revenue for the three months ended July 27, 2012 compared to 45% in the prior year.

**Cost of Software Entitlements and Maintenance Revenues (in millions, except percentages):**

	Three Months Ended		
	July 27, 2012	July 29, 2011	% Change
Cost of software entitlements and maintenance revenues	\$ 6.6	\$ 5.3	25%

Cost of SEM revenues increased by \$1.3 million, or 25%, during the three months ended July 27, 2012 compared to the prior year, primarily due to an increase in volume-related software support costs. Cost of SEM revenues represented 3% of SEM revenues for each of the three months ended July 27, 2012 and July 29, 2011.

**Cost of Service Revenues (in millions, except percentages):**

	Three Months Ended		
	July 27, 2012	July 29, 2011	% Change
Cost of service revenues	\$ 135.7	\$ 118.6	14%

Cost of service revenues increased by \$17.1 million, or 14%, during the three months ended July 27, 2012 compared to the prior year primarily due to an increase in service delivery and logistics costs. Costs represented 41% and 40% of service revenues for the three months ended July 27, 2012 and July 29, 2011, respectively.

***Operating Expenses***

*Sales and Marketing, Research and Development, and General and Administrative Expenses*

Compensation costs comprise the largest component of operating expenses. Included in compensation costs are salaries, benefits, other compensation-related costs, stock-based compensation costs and employee incentive compensation plan costs. Compensation costs included in operating expenses increased approximately \$39.7 million, or 10%, for the three months ended July 27, 2012 compared to the prior year, primarily due to:

- (i) an increase in salaries, benefits and other compensation-related costs of \$13.7 million due to an increase in average headcount;

**Table of Contents**

(ii) an increase in stock-based compensation of \$18.6 million, which includes \$12.8 million of expense related to the reset of the employee stock purchase plan (ESPP) offering triggered by the decline in our stock price below the grant date prices of the offerings that vested in May 2012;

(iii) an increase in incentive compensation expense of \$7.4 million reflecting increased headcount and stronger operating performance.

*Sales and Marketing Expenses (in millions, except percentages):*

	Three Months Ended		
	July 27, 2012	July 29, 2011	% Change
Sales and marketing expenses	\$ 482.9	\$ 454.8	6%

Sales and marketing expense consists primarily of compensation costs, commissions, outside services, allocated facilities and IT costs, advertising and marketing promotional expense and travel and entertainment expense. Sales and marketing expenses increased due to the following:

	Three Months Ended Fiscal 2013 to Fiscal 2012	
	Percentage Change Points	
Salaries	2	
Incentive plan compensation	1	
Stock-based compensation	2	
Other compensation and benefit costs		
Total compensation costs	5	
Outside services	(1)	
Amortization	(1)	
Facilities and IT support costs	2	
Advertising and marketing promotional expense	1	
Total change	6	

The increase in total compensation costs during the three months ended July 27, 2012 reflects a 12% increase in average sales and marketing headcount compared to the prior year and higher stock-based compensation expense. The increase in facilities and IT support costs during the three months ended July 27, 2012 reflects our investment in sales systems and infrastructure.

*Research and Development Expense (in millions, except percentages):*

	Three Months Ended		
	July 27, 2012	July 29, 2011	% Change
Research and development expenses	\$ 221.4	\$ 198.6	11%

Research and development expense consists primarily of compensation costs, allocated facilities and IT costs, depreciation and amortization, equipment and software-related costs, prototypes, non-recurring engineering charges and other outside services costs. Research and development expense increased due to the following:

	Three Months Ended Fiscal 2013 to Fiscal 2012 Percentage Change Points
Salaries	2
Incentive plan compensation	2
Stock-based compensation	4
Other compensation and benefit costs	(1)
<b>Total compensation costs</b>	<b>7</b>
Depreciation and amortization	2
Development projects	3
Other	(1)
<b>Total change</b>	<b>11</b>

**Table of Contents**

The increase in total compensation costs during the three months ended July 27, 2012 reflects a 15% increase in average engineering headcount compared to the prior year and higher stock-based compensation expense. Depreciation and amortization increased due to higher levels of investment in engineering equipment. The increase in development project expense reflects increased spending on materials and services associated with engineering activities to develop new product lines and enhancements to existing products.

We believe that our future performance will depend in large part on our ability to maintain and enhance our current product line, develop new products that achieve market acceptance, maintain technological competitiveness and meet an expanding range of customer requirements. We expect to continue to spend on current and future product development efforts, broaden our existing product offerings and introduce new products that expand our solutions portfolio.

*General and Administrative Expense (in millions, except percentages):*

	Three Months Ended		
	July 27, 2012	July 29, 2011	% Change
General and administrative expense	\$ 65.6	\$ 65.1	1%

General and administrative expense consists primarily of compensation costs, professional and corporate legal fees, outside services and allocated facilities and IT support costs. General and administrative expense increased due to the following:

	Three Months Ended Fiscal 2013 to Fiscal 2012	
	Percentage Change Points	
Salaries		1
Incentive plan compensation		2
Stock-based compensation		1
Other compensation and benefit costs		1
Total compensation costs		5
Outside services		(5)
Professional and corporate legal fees		1
Total change		1

The increase in total compensation costs during the three months ended July 27, 2012 reflects a 9% increase in average general and administrative headcount compared to the prior year and higher stock-based compensation expense. The decrease in outside services during the three months ended July 27, 2012 reflects lower spending on contractors and costs associated with Engenio integration activities that were completed in fiscal 2012 and various operational projects.

*Acquisition-related Expense (in millions, except percentages):*

	Three Months Ended		
	July 27, 2012	July 29, 2011	% Change
Acquisition-related expense	\$	\$ 2.2	(100)%

During the three months ended July 29, 2011, we incurred due diligence and legal costs of \$0.7 million and other integration charges of \$1.5 million associated with our acquisition of Engenio.

*Other Expense, Net*

Edgar Filing: NetApp, Inc. - Form 10-Q

*Interest Income (in millions, except percentages):*

	Three Months Ended		
	July 27, 2012	July 29, 2011	% Change
Interest income	\$ 10.8	\$ 10.6	2%

The increase in interest income during the three months ended July 27, 2012, compared to the prior year, was primarily due to an increase in the investment portfolio.

**Table of Contents**

*Interest Expense (in millions, except percentages):*

	Three Months Ended		
	July 27, 2012	July 29, 2011	% Change
Interest expense	\$ (19.9)	\$ (19.4)	3%

Interest expense was relatively flat for the three months ended July 27, 2012 compared to the prior year.

During the three months ended July 27, 2012 and July 29, 2011, we recognized non-cash interest expense from the amortization of debt discount and issuance costs related to our Notes, net of capitalized interest, of \$14.3 million and \$13.7 million, respectively. The coupon interest expense related to our Notes, net of capitalized interest, was \$5.4 million and \$5.5 million during the three months ended July 27, 2012 and July 29, 2011, respectively.

*Other Income (Expense), Net (in millions, except percentages):*

	Three Months Ended		
	July 27, 2012	July 29, 2011	% Change
Other income (expense), net	\$ 3.1	\$ (0.3)	NM

NM - Not Meaningful

Other income (expense), net, increased \$3.4 million primarily due to \$3.1 million of net foreign exchange gains.

*Provision for Income Taxes (in millions, except percentages):*

	Three Months Ended		
	July 27, 2012	July 29, 2011	% Change
Provision for income taxes	\$ 10.4	\$ 27.6	(62)%

Our effective tax rate for the three months ended July 27, 2012 was 14.0% compared to an effective tax rate of 16.5% for the three months ended July 29, 2011. Our effective tax rates for the three months ended July 27, 2012 and July 29, 2011 differ from the U.S. statutory rate of 35% because our foreign earnings are taxed at rates lower than the U.S. statutory rate. Our provision for income taxes and our effective tax rate decreased for the three months ended July 27, 2012 compared to the three months ended July 29, 2011 as a result of lower pre-tax income, primarily in the U.S.

As of July 27, 2012, we had \$162.8 million of unrecognized tax benefits, of which \$107.5 million has been recorded in other long-term liabilities and of which \$96.0 million, including penalties and interest, would affect our provision for income taxes if recognized.

**Liquidity and Capital Resources**

The following sections discuss our principal liquidity requirements, as well as our sources and uses of cash flows on our liquidity and capital resources. The principal objectives of our investment policy are the preservation of principal and maintenance of liquidity. We attempt to mitigate default risk by investing in high-quality investment grade securities, limiting the time to maturity and monitoring the counter-parties and underlying obligors closely. We believe our cash equivalents and short-term investments are liquid and accessible. We are not aware of any significant deterioration in the fair value of our cash equivalents or investments from the values reported as of July 27, 2012.



*Liquidity Sources and Cash Requirements*

Our principal sources of liquidity as of July 27, 2012 consisted of approximately \$5.4 billion in cash, cash equivalents and short-term investments, as well as cash we expect to generate from operations.

Cash, cash equivalents and short-term investments consist of the following (in millions):

	<b>July 27, 2012</b>	<b>April 27, 2012</b>
Cash and cash equivalents	\$ 1,529.4	\$ 1,549.8
Short-term investments	3,911.7	3,848.7
<b>Total</b>	<b>\$ 5,441.1</b>	<b>\$ 5,398.5</b>

**Table of Contents**

As of July 27, 2012, \$2.5 billion of cash, cash equivalents and short-term investments were held in the United States, while \$2.9 billion were held in foreign countries. Most of the amounts held outside the United States can be repatriated to the United States but, under current law, would be subject to U.S. federal and state income taxes. If we were to repatriate foreign earnings for cash requirements in the United States, we would incur U.S. federal and state income taxes reduced by the current amount of our U.S. federal and state net operating loss and tax credit carry forwards. However, our intent is to keep these funds permanently reinvested outside of the U.S., and our current plans do not contemplate a need to repatriate them to fund our U.S. operations. Our principal liquidity requirements are primarily to meet our working capital needs, support ongoing business activities, fund research and development, meet capital expenditure needs, invest in critical or complementary technologies, and service interest and principal payments on our debt. Our contractual obligations as of July 27, 2012 are summarized below in the Contractual Obligations table.

Key factors that could affect our cash flows include changes in our revenue mix and profitability, our ability to effectively manage our working capital, in particular, accounts receivable and inventories, our ability to effectively integrate acquired products, businesses and technologies and conversions of our Notes by holders. Based on our current business outlook, we believe that our sources of cash will satisfy our working capital needs, capital expenditures, investment requirements, stock repurchases, contractual obligations, commitments, principal and interest payments on our Notes and other liquidity requirements associated with operations and meet our cash requirements for at least the next 12 months. However, in the event our liquidity is insufficient, we may be required to curtail spending and implement additional cost saving measures and restructuring actions. We cannot be certain that we will continue to generate cash flows at or above current levels or that we will be able to obtain additional financing, if necessary, on satisfactory terms, if at all.

Our investment portfolio, including auction rate securities, has been and will continue to be exposed to market risk due to trends in the credit and capital markets. We continue to closely monitor current economic and market events to minimize our market risk on our investment portfolio. Based on our ability to access our cash and short-term investments, our expected operating cash flows, and our other potential sources of cash, we do not anticipate that the lack of liquidity of these investments will impact our ability to fund working capital needs, capital expenditures, acquisitions, debt obligations or other cash requirements. We intend to and believe that we have the ability to hold these investments until the market recovers. If current market conditions deteriorate, we may be required to record additional charges to earnings in future periods. We routinely monitor our financial exposure to both sovereign and non-sovereign borrowers and counterparties. Our gross exposures to our investments in Greece, Italy, Portugal, and Spain are individually and collectively not material.

***Debt Conversion and Redemption Requirements***

Our Notes, which have a principal amount of \$1.265 billion, become unconditionally convertible at the option of the holders of the Notes on March 1, 2013 and mature on June 1, 2013 unless earlier repurchased or converted (see Note 9 of the accompanying condensed consolidated financial statements). Our common stock price did not exceed the conversion threshold for the Notes for at least 20 trading days during the 30 consecutive trading days ended June 30, 2012, and accordingly, as of July 27, 2012 the Notes were not convertible at the option of the holder. Upon conversion of our Notes, we will deliver cash up to the principal amount of the Notes and, with respect to any excess conversion value greater than the principal amount of the Notes, shares of our common stock.

***Capital Expenditure Requirements***

We expect to fund our capital expenditures, including our commitments related to facilities, equipment, operating leases and internal-use software development projects over the next few years through existing cash, cash equivalents, investments and cash generated from operations. The timing and amount of our capital requirements cannot be precisely determined and will depend on a number of factors, including future demand for products, changes in the network storage industry, hiring plans and our decisions related to the financing of our facilities and equipment requirements. We expect that our existing facilities and those being developed in Sunnyvale, California; Research Triangle Park, North Carolina; India and other locations worldwide are adequate for our requirements over at least the next two years and that additional space will be available as needed. Our capital expenditures were \$61.9 million during the three months ended July 27, 2012. We anticipate capital expenditures for the remainder of fiscal 2013 to be between \$200.0 million and \$250.0 million, including \$69.6 million for the anticipated buyout of our properties subject to synthetic leases.

**Table of Contents****Share Repurchase**

As of July 27, 2012, our Board of Directors had authorized the repurchase of up to \$4.0 billion of our common stock under our stock repurchase program. As of July 27, 2012, the remaining authorized amount for stock repurchases under our stock repurchase program was \$0.3 billion with no termination date. The stock repurchase program may be suspended or discontinued at any time.

**Cash Flows**

As of July 27, 2012, our cash, cash equivalents and short-term and long-term investments increased by \$37.9 million from April 27, 2012, to \$5.5 billion. The increase was primarily a result of \$229.2 million of cash provided by operating activities and \$35.0 million from issuances of common stock under employee equity award plans, partially offset by \$150.0 million in cash paid for the repurchase of common stock and \$61.9 million in capital expenditures. We derive our liquidity and capital resources primarily from our operating cash flows and from working capital. Accounts receivable days sales outstanding as of July 27, 2012 decreased to 37 days, compared to 44 days as of April 27, 2012, primarily due to improvements in shipment linearity and faster collections. Working capital decreased by \$25.8 million to \$3.3 billion as of July 27, 2012, primarily due to a decrease in accounts receivable, partially offset by a decrease in accrued compensation and related benefits.

**Cash Flows from Operating Activities**

During the three months ended July 27, 2012, we generated cash from operating activities of \$229.2 million. The primary sources of cash from operating activities during the three months ended July 27, 2012 consisted of net income of \$63.8 million, adjusted by depreciation and amortization of \$82.4 million and stock-based compensation of \$79.2 million. Significant changes in assets and liabilities impacting operating cash flows included a decrease in accounts receivable of \$244.2 million and a decrease in accrued compensation and related benefits of \$123.1 million primarily attributable to employee payouts related to the fiscal year 2012 commissions and incentive compensation plans.

We expect that cash provided by operating activities may fluctuate in future periods as a result of a number of factors, including fluctuations in our operating results, shipment linearity, accounts receivable collections performance, inventory and supply chain management, tax benefits or charges from stock-based compensation, and the timing and amount of compensation and other payments.

**Cash Flows from Investing Activities**

During the three months ended July 27, 2012, we purchased \$66.1 million of investments, net of redemptions, and paid \$61.9 million for capital expenditures.

**Cash Flows from Financing Activities**

During the three months ended July 27, 2012, we used \$112.1 million in financing activities, which consisted of \$150.0 million for the repurchase of 4.9 million shares of common stock at an average price of \$30.31 per share and we generated \$35.0 million from the issuance of common stock under our employee equity award programs.

**Contractual Obligations**

The following table summarizes our contractual obligations as of July 27, 2012 and the effect such obligations are expected to have on our liquidity and cash flows in future periods (in millions):

	Remainder of						
	2013	2014	2015	2016	2017	Thereafter	Total
<b>Off-balance sheet commitments:</b>							
Office operating lease payments	\$ 26.5	\$ 40.0	\$ 39.9	\$ 34.4	\$ 19.7	\$ 53.8	\$ 214.3
Real estate lease payments <sup>(1)</sup>	60.2						60.2
Less: sublease income	(1.6)	(1.5)	(1.4)	(1.0)			(5.5)
Equipment operating lease payments	19.0	18.6	9.3	3.7	0.6		51.2
Purchase commitments with contract manufacturers <sup>(2)</sup>	279.6	1.2	0.2				281.0

Edgar Filing: NetApp, Inc. - Form 10-Q

Capital expenditures	26.4	1.0	19.0	3.9			50.3
Other purchase obligations <sup>(3)</sup>	107.3	38.6	25.7	15.5	12.0	1.5	200.6
Total off balance-sheet commitments	517.4	97.9	92.7	56.5	32.3	55.3	852.1
1.75% Convertible Notes <sup>(4)</sup>	1,275.9	11.1					1,287.0
Long-term financing arrangements	8.4	4.6	2.0	1.5	0.7		17.2
Uncertain tax positions <sup>(5)</sup>							109.7
Total	\$ 1,801.7	\$ 113.6	\$ 94.7	\$ 58.0	\$ 33.0	\$ 55.3	\$ 2,266.0

**Other Commercial Commitments:**

Letters of credit	\$ 9.7	\$ 0.1	\$ 0.2	\$ 0.4	\$ 1.7	\$ 1.0	\$ 13.1
-------------------	--------	--------	--------	--------	--------	--------	---------

**Table of Contents**

- (1) Included in real estate lease payments pursuant to three financing arrangements with BNP Paribas LLC (BNPPLC) are (i) lease commitments of \$1.1 million, which are based on a fixed rate for terms of five years and (ii) at the expiration or termination of the leasing arrangements, a supplemental payment obligation equal to our minimum guarantee of \$59.1 million in the event that we elect not to purchase or arrange for sale of the buildings.
- (2) Contract manufacturer commitments consist of obligations for on-hand inventories and non-cancelable purchase orders with our contract manufacturers. As of July 27, 2012, we recorded accruals of \$7.2 million for firm, non-cancelable purchase commitments with contract manufacturers for quantities in excess of our future demand forecasts, which is consistent with the valuation of our excess and obsolete inventory.
- (3) Purchase obligations represent an estimate of all open purchase orders and contractual obligations in the ordinary course of business, other than commitments with contract manufacturers and suppliers, for which we have not received the goods or services. Purchase obligations do not include contracts that may be cancelled without penalty. Although open purchase orders are considered enforceable and legally binding, the terms generally allow us the option to cancel, reschedule, and adjust our requirements based on our business needs prior to the delivery of goods or performance of services.
- (4) Included in these amounts are obligations related to the \$1.265 billion principal amount of our Notes (see Note 9 of the accompanying condensed consolidated financial statements). Estimated interest payments for the Notes are \$11.0 million and \$11.1 million for the remainder of fiscal 2013 and fiscal 2014, respectively.
- (5) As of July 27, 2012, our liability for uncertain tax positions was \$109.7 million, including interest and penalties, which due to the uncertainty of the timing of future payments, are presented in the total column on a separate line in this table.

Some of the amounts in the table above are based on management's estimates and assumptions, including the commitment duration, the possibility of renewal or termination, anticipated actions by management and third parties and other factors. Because these estimates and assumptions are subjective, our actual future obligations may vary from those reflected in the table. We expect to fund our contractual obligations and other commitments in the table above through existing cash, cash equivalents, investments, and cash generated from operations or obtain additional financing, if necessary.

As of July 27, 2012, we have three leasing arrangements with BNPPLC, one of which requires us to lease certain of our land to BNPPLC for a period of 99 years and all of which require us to lease approximately 0.3 million square feet of office space from BNPPLC for our headquarters in Sunnyvale, California, which had an aggregate original cost of \$69.6 million. Under these leasing arrangements, we pay BNPPLC minimum lease payments, which vary based on a fixed rate on the costs of the facilities on the respective lease commencement dates. We make payments for each of the leases for a term of five years. We have the option to renew each of the leases for two consecutive five-year periods upon approval by BNPPLC. Upon expiration (or upon any earlier termination) of the lease terms, we must elect one of the following options: (i) purchase the buildings from BNPPLC at cost; (ii) if certain conditions are met, arrange for the sale of the buildings by BNPPLC to a third-party, and be liable for any deficiency between the net proceeds received from the third-party and BNPPLC's cost, up to 85% of cost (residual guarantee); or (iii) pay BNPPLC supplemental payments for an amount equal to the difference between BNPPLC's cost and fair value, up to the residual guarantee, in which event we may recoup some or all of such payments by arranging for a sale of each or all buildings by BNPPLC during the ensuing two-year period. The following table summarizes the aggregate cost, the aggregate residual guarantee, the applicable fixed rates at July 27, 2012 and the lease commencement dates for our leasing arrangements:

Cost	Residual Guarantee	Fixed Rates	Lease Commencement Dates	Term
\$ 69.6 million	\$ 59.1 million	3.67% - 3.69%	December 2007 - January 2008	5 years

These leasing arrangements require us to maintain specified financial covenants with which we were in compliance as of July 27, 2012. Such financial covenants include a maximum ratio of Total Debt to Earnings before Interest, Taxes, Depreciation and Amortization of less than 3:1 and a minimum amount of Unencumbered Cash and Short-Term Investments of \$300.0 million. Our failure to comply with these financial covenants could result in a default under the leases, which, subject to our right and ability to exercise our purchase option, would give BNPPLC the right to, among other things, (i) terminate our possession of the leased property and require us to pay lease termination damages and other amounts as set forth in the lease agreements or (ii) exercise certain foreclosure remedies.

---

## **Table of Contents**

Based on a recent announcement by BNPPLC that it intends to phase out of its synthetic lease activities, we expect to exercise our option to buy out our synthetic leases when their five year terms expire in December 2012 through January 2013.

### ***Legal Contingencies***

We are subject to various legal proceedings and claims which arise in the normal course of business. See further details on such matters in Note 15 to our condensed consolidated financial statements.

### ***Off-Balance Sheet Arrangements***

During the ordinary course of business, we provide standby letters of credit or other guarantee instruments to third parties as required for certain transactions initiated either by us or our subsidiaries. As of July 27, 2012, our financial guarantees of \$13.1 million that were not recorded on our condensed consolidated balance sheet consisted of standby letters of credit related to workers' compensation, a customs guarantee, a corporate credit card program, foreign rent guarantees and surety bonds, which were primarily related to self-insurance.

We use derivative instruments to manage exposures to foreign currency risk. Our primary objective in holding derivatives is to reduce the volatility of earnings and cash flows associated with changes in foreign currency. The program is not designated for trading or speculative purposes. Currently, we do not enter into any foreign exchange forward contracts to hedge exposures related to firm commitments or nonmarketable investments. Our major foreign currency exchange exposures and related hedging programs are described below:

We utilize monthly foreign currency forward and options contracts to hedge exchange rate fluctuations related to certain foreign monetary assets and liabilities.

We use foreign currency forward contracts to hedge exposures related to forecasted sales denominated in certain foreign currencies. These contracts are designated as cash flow hedges and in general closely match the underlying forecasted transactions in duration. As of July 27, 2012, the notional fair value of foreign currency forward and option contracts totaled \$553.2 million. We do not believe that these derivatives present significant credit risks, because of the short term maturity of the outstanding contracts at any point in time, the counterparties to the derivatives consist of major financial institutions, and we manage the notional amount of contracts entered into with any one counterparty. Other than the risk associated with the financial condition of the counterparties, our maximum exposure related to foreign currency forward and option contracts is limited to the premiums paid. See Note 11 of the accompanying condensed consolidated financial statements for more information related to our hedging activities.

In the ordinary course of business, some of our customers have entered into recourse and nonrecourse financing leasing arrangements using third-party leasing companies. During the terms of recourse leases, which are generally three years or less, we remain liable for the aggregate unpaid remaining lease payments to the third-party leasing companies in the event of end-user customer default. Where we provide a guarantee for recourse leases, we defer revenues in accordance with our revenue recognition policies. As of July 27, 2012, the maximum guaranteed payment contingencies under our financing arrangements totaled approximately \$161.4 million, and the related deferred revenue totaled approximately \$151.3 million.

We enter into indemnification agreements with third parties in the ordinary course of business. Generally, these indemnification agreements require us to reimburse losses suffered by the third-parties due to various events, such as lawsuits arising from patent or copyright infringement. These indemnification obligations are considered off-balance sheet arrangements under accounting guidance.

We have commitments related to three leasing arrangements with BNPPLC for approximately 0.3 million square feet of office space for our headquarters in Sunnyvale, California (as further described above under Contractual Obligations). Our future minimum lease payments and residual guarantees under these real estate leases will amount to a total of \$60.2 million as discussed above in Contractual Obligations.

---

**Table of Contents**
**Item 3. Quantitative and Qualitative Disclosures About Market Risk**

We are exposed to market risk related to fluctuations in interest rates, market prices, and foreign currency exchange rates. We use certain derivative financial instruments to manage these risks. We do not use derivative financial instruments for speculative or trading purposes. All financial instruments are used in accordance with management-approved policies.

**Market Risk and Market Interest Risk**

*Investment and Interest Income* As of July 27, 2012, we had debt investments of \$4.0 billion. Our investment portfolio primarily consists of investments with original maturities greater than three months at the date of purchase, which are classified as available-for-sale investments. These investments, which consist primarily of corporate bonds, commercial paper, certificates of deposit and U.S. Treasury and government debt securities, are subject to interest rate and interest income risk and will decrease in value if market interest rates increase. A hypothetical 100 basis point increase in market interest rates from levels as of July 27, 2012 would have resulted in a decrease in the fair value of our fixed-income securities of approximately \$44 million. Volatility in market interest rates over time will cause variability in our interest income. We do not use derivative financial instruments in our investment portfolio.

Our investment policy is to limit credit exposure through diversification and investment in highly rated securities. We further mitigate concentrations of credit risk in our investments by limiting our investments in the debt securities of a single issuer and by diversifying risk across geographies and type of issuer. We actively review, along with our investment advisors, current investment ratings, company-specific events and general economic conditions in managing our investments and in determining whether there is a significant decline in fair value that is other-than-temporary. We monitor and evaluate our investment portfolio on a quarterly basis for any other-than-temporary impairments.

We are also exposed to market risk relating to our auction rate securities due to uncertainties in the credit and capital markets. As of July 27, 2012, our holdings in these securities had a par value of \$50.6 million and an estimated fair value of \$46.3 million. The fair value of our auction rate securities may change significantly due to events and conditions in the credit and capital markets. These securities/issuers could be subject to review for possible downgrade. Any downgrade in these credit ratings may result in an additional decline in the estimated fair value of our auction rate securities. Changes in the various assumptions used to value these securities and any increase in the market's perceived risk associated with such investments may also result in a decline in estimated fair value.

If current market conditions deteriorate, or the anticipated recovery in market values does not occur, we may be required to record additional unrealized losses in accumulated other comprehensive income (loss) or other-than-temporary impairment charges to earnings in future quarters. We intend, and have the ability, to hold these investments until the market recovers. We do not believe that the lack of liquidity relating to our portfolio investments will impact our ability to fund working capital needs, capital expenditures or other operating requirements.

*Convertible Notes* In June 2008, we issued \$1.265 billion principal amount of 1.75% Notes due 2013, of which \$1,017.0 million was allocated to debt and \$248.0 million was allocated to equity. Holders may convert the Notes prior to March 1, 2013 upon the occurrence of certain circumstances, including, but not limited to:

during the five business day period after any five consecutive trading day period in which the trading price of the Notes for each day in this five consecutive trading day period was less than 98% of an amount equal to (i) the last reported sale price of our common stock multiplied by (ii) the conversion rate of the Notes on each such day;

during any calendar quarter (and only during such calendar quarter) if the last reported sale price of our common stock for 20 or more trading days in a period of 30 consecutive trading days ending on the last trading day of the immediately preceding calendar quarter exceeds 130% of the applicable conversion price in effect for the Notes on the last trading day of such immediately preceding calendar quarter; or

upon the occurrence of specified corporate transactions described in the indenture for the Notes.

The Notes are convertible into the right to receive cash in an amount up to the principal amount and shares of our common stock for the conversion value in excess of the principal amount, if any, at an initial conversion rate of 31.40 shares of common stock per \$1,000 principal amount of Notes (which represents an initial effective conversion price of the Notes of \$31.85 per share), subject to adjustment as described in

the indenture governing the Notes.

Our common stock price did not exceed the conversion threshold price of \$41.41 per share set forth for these Notes for at least 20 trading days during the 30 consecutive trading days ended June 30, 2012. Accordingly, as of July 27, 2012, the Notes were not convertible at the option of the holder. Since the Notes were not convertible, the difference between the principal amount and the carrying value of the Notes was reflected as equity on our condensed consolidated balance sheet as of July 27, 2012.



**Table of Contents**

Upon conversion of any Notes, we deliver cash up to the principal amount of the Notes and, with respect to any excess conversion value greater than the principal amount of the Notes, shares of our common stock. As of July 27, 2012, shares issued related to the Notes were minimal. Based on the closing price of our common stock of \$32.91 on July 27, 2012, the if-converted value of our Notes exceeded their principal amount by approximately \$42.2 million.

The fair value of our Notes is subject to interest rate risk, market risk and other factors due to the convertible feature. Generally, the fair value of the Notes will increase as interest rates fall and/or our common stock price increases, and decrease as interest rates rise and/or our common stock price decreases. The interest and market value changes affect the fair value of our Notes, but do not impact our financial position, cash flows, or results of operations due to the fixed nature of the debt obligations. We do not carry the Notes at fair value, but present the fair value of the principal amount of the Notes for disclosure purposes. As of July 27, 2012, the principal amount of the Notes was \$1.265 billion, and the total estimated fair value of the principal amount was \$1.476 billion, or 116.7% of the face value of the Notes, based upon quoted market information as of that date.

**Foreign Currency Exchange Rate Risk and Foreign Exchange Forward Contracts**

We hedge risks associated with foreign currency transactions to minimize the impact of changes in foreign currency exchange rates on earnings. We utilize forward and option contracts to hedge against the short-term impact of foreign currency fluctuations on certain foreign-currency-denominated monetary assets and liabilities. All balance sheet hedges are marked-to-market through earnings each period. We also use foreign exchange forward contracts to hedge foreign currency forecasted transactions related to forecasted sales transactions. These derivatives are designated and qualify as cash flow hedges under accounting guidance for derivatives and hedging. For cash flow hedges outstanding at July 27, 2012, the time-value component is recorded in earnings while all other unrealized gains or losses are included in other comprehensive income.

We do not enter into foreign exchange contracts for speculative or trading purposes. In entering into forward and option foreign exchange contracts, we have assumed the risk that might arise from the possible inability of counterparties to meet the terms of their contracts. We attempt to limit our exposure to credit risk by executing foreign exchange contracts with creditworthy multinational commercial banks. All contracts have a maturity of less than one year.

The following table provides information about our currency forward contracts outstanding as of July 27, 2012 (in millions):

<b>Currency</b>	<b>Local Currency Amount</b>	<b>Notional Contract Amount (USD)</b>	<b>Fair Value (USD)</b>
<b>Forward Purchase Contracts:</b>			
Euro	236.7	\$ 291.5	\$ 291.7
British Pound Sterling	54.0	84.7	85.0
Australian Dollar	70.7	73.9	82.6
Canadian Dollar	20.8	20.7	20.8
Israeli Shekel	94.2	23.2	23.3
Other	N/A	59.2	59.3

**Table of Contents**

**Item 4. Controls and Procedures**

*Disclosure Controls and Procedures*

The phrase “disclosure controls and procedures” refers to controls and procedures designed to ensure that information required to be disclosed in our reports filed or submitted under the Securities Exchange Act of 1934, as amended (the Exchange Act), such as this Quarterly Report on Form 10-Q, is recorded, processed, summarized, and reported within the time periods specified in the rules and forms of the U.S. Securities and Exchange Commission (SEC). Disclosure controls and procedures are also designed to ensure that such information is accumulated and communicated to our management, including our CEO and CFO, as appropriate to allow timely decisions regarding required disclosure.

Under the supervision and with the participation of our management, including our CEO and CFO, we conducted an evaluation of the effectiveness of the design and operation of our disclosure controls and procedures, as defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act, as of July 27, 2012, the end of the fiscal period covered by this Quarterly Report on Form 10-Q (the Evaluation Date). Based on this evaluation, our CEO and CFO concluded as of the Evaluation Date that our disclosure controls and procedures were effective such that the information relating to NetApp, including our consolidated subsidiaries, required to be disclosed in our SEC reports (i) is recorded, processed, summarized, and reported within the time periods specified in SEC rules and forms, and (ii) is accumulated and communicated to our management, including our CEO and CFO, as appropriate to allow timely decisions regarding required disclosure.

*Changes in Internal Control Over Financial Reporting*

There has been no change in our internal control over financial reporting (as defined in Rule 13a-15(f) under the Exchange Act) identified in connection with our evaluation that occurred during the period covered by this Quarterly Report on Form 10-Q that has materially affected or is reasonably likely to materially affect our internal control over financial reporting.

**Table of Contents**

**PART II OTHER INFORMATION**

**Item 1. Legal Proceedings**

None

**Item 1A. Risk Factors**

*The following risk factors and other information included in this Quarterly Report on Form 10-Q should be carefully considered. The risks and uncertainties described below are not the only ones we face. Additional risks and uncertainties not presently known to us or that we presently deem less significant may also impair our business operations. Please see Part I Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations of this Quarterly Report on Form 10-Q for a discussion of the forward-looking statements that are qualified by these risk factors. If any of the events or circumstances described in the following risk factors actually occurs, our business, operating results, and financial condition could be materially adversely affected.*

***Our operating results may be adversely affected by uncertain economic and market conditions.***

We are subject to the effects of general global economic and market conditions. Challenging economic conditions worldwide or in certain geographic regions, such as the continuing fiscal challenges in the United States and Europe, have from time to time contributed to slowdowns in the computer, storage, and networking industries at large, as well as the information technology (IT) market, resulting in:

Reduced demand for our products as a result of constraints on IT-related spending by our customers;

Increased price competition for our products from competitors;

Deferment of purchases and orders by customers due to budgetary constraints or changes in current or planned utilization of our systems;

Risk of supply constraints;

Risk of excess and obsolete inventories;

Inability of customers to obtain credit to finance purchases of our product and services, failure of customers to pay or defaults by customers on credit extended to them;

Counterparty failures that negatively impact our treasury operations;

Excess facilities costs;

Higher overhead costs as a percentage of revenues;

Negative impacts from increased financial pressures on customers, distributors and resellers;

Negative impacts from increased financial pressures on key suppliers or contract manufacturers; and

Potential discontinuance of product lines and related asset impairments.

Any of the above-mentioned factors could have a material and adverse effect on our business and financial performance.

***Our quarterly operating results may fluctuate, which could adversely impact our common stock price.***

We believe that period-to-period comparisons of our results of operations are not necessarily meaningful and should not be relied upon as indicators of future performance. Our operating results have been in the past, and will continue to be, subject to quarterly fluctuations as a result of numerous factors, some of which may contribute to more pronounced fluctuations during times of economic volatility. These factors include, but are not limited to, the following:

**Table of Contents**

Fluctuations in demand for our products and services, in part due to changes in general economic conditions and specific economic conditions in the storage and data management market;

A shift in government spending patterns, particularly in light of continued worries about government debt levels and spending;

Changes in sales and implementation cycles for our products and reduced visibility into our customers' spending plans and associated revenues;

The level of price and product competition in our target markets;

The impact of economic uncertainty on our customers' budgets and IT spending capacity;

Our ability to maintain appropriate inventory levels and purchase commitments;

Our reliance on a limited number of suppliers and industry consolidation in our supply base, which could subject us to periodic supply-and-demand, price rigidity, and quality issues with our components;

Our ability to maintain product quality generally;

The timing and type of bookings, the cancellation of significant orders and the management of, or fluctuations in, our backlog;

Product configuration and mix;

The extent to which our customers renew their service and maintenance contracts with us;

Seasonality, such as our historical seasonal decline in revenues in the first quarter of our fiscal year and seasonal increase in revenues in the second quarter of our fiscal year, with the latter due in part to the impact of the U.S. federal government's September 30 fiscal year end on the timing of its orders;

Linearity, such as our historical intra-quarter bookings and revenue pattern in which a disproportionate percentage of each quarter's total bookings and related revenue occur in the last month of the quarter;

Announcements and introductions of, and transitions to, new products by us or our competitors;

Deferrals of customer orders in anticipation of new products or product enhancements introduced by us or our competitors;

Our ability to develop, introduce, and market new products and enhancements in a timely manner;

Our ability to effectively integrate acquired products and technologies;

Our levels of expenditure on research and development and sales and marketing programs;

Our ability to effectively manage our operating expenses;

Adverse movements in foreign currency exchange rates in the countries in which we do business;

The dilutive impact of our \$1.265 billion of 1.75% Convertible Senior Notes due June 2013 (the Notes ) and related warrants on our earnings per share;

Excess or inadequate facilities;

Actual events, circumstances, outcomes and amounts differing from judgments, assumptions, and estimates used in determining the values of certain assets (including the amounts of valuation allowances), liabilities, and other items reflected in our condensed consolidated financial statements;

---

## **Table of Contents**

Disruptions resulting from new systems and processes as we continue to enhance and scale our system infrastructure; and

Future accounting pronouncements and changes in accounting rules, such as the increased use of fair value measures, changes in accounting standards related to revenue recognition, lease accounting, and financial instruments and the potential requirement that U.S. registrants prepare financial statements in accordance with International Financial Reporting Standards (IFRS).

Due to such factors, operating results for future periods are difficult to predict, and, therefore, prior results are not necessarily indicative of results to be expected in future periods. Any of the foregoing factors, or any other factors discussed elsewhere herein, could have a material adverse effect on our business, results of operations, and financial condition. It is possible that in one or more quarters our results may fall below our forecasts and the expectations of public market analysts and investors. In such event, the trading price of our common stock would likely decrease.

***Our revenues for a particular period are difficult to forecast, and a shortfall in revenues may harm our business and our operating results.***

Our revenues for a particular period are difficult to forecast, especially in times of economic uncertainty. Because the storage and data management market is rapidly evolving, our sales cycle varies substantially from customer to customer, and we rely increasingly on sales through our indirect channel partners, including value-added resellers, systems integrators, distributors, original equipment manufacturers (OEMs) and strategic business partners. New product introductions and the transition from old to new products also increase the complexities of forecasting revenues.

In addition, we derive a majority of our revenues in any given quarter from orders booked in the same quarter. Bookings typically follow intra-quarter seasonality patterns weighted toward the back end of the quarter. If we do not achieve bookings in the latter part of a quarter consistent with our quarterly targets, our financial results will be adversely impacted. Additionally, due to the complexities associated with revenue recognition, we may not accurately forecast our non-deferred and deferred revenues, which could adversely impact our results of operations.

Economic uncertainties have caused, and may in the future again cause, consumers, businesses and governments to defer purchases in response to tighter budgets, credit, decreased cash availability and declining customer confidence. Accordingly, future demand for our products could differ from our current expectations.

***Supply chain and logistics issues, including financial problems of contract manufacturers or component suppliers, or a shortage of adequate component supply or manufacturing capacity that increases our costs or causes a delay in our ability to fulfill orders, could have a material adverse impact on our business and operating results, and our failure to estimate customer demand properly may result in excess or obsolete component supply, which could adversely affect our gross margins.***

The fact that we do not own or operate our manufacturing facilities, supply chain and logistics exposes us to risks, including reduced control over quality assurance, production costs and product supply, which could have a material adverse impact on the supply of our products and on our business and operating results. We rely on a limited number of suppliers for components utilized in the assembly of our products, including certain single source suppliers, which has and could subject us to future price rigidity, periodic supply constraints, and the inability to produce our products. If our third-party manufacturers or suppliers experience strikes, protests or other labor unrest, or are subject to lawsuits, injunctions or other legal challenges, there may be delays, interruptions or permanent impairment in the ability of such manufacturers and suppliers to ship products to us, or such manufacturers and suppliers may incur increased costs, any of which could impact our business and harm our operating results, liquidity and financial condition.

Drive supply shortages and pricing complexities could materially and adversely affect our supply chain, customer relationships and results of operations. Qualifying new contract manufacturers and commencing volume production is expensive and time-consuming, and disruption or termination of manufacturing capacity with respect to any contract manufacturer could negatively impact our ability to manufacture, sell and ship our products.

We intend to continue to regularly introduce new products and product enhancements, which will require us to rapidly achieve volume production by coordinating with our contract manufacturers and suppliers. A reduction or interruption in supply; a significant increase in the price of one or more components; a failure to adequately procure inventory by our contract manufacturers; a failure to timely cancel, reschedule, or adjust our requirements based on our business needs; perceived or real problems with product quality control; or a decrease in demand for our products could materially adversely affect our business, operating results, and financial condition and could materially damage customer relationships. Furthermore, as a result of binding price or purchase commitments with suppliers, we may be obligated to purchase components at prices that are higher than those available in the current market. An increase in component costs relative to product prices could have an adverse

## Edgar Filing: NetApp, Inc. - Form 10-Q

affect on our gross margin and earnings. As the demand for our products has increased, we have experienced, and may continue to experience, tightening of supply of some components leading to longer lead times and component supply constraints, which has resulted in and in the future could continue to result in the delay of shipments.



## **Table of Contents**

Our business operations are subject to business interruptions and other events beyond our control. Such events could make it difficult or impossible for us to receive components from our suppliers and create delays and inefficiencies in our supply chain.

***We have experienced periods of alternating growth and decline in revenues and operating expenses. If we are not able to successfully manage these fluctuations, our business, financial condition and results of operations could be significantly impacted.***

Changing market conditions and economic uncertainty create a challenging operating environment for our business. It is critical that we maintain appropriate alignment between our cost structure and our expected growth and revenues, while at the same time, continuing to make strategic investments for future growth.

Our expense levels are based in part on our expectations as to future revenues, and a significant percentage of our expenses are fixed. We have a limited ability to significantly reduce our fixed costs quickly, and if revenue levels are below our expectations, operating results will be adversely impacted. During periods of uneven growth or decline, we may incur costs before we realize the anticipated related benefits, which could harm our operating results. We have made, and will continue to make, significant investments in engineering, sales, service and support, marketing and other functions to support and grow our business. We are likely to recognize the costs associated with these investments earlier than some of the related anticipated benefits, such as revenue growth, and the return on these investments may be lower, or may develop more slowly, than we expect, which could harm our business, operating results and financial condition.

Conversely, if we are unable to effectively manage our resources and capacity during periods of increasing demand for our products, we could also experience an adverse impact on our business, operating results and financial condition and our customer relationships may be adversely impacted. If the storage and data management market fails to grow, or grows slower than we expect, our revenues will be adversely affected.

***Our gross margins have varied over time and may continue to vary, and such variation makes it more difficult to forecast our earnings.***

Our total gross margins are impacted by the mix of our product, software entitlements and maintenance and services revenues.

Our product gross margins have been and may continue to be affected by a variety of factors, including:

Demand for storage and data management products;

Pricing actions, rebates, sales initiatives, discount levels, and price competition;

Changes in the mix between direct versus indirect and OEM sales, each of which has a different gross margin structure;

Changes in customer, geographic, or product mix, including mix of configurations within products;

The timing and amount of revenue recognized and deferred;

New product introductions and enhancements;

Licensing and royalty arrangements;

Excess inventory levels or purchase commitments as a result of changes in demand forecasts or last time buy purchases;

Possible product and software defects as we transition our products; and

## **Table of Contents**

The cost of components, contract manufacturing costs, quality, warranty, and freight.  
Changes in software entitlements and maintenance gross margins may result from various factors, such as:

The size of the installed base of products under technical support contracts;

The timing of technical support service contract renewals; and

Demand for and the timing of delivery of upgrades.  
Changes in service gross margins may result from various factors, such as:

The mix of customers;

The size and timing of service contract renewals;

Spares stocking requirements to support new product introductions, service needs and logistics requirements;

The level of spending on our customer support infrastructure;

The volume, cost and use of outside partners to deliver support services on our behalf; and

Product quality and serviceability issues.  
Due to such factors, gross margins are subject to variation from period-to-period and are difficult to predict.

***An increase in competition and industry consolidation could materially and adversely affect our operating results.***

The storage and data management markets are intensely competitive and are characterized by rapidly changing technology. We compete with many companies in the markets we serve, including companies that offer a broad spectrum of IT products and services (full-stack vendors) and others that offer a more limited set of storage and data management products or services. In the primary storage market, our system products and associated software portfolio mainly compete with storage system products and data management software from Dell, EMC, Hitachi Data Systems, HP, IBM, and Oracle Corporation. We compete against these same companies in the secondary storage market, which includes the disk-to-disk backup, archival and compliance, and business continuity segments. In markets such as cloud, big data, and converged infrastructure, our primary competitors include EMC, Hitachi Data Systems, HP, and IBM. In the healthcare, financial services, life sciences, and service provider markets, we compete primarily with EMC, Hitachi Data Systems, HP, and IBM. Some of our competitors in the primary and secondary storage markets also offer their systems to OEM customers. In addition, we compete in the OEM market against products from DotHill and Xyratex.

There has been a trend toward industry consolidation in our markets for several years. We expect this trend to continue as companies attempt to strengthen or hold their market positions in an evolving industry, as companies become unable to maintain their competitive positions or continue operations and as customers demand more flexible business models and terms. We believe that industry consolidation may result in stronger competitors that are better able to compete for customers as sole-source vendors. In addition, current and potential competitors have established or may establish strategic alliances among themselves or with third parties, including some of our partners. It is possible that new competitors or alliances among competitors may emerge and rapidly acquire significant market share. We may not be able to compete

successfully against current or future competitors. Competitive pressures we face could materially and adversely affect our business and operating results.

***Disruption of, or changes in, our distribution model could harm our sales.***

If we fail to develop and maintain strong relationships with our channel partners, or if our channel partners fail to effectively manage the sale of our products or services on our behalf, our revenues and gross margins could be adversely affected.

We market and sell our storage data management solutions directly through our worldwide sales force and indirectly through channel partners such as value-added resellers, systems integrators, distributors, OEMs and strategic business partners, and we derive a significant portion of our revenues from these indirect channels. During the three months ended July 27, 2012, revenues generated from sales through our indirect channel accounted for 78% of net revenues. In order for us to maintain or increase our revenues, we must effectively manage our relationships with channel partners.

---

## **Table of Contents**

Several factors could result in disruption of or changes in our indirect channel distribution model, which could materially harm our revenues and gross margins, including the following:

Our indirect channel partners may compete directly with other channel partners or with our direct sales force. Due to these conflicts, our indirect channel partners could stop or reduce their efforts in marketing our products.

Our indirect channel partners may demand that we absorb a greater share of the risks that their customers may ask them to bear;

Our indirect channel partners may have insufficient financial resources and may not be able to withstand changes and challenges in business conditions; and

Our indirect channel partners' financial condition or operations may weaken.

The loss of one or more of our key indirect channel partners in a given geographic area could harm our operating results within that area, as qualifying and developing new indirect channel partners typically requires a significant investment of time and resources before acceptable levels of productivity are met. There is no assurance that we will be able to attract new indirect channel partners, retain these indirect channel partners or that we will be able to secure additional or replacement indirect channel partners in the future, especially in light of continued changes in end customer demand patterns and changes in available and competing technologies from competitors. Our inability to effectively establish, train, retain and manage our indirect channel partners could harm our sales.

In addition, we depend on our indirect channel partners to comply with applicable regulatory requirements in the jurisdictions in which they operate. Their failure to do so could have a material adverse effect on our revenues and operating results.

### ***Our OEM relationships may not continue to generate significant revenues.***

We have OEM relationships with several companies including IBM, Teradata, Fujitsu Technology Solutions (Fujitsu), Oracle and Dell, which collectively accounted for 14% of our net revenue during the three months ended July 27, 2012. These relationships enable these OEMs to market and sell their branded solutions based on our unified solutions, as well as associated software offerings, or in the case of Fujitsu, enables Fujitsu to lease, sell, market and resell our products to end users and Fujitsu sales partners worldwide, to integrate our products into Fujitsu bundled offerings, and to market our support services. While these arrangements are part of our general strategy to expand our reach to more customers and into more countries, we do not have exclusive relationships with our OEMs, and there is no minimum commitment for any given period of time. Therefore, our relationships with these OEMs may not continue to generate significant revenues. In addition, we have no control over the products that the OEMs select to sell, or their release schedule and timing of those products; nor do we control their pricing.

As our OEM relationships increase, we may experience distribution channel conflicts between our direct sales force and the OEMs or among our channel partners. If we fail to minimize channel conflicts, or if our OEM relationships do not continue to generate significant revenues, our operating results and financial condition could be harmed.

### ***A portion of our revenues is generated by large, recurring purchases from various customers, resellers and distributors. A loss, cancellation or delay in purchases by any of these parties has and in the future could negatively affect our revenues.***

During the three months ended July 27, 2012, sales to distributors Arrow Electronics, Inc. and Avnet, Inc. accounted for approximately 16% and 14%, respectively, of our net revenues. We also have significant OEM agreements, as discussed above. The loss of orders from these, or any of our more significant customers, strategic partners, distributors or resellers could cause our revenues and profitability to suffer.

We generally do not enter into binding purchase commitments with our customers for extended periods of time, and thus we may not be able to continue to receive large, recurring orders from these customers, resellers or distributors. For example, our reseller agreements generally do not require minimum purchases and our customers, resellers and distributors can stop purchasing and marketing our products at any time.



---

**Table of Contents**

Unfavorable economic conditions may negatively impact our operations by affecting the solvency of our customers, resellers and distributors, or the ability of our customers to obtain credit to finance purchases of our products. If the uncertainty in the economy continues, or conditions deteriorate, and our sales decline, our financial condition and operating results could be adversely impacted.

Because our expenses are based on our revenue forecasts, a substantial reduction or delay in sales of our products to, or unexpected returns from customers and resellers, or the loss of any significant customer or reseller, could harm our business. We expect that our largest customers in the future could be different from our largest customers today. The loss of one or more of our key indirect channel partners or the failure to obtain and ship a number of large orders each quarter could harm our operating results. In addition, a change in the pricing practices of one or more of our large indirect channel partners could adversely affect our revenues and gross margins.

*The U.S. government has historically contributed to our revenue growth and has become an important customer for us. Future revenues from the U.S. government are subject to shifts in government spending patterns. A decrease in government demand for our products could materially and adversely affect our revenues. In addition, our business could be adversely affected by claims that we or a channel partner have failed to comply with regulatory and contractual requirements applicable to sales to the U.S. government.*

The U.S. government has become an important customer for the storage and data management market generally and for us in particular; however, government demand is unpredictable, and there can be no assurance that we will maintain or grow our revenues from the U.S. government. Government agencies are subject to budgetary processes and expenditure constraints that could lead to delays or decreased capital expenditures in IT spending, particularly in light of recent and continued uncertainties about U.S. spending levels. If the government or individual agencies within the government reduce or shift their capital spending patterns, our revenues and operating results may be harmed.

Selling our products to the U.S. government, whether directly or through channel partners, also subjects us to certain regulatory and contractual requirements. Failure to comply with these requirements by either us or our channel partners could subject us to investigations, fines, and other penalties, which could have a material adverse effect on our revenues, operating results and financial position. As an example, the United States Department of Justice ( DOJ ) and the General Services Administration ( GSA ) have in the past pursued claims against and financial settlements with IT vendors, including us and several of our competitors and channel partners, under the False Claims Act and other statutes related to pricing and discount practices and compliance with certain provisions of GSA contracts for sales to the federal government. The DOJ and GSA continue to pursue actively such claims. We are currently discussing contract compliance matters regarding sales made through a channel partner with the DOJ and GSA, and have produced documents and met with the DOJ and GSA on several occasions. If the DOJ determines to initiate an action against a channel partner and/or us, we would be subject to litigation, could be subjected to fines and penalties. We could also decide to pay the DOJ a settlement, either to avoid a potential action or in termination of an action. Violations of certain regulatory and contractual requirements could also result in us being suspended or debarred from future government contracting. Any of these outcomes could have a material adverse effect on our revenues, operating results and financial position.

*Certain of our products are subject to U.S. export control laws and other laws affecting the countries in which our products and services may be sold, distributed, or delivered; if we were found to have violated these laws, the consequences of such a determination could have a material and adverse effect on our business, financial condition and results of operations.*

Due to the global nature of our business, we are subject to import and export restrictions and regulations, including the Export Administration Regulations (EAR) administered by the Commerce Department's Bureau of Industry and Security (BIS) and the trade and economic sanctions regulations administered by the Treasury Department's Office of Foreign Assets Control (OFAC). The U.S., through the BIS and OFAC, places restrictions on the sale or export of certain products and services to certain countries and persons. Violators of these export control and sanctions laws may be subject to significant penalties, which may include significant monetary fines, criminal proceedings against them and their officers and employees, a denial of export privileges, and suspension or debarment from selling products to the federal government. We take a variety of precautions to prevent our products from being shipped to U.S.-sanctioned targets; however, our products could be shipped to those targets by third parties, including potentially our channel partners, despite such precautions. For instance, media reports starting in November 2011 have asserted that certain of our products were delivered to Syria through a third-party possibly in violation of U.S. export-control laws. We have publicly stated that we condemn any use of our products or technologies in Syria, we have notified the U.S. government that we are conducting a review of these allegations, and intend to cooperate fully with any government inquiry. We have met with U.S. government officials, provided information at their request, and expressed our willingness to continue cooperating with any further inquiry or investigation. If we become the subject of an investigation and are found to have violated U.S. export control laws, we may be subject to various penalties available under the laws, any of which could have a material and adverse impact on our business, operating results and financial position. Even if we are not found to have violated such laws, the political and media scrutiny surrounding any governmental investigation of us could cause us significant financial and reputational harm and distract senior executives from managing our normal day-to-day operations, which could have a material and adverse impact on our business, operating results and financial position.





---

**Table of Contents**

***If we are unable to maintain our existing relationships and develop new relationships with major strategic partners, our revenues may be impacted negatively.***

An element of our strategy to increase revenues is to strategically partner with major third-party software and hardware vendors to integrate our products into their products and also co-market our products with them. We have significant partner relationships with database, business application, backup management and server virtualization companies, including Microsoft, Cisco, Oracle, SAP, Symantec and VMware. A number of these strategic partners are industry leaders that offer us expanded access to segments of the storage and data management market. There is intense competition for attractive strategic partners, and even if we can establish relationships with these or other partners, these partnerships may not generate significant revenues or may not continue to be in effect for any specific period of time. If these relationships are not maintained or fail to materialize as expected, we could experience lower than expected revenue, suffer delays in product development, or experience other operational difficulties.

In addition, some of our partners, including Oracle, Cisco and VMware, are also partnering with other storage vendors, which may increase the availability of competing solutions, harm our ability to continue as the vendor of choice for those partners and harm our ability to grow our business with those partners.

We intend to continue to establish and maintain business relationships with technology companies to expand our marketing reach and accelerate the development of our storage and data management solutions. To the extent that we are unsuccessful in developing new relationships or maintaining our existing relationships, our future revenues and operating results could be negatively impacted. In addition, the loss of a strategic partner could have a material adverse effect on our revenues and operating results.

***Our future financial performance depends on growth in the storage and data management markets. If the performance of these markets do not meet the expectations upon which we calculate and forecast our revenues or if we are unable to develop product offerings that meet the future demands of these markets, our operating results will be materially and adversely impacted.***

All of our products address the storage and data management markets. Accordingly, our future financial performance will depend in large part on continued growth in the storage and data management markets and on our ability to adapt to emerging standards in these markets. The markets for storage and data management have been recently adversely impacted by the global economic uncertainty, and as a result of continued uncertainty, the markets may not grow as anticipated or may decline. Also, even if spending in the IT market increases, our revenues may not grow at the same pace or at all.

Additionally, emerging standards in these markets may adversely affect the UNIX®, Windows® and the World Wide Web server markets upon which we depend. For example, we provide our open access data retention solutions to customers within the financial services, healthcare, pharmaceutical and government market segments, industries that are subject to various evolving governmental regulations with respect to data access, reliability and permanence (such as Rule 17(a)(4) of the Securities Exchange Act of 1934, as amended) in the U.S. and in the other countries in which we operate. If our products do not meet and continue to comply with these evolving governmental regulations in this regard, customers in these market and geographical segments will not purchase our products, and we will not be able to expand our product offerings in these market and geographical segments at the rates which we have forecasted.

***The market price for our common stock has fluctuated significantly in the past and will likely continue to do so in the future.***

The market price for our common stock has experienced substantial volatility in the past, and several factors could cause substantial fluctuation in the future. These factors include but are not limited to:

Fluctuations in our operating results compared to prior periods and forecasts;

**Table of Contents**

Variations between our operating results and either the guidance we have furnished to the public or the published expectations of securities analysts;

Industry consolidation and the resulting perception of increased competition;

Economic developments in the storage and data management market as a whole;

Fluctuations in the valuation of companies perceived by investors to be comparable to us;

Changes in analysts' recommendations or projections;

Changes in our relationships with our suppliers, customers, channel and strategic partners;

Announcements of the completion or dissolution of strategic alliances within the industry;

Dilutive impacts of our convertible Notes and related warrants;

International conflicts and acts of terrorism;

Announcements of new products, applications, or product enhancements by us or our competitors;

Announcements related to planned or completed mergers or other acquisitions by us or our competitors;

Inquiries by the SEC, NASDAQ, law enforcement, or other regulatory bodies; and

General market conditions, including recent global and regional economic uncertainties.

In addition, the stock market has experienced volatility that has particularly affected the market prices of the equity securities of many technology companies. Certain macroeconomic factors such as the market climate for the technology sector, changes in interest rates, and levels of corporate spending on IT, could continue to have an impact on the trading price of our stock, and the market price of our common stock may fluctuate significantly in the future.

***If we are unable to develop and introduce new products and respond to technological change, if our new products do not achieve market acceptance, if we fail to manage the interoperability and transition between our new and old products, or if we cannot provide the expected level of quality, service and support for our new products, our operating results could be materially and adversely affected.***

Our future growth depends upon the successful development and introduction of new hardware and software products. Due to the complexity of storage subsystems and storage security appliances and the difficulty in gauging the engineering effort required to produce new products, such products are subject to significant technical and quality control risks. In addition, our new products must respond to technological changes and evolving industry standards. If we are unable, for technological or other reasons, to develop and introduce new products in a timely manner in response to changing market conditions or customer requirements, or if such products do not achieve market acceptance, our operating results could be materially and adversely affected. New or additional product introductions increase the complexities of forecasting revenues, and

## Edgar Filing: NetApp, Inc. - Form 10-Q

subject us to additional financial and operational risks. If they are not managed effectively, we could experience material risks to our operations, financial condition and business model.

As new or enhanced products are introduced, we must attempt to successfully manage the interoperability and transition from older products in order to minimize disruption in customers' ordering patterns, avoid excessive levels of older product inventories, and ensure that enough supplies of new products can be delivered to meet customers' demands.

As we enter new or emerging markets, we will likely increase demands on our service and support operations and may be exposed to additional competition. We may not be able to provide products, service and support to effectively compete for these market opportunities.

---

**Table of Contents**

*Undetected software errors, hardware errors, or failures found in new products may result in loss of or delay in market acceptance of our products, which could increase our costs and reduce our revenues. Product quality problems could lead to reduced revenues, gross margins and operating results.*

Our products may contain undetected software errors, hardware errors or failures when first introduced or as new versions are released. Despite testing by us and by current and potential customers, errors may not be found in new products until after commencement of commercial shipments, resulting in loss of or delay in market acceptance, which could materially and adversely affect our operating results.

In addition, if we fail to remedy a product defect, we may experience a failure of a product line, temporary or permanent withdrawal from a product or market, damage to our reputation, inventory costs or product reengineering expenses and higher ongoing warranty and service costs, and these occurrences could have a material impact on our revenues, gross margins and operating results. We may be subject to losses that may result from or are alleged to result from defects in our products, which could subject us to claims for damages, including consequential damages.

*Due to the global nature of our business, risks inherent in our international operations could have a material adverse effect on our business.*

Although a substantial portion of our business is located and conducted in the U.S., a significant portion of our operations are located, and a significant portion of our revenues are derived, outside of the U.S. During the three months ended July 27, 2012, our international revenues accounted for 51% of our total revenues. A substantial portion of our products are manufactured outside of the U.S., and we have research and development and service centers overseas. Accordingly, our business and our future operating results could be adversely affected by a variety of factors affecting our international operations, some of which are beyond our control, including regulatory, political, or economic conditions in a specific country or region, trade protection measures and other regulatory requirements, government spending patterns, and acts of terrorism and international conflicts. In addition, we may not be able to maintain or increase international market demand for our products.

We face exposure to adverse movements in foreign currency exchange rates as a result of our international operations. These exposures may change over time as business practices evolve, and they could have a material adverse impact on our financial results and cash flows. We utilize forward and option contracts in an attempt to reduce the adverse earnings impact from the effect of exchange rate fluctuations on certain assets and liabilities as well as certain anticipated foreign currency cash flows on a short-term basis. These hedging contracts attempt to reduce, but do not always entirely eliminate, the impact of currency exchange movements. Factors that could have a negative impact on the effectiveness of our hedging program include inaccuracies in forecasting, widening interest rate differentials, and volatility in the foreign exchange market. Our hedging strategies may not be successful and currency exchange rate fluctuations could have a material adverse effect on our operating results. In addition, our foreign currency exposure on assets and liabilities for which we do not hedge could have a material impact on our results of operations in periods when the U.S. dollar significantly fluctuates in relation to unhedged non-U.S. currencies in which we transact business.

As a result of entering into these hedging contracts with major financial institutions, we may be subject to counterparty nonperformance risk. Should there be a counterparty default, we could be exposed to the net losses on the hedged arrangements or be unable to recover anticipated net gains from the transactions.

Additional risks inherent in our international business activities generally include, among others, longer accounts receivable payment cycles and difficulties in managing international operations.

In addition, due to the global nature of our business, we are subject to complex legal and regulatory requirements in the U.S. and the foreign jurisdictions in which we operate and sell our products, including antitrust and anti-competition laws, rules and regulations, and regulations related to data privacy. We are also subject to the potential loss of proprietary information due to piracy, misappropriation or laws that may be less protective of our intellectual property rights than U.S. laws. Such factors could have an adverse impact on our business, operating results and financial position.

Moreover, in many foreign countries, particularly in those with developing economies, it is common to engage in business practices that are prohibited by our internal policies and procedures, or U.S. laws and regulations applicable to us, such as the Foreign Corrupt Practices Act. There can be no assurance that all of our employees, contractors and agents, as well as those companies to which we outsource certain of our business operations, will comply with these policies, procedures, laws and/or regulations. Any such violation could subject us to fines and other penalties, which could have a material adverse effect on our business, financial condition or results of operations.

---

**Table of Contents**

*Changes in our effective tax rate or adverse outcomes resulting from examination of our income tax returns could adversely affect our results.*

Our effective tax rate could be adversely affected by several factors, many of which are outside of our control, including:

Earnings being lower than anticipated in countries where we are taxed at lower rates as compared to the U.S. statutory tax rate;

Material differences between forecasted and actual tax rates as a result of a shift in the mix of pretax profits and losses by tax jurisdiction, our ability to use tax credits or effective tax rates by tax jurisdiction that differ from our estimates;

Changing tax laws or related interpretations, accounting standards, regulations, and interpretations in multiple tax jurisdictions in which we operate, as well as the requirements of certain tax rulings;

An increase in expenses not deductible for tax purposes, including certain stock-based compensation, write-offs of acquired in-process research and development, and impairment of goodwill;

The tax effects of purchase accounting for acquisitions and restructuring charges that may cause fluctuations between reporting periods;

Changes related to our ability to ultimately realize future benefits attributed to our deferred tax assets, including those related to other-than-temporary impairments;

Tax assessments resulting from income tax audits or any related tax interest or penalties could significantly affect our income tax provision for the period in which the settlements take place;

Adverse tax consequences, including imposition of withholding or other taxes on payments by subsidiaries or customers; and

A change in our decision to indefinitely reinvest foreign earnings.

We receive significant tax benefits from sales to our non-U.S. customers. These benefits are contingent upon existing tax laws and regulations in the U.S. and in the countries in which our international operations are located. Future changes in domestic or international tax laws and regulations could adversely affect our ability to continue to realize these tax benefits. We have not provided for U.S. federal and state income taxes or foreign withholding taxes that may result from future remittances of undistributed earnings of foreign subsidiaries. The President's administration and Congress have announced several proposals to reform U.S. tax rules, including proposals that may result in a reduction or elimination of the deferral of U.S. income tax on our future unrepatriated earnings. Should such anti-deferral provisions be enacted, our effective tax rate could be adversely affected.

We are currently undergoing income tax audits in the U.S. and several foreign tax jurisdictions. The rights to some of our intellectual property (IP) are owned by certain of our foreign subsidiaries, and payments are made between U.S. and foreign tax jurisdictions relating to the use of this IP in a qualified cost sharing arrangement. In recent years, several other U.S. companies have had their foreign IP arrangements challenged as part of Internal Revenue Service (IRS) examinations, which have resulted in material proposed assessments and/or litigation with respect to those companies.

On March 26, 2012, we received a Revenue Agent's Report from the IRS for our fiscal 2005 through 2007 tax returns. On April 25, 2012, we filed a protest related to transfer pricing. In February 2012, the IRS commenced an examination of our fiscal 2008 through fiscal 2010 income tax returns. We are also under audit by the California Franchise Tax Board for our fiscal 2007 and 2008 California income tax returns. Our open

## Edgar Filing: NetApp, Inc. - Form 10-Q

years in U.S. federal jurisdictions are fiscal 2005 and later years. In addition, we are effectively subject to federal tax examination adjustments for tax years ended on or after fiscal year 2000, in that we have tax attribute carryforwards from these years that could be subject to adjustments, if and when utilized.

On September 17, 2010, the Danish Tax Authorities issued a decision concluding that distributions declared in 2005 and 2006 from our Danish subsidiary were subject to Danish at-source dividend withholding tax. We do not believe that our Danish subsidiary is liable for withholding tax and filed an appeal with the Danish Tax Tribunal to that effect. On December 19, 2011, the Danish Tax Tribunal issued a ruling that our Danish subsidiary was not liable for Danish withholding tax. The Danish tax examination agency appealed to the Danish High Court in March 2012.

We are in various stages of the examination and appeals process in connection with tax audits worldwide and it is difficult to determine when these examinations will be settled. It is reasonably possible that over the next twelve-month period, we may experience an increase or decrease in unrecognized tax benefits. It is not possible to determine either the magnitude or the range of any increase or decrease at this time.

---

**Table of Contents**

If the ultimate determination of income taxes or at-source withholding taxes assessed under the current IRS audits or under audits being conducted in any of the other tax jurisdictions in which we operate results in an amount in excess of the tax provision we have recorded or reserved for, our operating results, cash flows and financial condition could be adversely affected.

Our international operations currently benefit from a tax ruling concluded in the Netherlands which expires on April 30, 2015 and results in a lower level of earnings subject to tax in the Netherlands. If we are unable to negotiate a similar tax ruling upon expiration of the current ruling, our effective tax rate could increase and our operating results could be adversely affected. Our effective tax rate could also be adversely affected by different and evolving interpretations of existing law or regulations, which in turn would negatively impact our operating and financial results as a whole. Our effective tax rate could also be adversely affected if there is a change in international operations and how the operations are managed and structured. The price of our common stock could decline to the extent that our financial results are materially affected by an adverse change in our effective tax rate.

***Our leverage and debt service obligations and Note conversion may adversely affect our financial condition, results of operations and earnings per share.***

As a result of the sale of our Notes, we have a greater amount of debt than we have maintained in the past. In addition, we have various synthetic lease arrangements related to some of our facilities at our corporate headquarters in Sunnyvale, California, and, subject to the restrictions in our existing and any future financing agreements, we may incur additional debt.

Our ability to meet our expenses and debt obligations will depend on our future performance, which will be affected by financial, business, economic, regulatory and other factors. We will not be able to control many of these factors, such as economic conditions and governmental regulations. Furthermore, our operations may not generate sufficient cash flows to enable us to meet our expenses and service our debt.

Any conversion of the Notes may cause dilution to our shareholders and to our earnings per share. If the average trading price of our common stock in each fiscal quarter exceeds the conversion price of \$31.85 per share, the Notes will cause an increase in diluted share count and result in lower reported earnings per share. Based on the trading price of our common stock as of July 27, 2012, we had approximately 1 million shares of common stock potentially issuable on conversion of our Notes. The Note hedge transactions discussed below, if exercised upon conversion of the Notes, are expected to reduce approximately 80% of the common stock potentially issuable on conversion of the Notes. Upon conversion of any Notes, we would be required to deliver cash up to the principal amount of the Notes and, with respect to any excess conversion value greater than the principal amount of the Notes, shares of our common stock, which would result in dilution to our shareholders.

***The Note hedges and warrant transactions that we entered into in connection with the sale of the Notes may affect the trading price of our common stock.***

In connection with the issuance of the Notes, we entered into privately negotiated convertible Note hedge transactions with certain option counterparties (the Counterparties), which are expected to offset the potential dilution to our common stock upon any conversion of the Notes. At the same time, we also entered into warrant transactions with the Counterparties pursuant to which we may issue shares of our common stock above a certain strike price. In connection with these hedging transactions, the Counterparties may have entered into various over-the-counter derivative transactions with respect to our common stock or purchased shares of our common stock in secondary market transactions at or following the pricing of the Notes. Such activities may have had the effect of increasing the price of our common stock. The Counterparties are likely to modify their hedge positions from time to time prior to conversion or maturity of the Notes by purchasing and selling shares of our common stock or entering into other derivative transactions. Additionally, these transactions may expose us to counterparty credit risk for nonperformance. The effect, if any, of any of these transactions and activities on the market price of our common stock or the Notes will depend, in part, on market conditions and cannot be ascertained at this time, but any of these activities could adversely affect the value of our common stock. In addition, if our stock price exceeds the strike price for the warrants, there could be additional dilution to our shareholders, which could adversely affect the value of our common stock.

The price of our common stock could also be affected by sales of our common stock by investors who view the Notes as a more attractive means of equity participation in our Company and by hedging or arbitrage trading activity that we expect to develop involving our common stock by holders of the Notes. The hedging or arbitrage could, in turn, affect the trading price of the Notes and warrants.

---

**Table of Contents**

***Future issuances of common stock related to our Notes, warrants and employee equity awards may adversely affect the trading price of our common stock and the Notes.***

The conversion of some or all of our outstanding Notes will dilute the ownership interest of existing stockholders to the extent we deliver common stock upon conversion of the Notes. At July 27, 2012 the contingent conversion thresholds of the Notes were not exceeded. Accordingly, as of July 27, 2012, the Notes were not convertible at the option of the holder. The determination of whether or not the Notes are convertible will be performed quarterly on a calendar basis. Upon conversion of any Notes, we would be required to deliver cash for the principal amount of the Notes and shares of common stock, if any, to the extent the conversion value exceeds the principal amount. Any new issuance of equity securities, including the issuance of shares upon conversion of the Notes or the exercise of related warrants which are not offset by our Note hedges, could dilute the interests of our then-existing stockholders, including holders who receive shares upon conversion of their Notes, and could substantially decrease the trading price of our common stock and the Notes. In addition, any sales in the public market of any common stock issuable upon such conversion or the exercise of warrants could adversely affect prevailing market prices of our common stock.

As of July 27, 2012, we had options outstanding to purchase approximately 22 million shares of our common stock and a total of approximately 14 million restricted stock units, for which common stock will be issued upon vesting of such. If all the outstanding options were exercised, the proceeds to the Company would average approximately \$30 per share. We also had 9 million shares of our common stock reserved for future issuance under our stock plans with respect to equity awards that have not been granted. The exercise of all of the outstanding options and/or the vesting of all outstanding restricted stock units would dilute the interests of our then-existing stockholders, and any sales in the public market of the common stock issuable upon such exercise/vesting could adversely affect the trading price of our common stock.

As of July 27, 2012, we had approximately 3 million shares of our common stock available for future issuance under our Employee Stock Purchase Plan (ESPP). The issuance of shares under the ESPP would dilute the interests of our then-existing stockholders, and any sales in the public market of the common stock issuable upon such exercise could adversely affect the trading price of our common stock. In addition, the ESPP includes a purchase price adjustment provision such that employees who elect to participate are granted options to purchase common stock at a 15% discount from the market value of the common stock at certain specified dates within a two-year offering period. If the adjustment is triggered due to a decline in the market value of our common stock, we could incur a significant non-cash charge in our statement of operations. For example, during the three months ended January 27, 2012 and July 27, 2012, we recorded charges related to the purchase price adjustment provision of approximately \$10.9 million and \$12.8 million, respectively.

We may issue equity securities in the future for a number of reasons, including to finance our operations related to business strategy (including in connection with acquisitions, strategic alliances or other transactions), to increase our capital, to adjust our ratio of debt to equity, to satisfy our obligations upon the exercise of outstanding warrants or options upon conversion of the Notes, or for other reasons.

***Our acquisitions may disrupt our existing business and harm our results of operations.***

As part of our strategy, we are continuously evaluating opportunities to buy other businesses or technologies that would complement our current products, expand the breadth of our markets, or enhance our technical capabilities. In fiscal year 2011, we completed acquisitions of two technology companies, and in fiscal 2012, we completed the acquisition of certain assets related to Engenio. The acquisition and ongoing integration of new businesses into our business may adversely affect our operations and profitability. We may not achieve the anticipated cost savings and synergies or realize our estimated revenue, gross margin, profit or other financial projections or business objectives in a timely manner or at all due to a number of factors, including the following:

The inability to successfully integrate the operations, technologies, products, personnel and business systems of the acquired companies;

In the case of an asset purchase, the failure to acquire all of the assets necessary to operate the acquired business;

The loss of key employees of the acquired businesses, which could adversely impact our ability to manage the business and our ability to realize our financial forecasts;





**Table of Contents**

The inability to retain the customers and partners of acquired businesses following the acquisition;

Substantial transaction costs and accounting charges; and

Exposure to litigation related to acquisitions.

Acquisitions may also result in risks to our existing business, including:

The diversion of management's attention from daily operations of the existing business;

Deterioration of our internal control over financial reporting as a result of inconsistencies between our standards, procedures and policies and those of acquired businesses;

Reliance on the selling party's processes, data, supply chain management and reporting during the transition period following the completion of acquisitions;

Dilution of our current stockholders' percentage ownership to the extent we issue new equity;

Assumption of additional liabilities;

Incurrence of additional debt or a decline in available cash;

The need to incur restructuring charges or other non-recurring expenses;

Liability for intellectual property infringement and other litigation claims, which we may or may not be aware of at the time of acquisition; and

Intangible assets that could result in significant future amortization expense.

The failure to achieve the anticipated benefits of an acquisition may also result in impairment charges for goodwill and purchased intangible assets. For example, we have in the past discontinued certain products which were originally acquired through business acquisitions. Additional or realized risks of this nature could have a material adverse effect on our business, financial condition and results of operations.

***We are exposed to fluctuations in the market values of our portfolio investments and in interest rates; impairment of our investments could harm our financial results.***

As of July 27, 2012, we had \$5.5 billion in cash, cash equivalents, investments and restricted cash. We invest our cash in a variety of financial instruments, consisting principally of investments in corporate bonds, money market funds and U.S. Treasury securities. These investments are subject to general credit, liquidity, market and interest rate risks, which have been exacerbated by unusual events such as the financial and credit crisis, the downgrade in the U.S.'s credit rating, and bankruptcy filings in the U.S., which have affected various sectors of the financial markets and led to global credit and liquidity issues. The fair value of these financial investments may change significantly due to events and conditions in the credit and capital markets. Any investment securities that we hold or the issues comprising such securities, could be subject to review for possible downgrade. Any downgrade in credit ratings may result in an additional decline in the estimated fair value of our investments. Changes

## Edgar Filing: NetApp, Inc. - Form 10-Q

in the various assumptions used to value these securities and any increase in the markets perceived risk associated with such investments may also result in a decline in estimated fair value.

Investments in both fixed rate and floating rate interest earning instruments carry a degree of interest rate risk. Fixed rate debt securities may have their market value adversely impacted due to a rise in interest rates, while floating rate securities may produce less income than expected if interest rates fall. Due in part to these factors, our future investment income may fall short of expectations due to changes in interest rates. Currently, we do not use derivative financial instruments in our investment portfolio. We may suffer losses if forced to sell securities that have experienced a decline in market value because of changes in interest rates.

In addition, we hold investments in auction rate securities (ARSs) with a par value of \$50.6 million and a fair value of \$46.3 million, which are securities with long-term nominal maturities. All of our ARSs are backed by pools of student loans guaranteed by the U.S. Department of Education, and we believe the credit quality of these securities is high, based on this guarantee.

---

## **Table of Contents**

We have classified all of our ARSs as other non-current assets in our consolidated balance sheet as of July 27, 2012 as our ability to liquidate such securities in the next 12 months is uncertain. Although we currently have the ability and intent to hold these ARS investments until recovery in market value or until maturity, if current market conditions deteriorate, or the anticipated recovery in market values does not occur, we may be required to record additional impairment charges in future periods.

On occasion, we make strategic investments in other companies which may decline in value and/or not meet desired objectives. The success of these investments depends on various factors over which we may have limited or no control.

In the event of adverse conditions in the credit and capital markets, our investment portfolio may be impacted and our results of operations or financial condition could be adversely impacted.

***We are exposed to the credit and non-payment risk of our customers, resellers, and distributors, especially during times of economic uncertainty and tight credit markets, which could result in material losses.***

Most of our sales to customers are on an open credit basis, with typical payment terms of 30 days. While we monitor individual customer payment capability in granting such open credit arrangements, and seek to limit such open credit to amounts we believe are reasonable, we may experience losses due to a customer's inability to pay.

Beyond our open credit arrangements, some of our customers have entered into recourse and nonrecourse financing leasing arrangements using third-party leasing companies. Under the terms of recourse leases, which are generally three years or less, we remain liable for the aggregate unpaid remaining lease payments to the third-party leasing companies in the event of end-user customer default.

We expect demand for customer financing to continue. During periods of economic uncertainty, our exposure to credit risks from our customers increases. In addition, our exposure to credit risks of our customers may increase further if our customers and their customers or their lease financing sources are adversely affected by global economic conditions.

In the past, there have been bankruptcies by our customers to whom we had extended open credit, provided lease financing arrangements or guaranteed lease payments under full recourse lease arrangements. Such events have caused us to incur bad debt charges, in the case of financing arrangements have caused a loss of revenues, and in the case of recourse lease arrangements have caused us to make payments to third party financiers. We may be subject to similar losses in future periods. Any future losses could harm our business and have a material adverse effect on our operating results and financial condition. Additionally, to the extent that the recent turmoil in the credit markets makes it more difficult for customers to obtain open credit or lease financing, those customers' ability to purchase our products could be adversely impacted, which in turn could have a material adverse impact on our financial condition and operating results.

***A significant portion of our cash and cash equivalents are held overseas. If we are not able to generate sufficient cash domestically in order to fund our U.S. operations and strategic opportunities, and to service our debt, we may incur a significant tax liability in order to repatriate the overseas cash balances, or we may need to raise additional capital in the future.***

As of July 27, 2012, \$2.9 billion of cash, cash equivalents and short-term investments were held in foreign countries. These amounts are not freely available for dividend repatriation to the U.S. without triggering significant adverse tax consequences in the U.S. As a result, if the cash generated by our domestic operations is not sufficient to fund our domestic operations, our broader corporate initiatives such as stock repurchases, acquisitions, and other strategic opportunities, and to service our outstanding indebtedness, we may need to raise additional funds through public or private debt or equity financings, or we may need to obtain new credit facilities to the extent we choose not to repatriate our overseas cash. Such additional financing may not be available on terms favorable to us, or at all, and any new equity financings or offerings would dilute our current stockholders' ownership. Furthermore, lenders, particularly in light of the current challenges in the credit markets, may not agree to extend us new, additional or continuing credit. If adequate funds are not available, or are not available on acceptable terms, we may be forced to repatriate our foreign sources of liquidity and incur a significant tax expense or we may not be able to take advantage of strategic opportunities, develop new products, respond to competitive pressures or repay our outstanding indebtedness. In any such case, our business, operating results or financial condition could be adversely impacted.

---

## **Table of Contents**

***Our synthetic leases are off-balance sheet arrangements that could negatively affect our financial condition and operating results. In addition, we have invested substantial resources in new facilities and physical infrastructure, which will increase our fixed costs. Our operating results could be harmed if our business does not grow proportionately to our increased fixed costs.***

We have various synthetic leasing arrangements with BNP Paribas Leasing Corporation as lessor (BNPPLC) for our headquarters office buildings and land in Sunnyvale, California, as well as long-term facilities leases at various other domestic and international sites.

Our future minimum lease payments under these leases limit our flexibility in planning for, or reacting to, changes in our business by restricting the funds available for use in addressing such changes. If we are unable to grow our business and revenues proportionately to our increase in fixed costs, our operating results will be harmed. In addition, with respect to our synthetic leases, if we elect not to purchase the properties at the end of the lease term, we have guaranteed a minimum residual value of up to \$59 million to BNPPLC. If the fair value of the properties declines below their cost, our residual value guarantee would require us to pay the difference to BNPPLC, up to the residual guarantee. As of July 27, 2012, the estimated fair value of certain properties was approximately \$5 million below the cost of the properties, which we have accrued as of July 27, 2012. Any further decline in the fair value of the properties could adversely impact our financial condition and operating results.

***We are subject to restrictive and financial covenants in our synthetic lease arrangements. The restrictive covenants may restrict our ability to operate our business.***

Our ongoing extension of credit under our synthetic lease arrangements are subject to continued compliance with financial covenants. If we do not comply with these restrictive and financial covenants or otherwise default under the arrangements, we may be required to repay any outstanding amounts or repurchase the properties which are subject to the synthetic lease arrangements. If we lose access to the synthetic lease arrangements, we may not be able to obtain alternative financing on acceptable terms, which could limit our operating flexibility.

***Changes in market conditions have led, and in the future could lead, to charges related to the discontinuance of certain of our products and asset impairments.***

In response to changes in economic conditions and market demands, we may decide to strategically realign our resources and consider cost containment measures including restructuring, disposing of, or otherwise discontinuing certain products. Any decision to limit investment in, dispose of, or otherwise exit products may result in the recording of charges to earnings, including inventory and technology-related or other intangible asset write-offs, workforce reduction costs, charges relating to consolidation of excess facilities, cancellation penalties or claims from third parties who were resellers or users of discontinued products, which would harm our operating results. Our estimates with respect to the useful life or ultimate recoverability of our carrying basis of assets, including purchased intangible assets, could change as a result of such assessments and decisions. Additionally, we are required to perform goodwill impairment tests on an annual basis, and between annual tests in certain circumstances when impairment indicators exist or if certain events or changes in circumstances have occurred. Future goodwill impairment tests may result in charges to earnings, which could materially harm our operating results.

***We may need to undertake cost-reduction initiatives and restructuring initiatives in the future.***

We have previously recognized restructuring and other charges related to initiatives to realign our business strategies and resize our business in response to economic and market conditions, including those announced in February 2009 and December 2008. We may undertake future cost-reduction initiatives and restructuring plans that may adversely impact our operations, and we may not realize all of the anticipated benefits of our prior or any future restructurings.

***Our business and operations have experienced rapid growth and organizational change. If we fail to effectively manage such growth and change in a manner that preserves our reputation and the key aspects of our corporate culture, our business and operating results could be harmed.***

Due to recent organic growth and acquisitions, we have experienced, and may continue to experience, rapid growth and organizational change, which has placed, and may continue to place, significant demands on our management, operational and financial resources. We incur significant expenditures and the allocation of valuable management resources to assimilate new human resources in a manner that preserves the key aspects of our corporate culture and enables us to maintain our reputation in the marketplace. If we do not effectively manage our growth and train, retain and manage our employee base, our corporate culture could be undermined, the quality of our products and customer service could suffer, and our reputation could be harmed, each of which could adversely impact our business, financial condition and results of operations.



---

**Table of Contents**

In addition, as our headcount increases, our costs could also increase. Our business will be harmed if our efforts to expand our organization and headcount are not accompanied by a corresponding increase in revenues.

*We are continually seeking ways to make our cost structure, business processes and systems more efficient, including moving activities from higher-cost to lower-cost owned locations, outsourcing certain business process functions and implementing new business information systems. Problems with the execution of these activities could have an adverse effect on our business or results of operations.*

We continuously seek to make our cost structure and business processes more efficient. We are focused on increasing workforce flexibility and scalability, and improving overall competitiveness by leveraging our global capabilities, as well as external talent and skills worldwide. For example, certain engineering activities and projects that were formerly performed in the U.S. have been moved to lower cost international locations and we rely on partners or third-party service providers for the provision of certain customer support and service, business process functions and activities in IT, human resources and accounting.

The challenges involved with moving or outsourcing activities include executing business functions in accordance with local laws and other obligations while maintaining adequate standards, controls and procedures. We are also subject to increased business continuity risks as we increase our reliance on outsource providers. For example, we may no longer be able to exercise control over some aspects of the future development, support or maintenance of outsourced operations and processes, including the management and internal controls associated with those outsourced business operations and processes, which could adversely affect our business. If we are unable to effectively utilize or integrate and interoperate with external resources or if our partners or third-party service providers experience business difficulties or are unable to provide business services as anticipated, we may need to seek alternative service providers or resume providing these business processes internally, which could be costly and time-consuming and have a material adverse effect on our operating results. In addition, we may not achieve the expected benefits of our business process improvement initiatives.

We are currently implementing changes to our business information systems and processes and other IT initiatives. These initiatives involve a large investment of capital and resources and significant changes to our current operating processes. Failure to properly implement one or more of these initiatives, or an interruption in service or unavailability of our systems, could result in lost business and increased costs which could negatively impact our business, results of operations and cash flows.

*We are subject to risks related to the provision of employee health care benefits and recent health care reform legislation.*

We use a combination of insurance and self-insurance for workers' compensation coverage and health care plans. We record expenses under these plans based on estimates of the number and costs of expected claims, administrative costs and stop-loss premiums. These estimates are then adjusted each year to reflect actual costs incurred. Actual costs under these plans are subject to variability depending primarily upon participant enrollment and demographics, the actual number and costs of claims made and whether and how much the stop-loss insurance we purchase covers the cost of these claims. In the event that our cost estimates differ from actual costs, we could incur additional unplanned health care costs which could adversely impact our financial condition.

In March 2010, President Obama signed into law a comprehensive health care reform package. We cannot currently determine the impact that such legislation could have on our business, results of operations or financial condition.

*We depend on attracting and retaining qualified personnel. If we are unable to attract and retain such personnel, our operating results could be materially and adversely impacted.*

Our continued success depends, in part, on our ability to identify, attract, motivate and retain qualified personnel. Because our future success is dependent on our ability to continue to enhance and introduce new products, we are particularly dependent on our ability to identify, attract, motivate and retain qualified engineers with the requisite education, background and industry experience. Competition for qualified employees, particularly in Silicon Valley, can be intense. The loss of the services of a significant number of our employees, particularly our engineers, salespeople and key managers, could be disruptive to our development efforts or business relationships and could materially and adversely affect our operating results.

---

## **Table of Contents**

A component of our strategy to hire and retain personnel consists of long-term compensation in the form of equity-based grants. We face increased risk of the inability to continue to offer equity if we are unable to obtain shareholder approval in light of increased shareholder activism, heightened focus on corporate compensation practices, and increased scrutiny of the dilutive effects of such equity compensation programs. Such inability could adversely impact our ability to continue to attract and retain employees.

In addition, because of the structure of our incentive compensation plans, we may be at increased risk of losing employees at certain points in time. For example, the retention value of our compensation plans decreases after the payment of bonuses or the vesting of equity awards or other equity compensation. As a result, employees may be more likely to leave us during periods following such payments or the vesting of such awards. The loss of services of a significant number of our key employees during a short period of time could be disruptive to our product development and sales efforts and adversely impact our business relationships and operating results.

### ***Our business could be materially and adversely affected as a result of a natural disaster, terrorist acts or other catastrophic events.***

We depend on the ability of our personnel, raw materials, equipment and products to move reasonably unimpeded around the world. Any political, military, terrorism, global trade, world health or other issue that hinders this movement or restricts the import or export of materials could lead to significant business disruptions. Furthermore, any economic failure or other material disruption caused by fire, floods, hurricanes, earthquakes, volcanoes, power loss, power shortages, environmental disasters, telecommunications or business information systems failures or break-ins and similar events could also adversely affect our ability to conduct business. If such disruptions result in cancellations of customer orders or contribute to a general decrease in economic activity or corporate spending on information technology, or directly impact our marketing, manufacturing, financial and logistics functions, or impair our ability to meet our customer demands, our results of operations and financial condition could be materially adversely affected. In addition, our headquarters and one of our major data centers are located in Northern California, an area susceptible to earthquakes. If any significant disaster were to occur, our ability to operate our business could be impaired.

### ***We are exposed to various risks related to legal proceedings or claims and protection of intellectual property rights, which could adversely affect our operating results.***

We may be a party to lawsuits and other claims in the normal course of our business from time to time, including intellectual property, commercial, product liability, employment, class action, whistleblower and other litigation and claims, and governmental and other regulatory investigations and proceedings. Litigation can be expensive, lengthy and disruptive to normal business operations. Moreover, the results of complex legal proceedings are difficult to predict. An unfavorable resolution of a particular lawsuit could have a material adverse effect on our business, operating results, or financial condition.

If we are unable to protect our intellectual property, we may be subject to increased competition that could materially and adversely affect our operating results. Our success depends significantly upon our proprietary technology. We rely on a combination of copyright and trademark laws, trade secrets, confidentiality procedures, contractual provisions with employees, resellers, strategic partners and customers, and patents to protect our proprietary rights. We seek to protect our software, documentation and other written materials under trade secret, copyright and patent laws, which afford only limited protection. Some of our U.S. trademarks are registered internationally as well. We will continue to evaluate the registration of additional trademarks as appropriate. We currently have multiple U.S. and international patent applications pending and multiple U.S. patents issued. The pending applications may not be approved, and our existing and future patents may be challenged. If such challenges are brought, the patents may be invalidated. We may not be able to develop proprietary products or technologies that are patentable, and patents issued to us may not provide us with any competitive advantages and may be challenged by third parties. Further, the patents of others may materially and adversely affect our ability to do business. In addition, a failure to obtain and defend our trademark registrations may impede our marketing and branding efforts and competitive position.

Litigation may be necessary to protect our proprietary technology. Any such litigation may be time-consuming and costly. Despite our efforts to protect our proprietary rights, unauthorized parties may attempt to copy aspects of our products or obtain and use information that we regard as proprietary. In addition, the laws of some foreign countries do not protect proprietary rights to as great an extent as do the laws of the U.S. Our means of protecting our proprietary rights may not be adequate or our competitors may independently develop similar technology, duplicate our products, or design around patents issued to us or other intellectual property rights of ours.



---

**Table of Contents**

We are subject to intellectual property infringement claims. We may, from time to time, receive claims that we are infringing third parties intellectual property rights. Third parties may in the future, claim infringement by us with respect to current or future products, patents, trademarks or other proprietary rights. We expect that companies in the network storage and data management market will increasingly be subject to infringement claims as the number of products and competitors in our industry segment grows and the functionality of products in different industry segments overlaps. Any such claims could be time consuming, result in costly litigation, cause product shipment delays, require us to redesign our products or enter into royalty or licensing agreements, any of which could materially and adversely affect our operating results. Such royalty or licensing agreements, if required, may not be available on terms acceptable to us or at all.

***Our business could be materially adversely affected by changes in regulations or standards regarding energy efficiency of our products and climate change issues and environmental disclosures.***

We are subject to a variety of environmental and safety regulations governing materials usage, packaging, climate control and other environmental impacts in the various countries in which we do business. For example, various international, federal, state, and local provisions regulate the use and discharge of certain hazardous materials used in the manufacture of our products. Environmental laws are complex, change frequently, and have tended to become more stringent over time. Failure to comply with such laws and regulations in the future could cause us to incur substantial costs or subject us to business interruptions.

Recently, governmental and non-governmental organizations have turned their attention to development of regulations and standards to drive technological improvements to reduce carbon emissions. While we continuously seek to optimize the energy efficiency of our products, there is a risk that the development of these standards will not fully address the complexity of the technology developed by the IT industry or will favor certain technological approaches. Depending on the regulations or standards that are ultimately adopted, the cost of compliance could adversely affect our business, financial condition or operating results.

In addition, we are subject to provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act intended to improve transparency and accountability concerning the supply of minerals originating from the conflict zones of the Democratic Republic of Congo or adjoining countries. We may incur costs to comply with the new disclosure requirements of this law and may realize other costs relating to the sourcing and availability of minerals used in our products. Further, since our supply chain is complex, we may face reputational harm if our customers or other stakeholders conclude that we are unable to verify sufficiently the origins of the minerals used in the products we sell.

***Our business is subject to increasingly complex corporate governance, public disclosure, and accounting and tax requirements that have increased both our costs and the risk of noncompliance.***

Because our common stock is publicly traded, we are subject to certain rules and regulations of federal, state and financial market exchange entities charged with the protection of investors and the oversight of companies whose securities are publicly traded. For example, in July 2010, the President signed into law the Dodd-Frank Act. Because new and modified laws, regulations, and standards are subject to varying interpretations in many cases due to their lack of specificity, their application in practice may evolve over time as new guidance is provided by regulatory and governing bodies. This evolution may result in continuing uncertainty regarding compliance matters and additional costs necessitated by ongoing revisions to our disclosure and governance practices.

***If a data center or other third-party who relies on our products experiences a disruption in service or a loss of data, such disruption or loss could be attributed to the quality of our products, thereby causing financial or reputational harm to our business.***

Third-party vendors, including data centers, Software as a Service (SaaS), cloud computing and Internet infrastructure and bandwidth providers rely on our products for their data storage needs. We exercise little control over how these third-party vendors use or maintain our products, and in some cases improper usage or maintenance could impair the performance of our products. A disruption in the services provided by these third-party vendors, or the loss of data stored by such vendors, could result in financial or reputational harm to our business to the extent that such disruption or loss is caused by, or perceived by our customers to have been caused by, defects in our products. Moreover, the risk of reputational harm may be magnified and/or distorted through the rapid dissemination of information over the Internet, including through news articles, blogs, chat rooms, and social media sites.

**Table of Contents**

*Security and privacy breaches may expose us to liability, and our reputation and business could suffer.*

We obtain and store sensitive data related to our employees, customers and partners, including intellectual property, books of record and personally identifiable information. It is critical to our business strategy that our infrastructure remains secure and is perceived by our employees, customers and partners to be secure. If our security measures are breached as a result of technical problems, third-party actions, employee error, or malfeasance, our reputation could be damaged and our business could suffer.

*Changes in financial accounting standards may cause adverse unexpected fluctuations and affect our reported results of operations.*

A change in accounting standards or practices and varying interpretations of existing accounting pronouncements, such as the changes to revenue recognition standards that we recently adopted, the increased use of fair value measures, additional proposed changes to revenue recognition, lease accounting, financial instruments and other accounting standards, and the potential requirement that U.S. registrants prepare financial statements in accordance with International Financial Reporting Standards (IFRS), could have a significant effect on our reported financial results or the way we conduct our business.

Implementation of accounting regulations and related interpretations and policies, particularly those related to revenue recognition, could cause us to defer recognition of revenue or recognize lower revenue, which may affect our results of operations.

**Item 2. Unregistered Sales of Equity Securities and Use of Proceeds**

The following table provides information with respect to the shares of common stock repurchased by us during the three months ended July 27, 2012:

<u>Period</u>	Total Number of Shares Purchased (Shares in thousands)	Average Price Paid per Share	Approximate Dollar Value	
			Total Number of Shares Purchased as Part of Publicly Announced Program <sup>(1)</sup> (Shares in thousands)	Shares That May Yet Be Purchased Under The Repurchase Program <sup>(1)</sup> (Dollars in millions)
April 28, 2012 - May 25, 2012		\$	118,971	\$ 496.2
May 26, 2012 - June 22, 2012		\$	118,971	496.2
June 23, 2012 - July 27, 2012	4,949	\$ 30.31	123,921	346.2
Total	4,949	\$ 30.31	123,921	346.2

<sup>(1)</sup> As of July 27, 2012, our Board of Directors had authorized the repurchase of up to \$4.0 billion of our common stock under a stock repurchase program. Since the May 13, 2003 inception of this program through July 27, 2012, we repurchased a total of 123.9 million shares of our common stock at an average price of \$29.68 per share, for an aggregate purchase price of \$3.7 billion. As of July 27, 2012, the remaining authorized amount for stock repurchases under this program was \$0.3 billion with no termination date. The stock repurchase program may be suspended or discontinued at any time.

**Item 3. Defaults upon Senior Securities**

None

**Item 4. Mine Safety Disclosures**

Not Applicable.

**Item 5. Other Information**

None

**Item 6. Exhibits**

See the Exhibit Index immediately following the signature page of this Quarterly Report on Form 10-Q.

**Table of Contents**

**SIGNATURE**

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

NETAPP, INC.

(Registrant)

/S/ NICHOLAS R. NOVIELLO

Nicholas R. Noviello  
Executive Vice President and

Chief Financial Officer

Dated: August 30, 2012

**Table of Contents****EXHIBIT INDEX**

<b>Exhibit</b>	
<b>No</b>	<b>Description</b>
3.1 <sup>(1)</sup>	Certificate of Incorporation of the Company, as amended.
3.2 <sup>(2)</sup>	Bylaws of the Company.
10.1	Form of Amendment to Change of Control Severance Agreement
10.2	Form of Change of Control Severance Agreement (Non-CEO Executives)
31.1	Certification of the Chief Executive Officer pursuant to Section 302(a) of the Sarbanes-Oxley Act of 2002.
31.2	Certification of the Chief Financial Officer pursuant to Section 302(a) of the Sarbanes-Oxley Act of 2002.
32.1	Certification of Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to section 906 of the Sarbanes-Oxley Act of 2002.
32.2	Certification of Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to section 906 of the Sarbanes-Oxley Act of 2002.
101.INS*	XBRL Instance Document
101.SCH*	XBRL Taxonomy Extension Schema Document
101.CAL*	XBRL Taxonomy Calculation Linkbase Document
101.DEF*	XBRL Taxonomy Extension Definition Linkbase Document
101.LAB*	XBRL Taxonomy Label Linkbase Document
101.PRE*	XBRL Taxonomy Extension Presentation Linkbase Document

<sup>(1)</sup> Previously filed as an exhibit to the Company's Annual Report on Form 10-K dated June 24, 2008.

<sup>(2)</sup> Previously filed as an exhibit to the Company's Quarterly Report on Form 10-Q dated December 6, 2010.

\* XBRL (Extensible Business Reporting Language) information is furnished and not filed or a part of a registration statement or prospectus for purposes of sections 11 or 12 of the Securities Act of 1933, is deemed not filed for purposes of section 18 of the Securities Exchange Act of 1934, and is otherwise not subject to liability under these sections.