

F5 NETWORKS INC  
Form 10-Q/A  
December 13, 2006

**Table of Contents**

**UNITED STATES SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549  
FORM 10-Q/A**

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

**For the quarterly period ended March 31, 2006**

**OR**

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

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

**Commission File Number 000-26041**

**F5 NETWORKS, INC.**

(Exact name of registrant as specified in its charter)

**WASHINGTON**

(State or other jurisdiction of  
incorporation or organization)

**91-1714307**

(I.R.S. Employer Identification No.)

**401 Elliott Avenue West  
Seattle, Washington 98119**

(Address of principal executive offices and zip code)

**(206) 272-5555**

(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 is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer  Accelerated filer  Non-accelerated filer

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

The number of shares outstanding of the registrant's common stock as of May 5, 2006 was 40,547,825.

**Table of Contents**

**EXPLANATION OF AMENDMENT**

We are amending our Quarterly Report on Form 10-Q for the quarter ended March 31, 2006 filed on May 9, 2006 (the Original Report ) to restate our condensed consolidated financial statements for the quarters ended March 31, 2006 and 2005 and the related disclosures.

The restatement (the Restatement ) of the Original Report reflected in this Quarterly Report on Form 10-Q/A for the quarter ended March 31, 2006 this Amendment includes adjustments arising from the determinations of a Special Committee of our Board of Directors, consisting of independent members of our Board of Directors, which was formed by our Board of Directors to conduct an internal investigation into our past stock option practices.

For more information on these matters, please refer to Item 2, Management s Discussion and Analysis of Financial Condition and Results of Operations Restatement of Consolidated Financial Statements, Special Committee and Company Findings, Internal Controls, Remedial Measures and Related Proceedings, Note 2, Restatement of Previously Issued Financial Statements, of the Notes to the Consolidated Financial Statements, and Item 4, Controls and Procedures.

As a result of the findings of the Special Committee as well as our own internal review, we concluded that we needed to amend our Annual Report on Form 10-K/A No. 1 for the year ended September 30, 2005, originally filed on December 15, 2005 and amended by our Annual Report on Form 10-K/A No. 2, which was filed on December 12, 2006 to restate our consolidated financial statements for the years ended September 30, 2005, 2004 and 2003 and the related disclosures as well as Management s Report on Internal Control Over Financial Reporting as of September 30, 2005.

We have not amended and we do not intend to amend any of our other previously filed annual reports on Form 10-K or quarterly reports on Form 10-Q for the periods affected by the Restatement or adjustments other than (i) this Amendment, (ii) the amended Quarterly Report on Form 10-Q/A for the quarter ended December 31, 2005 and (iii) the amended Annual Report on Form 10-K/A No. 2 for the year ended September 30, 2005. For this reason, the condensed consolidated financial statements and related financial information contained in such previously filed reports should no longer be relied upon. Except for the sections of this Amendment entitled Restatement of Consolidated Financial Statements, Special Committee and Company Findings, Internal Controls, Remedial Measures and Related Proceedings and Risk Factors that May Affect Future Results (included in Item 2, Management s Discussion and Analysis of Financial Condition and Results of Operations ), Note 2 and 6 of the Notes to the Consolidated Financial Statements, and Item 4, Controls and Procedures, all of the information in this Amendment is as of March 31, 2006 and does not reflect events occurring after the Original Report, other than the restatement, or modify or update disclosures (including, except for the updated Exhibits 31.1, 31.2 and 32.1 described below, the exhibits to the Original Report) affected by subsequent events.

For the convenience of the reader, this Amendment sets forth the Original Report in its entirety, as amended by, and to reflect, the Restatement. The following items have been amended principally as a result of, and to reflect, the Restatement, and no other information in the Original Report is amended hereby as a result of the Restatement:

Part I Item 1 Unaudited Financial Statements;

Part I Item 2 Management s Discussion and Analysis of Financial Condition and Results of Operations and Risk Factors;

Part I Item 4 Controls and Procedures;

Part II-Item 1 Legal Proceedings

Part II Item 6 Exhibits

This Amendment should be read in conjunction with our amended Annual Report on Form 10-K/A No.2 for the year ended September 30, 2005, as well as any Current Reports filed on Form 8-K subsequent to the date of the Original Report. In addition, in accordance with applicable SEC rules, this Amendment includes updated certifications from our Chief Executive Officer (CEO) and Chief Accounting Officer (CAO) as Exhibits 31.1, 31.2 and 32.1

**F5 NETWORKS, INC.**  
**QUARTERLY REPORT ON FORM 10-Q**  
**For the Quarter Ended March 31, 2006**  
**Table of Contents**

	<b>Page</b>
<b><u>PART I. FINANCIAL INFORMATION</u></b>	4
<u>Item 1. Financial Statements (unaudited)</u>	4
<u>Consolidated Balance Sheets (as restated)</u>	4
<u>Consolidated Income Statements (as restated)</u>	5
<u>Consolidated Statement of Shareholders' Equity (as restated)</u>	6
<u>Consolidated Statements of Cash Flows (as restated)</u>	7
<u>Notes to Consolidated Financial Statements (as restated)</u>	8
<u>Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	17
<u>Item 3. Quantitative and Qualitative Disclosures About Market Risk</u>	33
<u>Item 4. Controls and Procedures</u>	33
<b><u>PART II. OTHER INFORMATION</u></b>	34
<u>Item 1. Legal Proceedings</u>	34
<u>Item 4. Submission of Matters to a Vote of Security Holders</u>	35
<u>Item 6. Exhibits</u>	36
<b><u>SIGNATURES</u></b>	37
<u>EXHIBIT 31.1</u>	
<u>EXHIBIT 31.2</u>	
<u>EXHIBIT 32.1</u>	

**Table of Contents****PART I. FINANCIAL INFORMATION****Item 1. Financial Statements**

**F5 NETWORKS, INC.**  
**CONSOLIDATED BALANCE SHEETS**  
(unaudited, in thousands)

	<b>March 31, 2006 (as restated)(1)</b>	<b>September 30, 2005 (as restated)(1)</b>
<b>ASSETS</b>		
Current assets		
Cash and cash equivalents	\$ 23,003	\$ 51,867
Short-term investments	321,003	184,314
Accounts receivable, net of allowances of \$2,309 and \$2,969	51,953	41,703
Inventories	3,024	2,699
Deferred tax assets	4,182	4,175
Other current assets	12,266	9,906
 Total current assets	 415,431	 294,664
 Restricted cash	 3,870	 3,871
Property and equipment, net	23,669	16,158
Long-term investments	76,009	128,834
Deferred tax assets	19,682	36,212
Goodwill	81,652	49,677
Other assets, net	16,674	8,323
 Total assets	 \$ 636,987	 \$ 537,739
<b>LIABILITIES AND SHAREHOLDERS EQUITY</b>		
Current liabilities		
Accounts payable	\$ 14,605	\$ 7,668
Accrued liabilities	27,325	23,931
Deferred revenue	44,256	36,009
 Total current liabilities	 86,186	 67,608
 Other long-term liabilities	 7,580	 6,650
Deferred revenue, long-term	3,650	3,314
 Total long-term liabilities	 11,230	 9,964
 Commitments and contingencies		
Shareholders' equity		
Preferred stock, no par value; 10,000 shares authorized, no shares outstanding	480,267	431,897

Edgar Filing: F5 NETWORKS INC - Form 10-Q/A

Common stock, no par value; 100,000 shares authorized, 40,388 and 38,593 shares issued and outstanding		
Accumulated other comprehensive loss	(1,684)	(1,430)
Retained earnings	60,988	29,700
Total shareholders' equity	539,571	460,167
Total liabilities and shareholders' equity	\$ 636,987	\$ 537,739

(1) See Note 2,  
Restatement of  
Previously  
Issued Financial  
Statements, of  
the Notes to  
Consolidated  
Financial  
Statements

The accompanying notes are an integral part of these consolidated financial statements.

4

---

**Table of Contents**

**F5 NETWORKS, INC.**  
**CONSOLIDATED INCOME STATEMENTS**  
(unaudited, in thousands, except per share data)

	<b>Three months ended</b>		<b>Six months ended</b>	
	<b>March 31,</b>		<b>March 31,</b>	
	<b>2006</b>	<b>2005</b>	<b>2006</b>	<b>2005</b>
		<b>(as</b>		<b>(as</b>
		<b>restated)(1)</b>		<b>restated)(1)</b>
Net revenues				
Products	\$ 72,775	\$ 53,332	\$ 141,366	\$ 99,729
Services	21,341	14,398	40,837	28,010
Total	94,116	67,730	182,203	127,739
Cost of net revenues				
Products	15,441	11,822	30,034	22,352
Services	5,846	3,915	10,820	7,310
Total	21,287	15,737	40,854	29,662
Gross profit	72,829	51,993	141,349	98,077
Operating expenses				
Sales and marketing	31,162	20,988	60,027	41,072
Research and development	12,276	7,834	22,754	14,866
General and administrative	7,148	6,341	14,545	11,832
Total	50,586	35,163	97,326	67,770
Income from operations	22,243	16,830	44,023	30,307
Other income, net	3,877	1,641	6,847	3,028
Income before income taxes	26,120	18,471	50,870	33,335
Provision for income taxes	10,053	7,507	19,582	14,033
Net income	\$ 16,067	\$ 10,964	\$ 31,288	\$ 19,302
Net income per share basic	\$ 0.40	\$ 0.30	\$ 0.79	\$ 0.53
Weighted average shares basic	40,120	36,905	39,636	36,234
Net income per share diluted	\$ 0.39	\$ 0.28	\$ 0.76	\$ 0.50
Weighted average shares diluted	41,627	38,939	41,278	38,419

(1) See Note 2,  
Restatement of

Previously  
Issued Financial  
Statements, of  
the Notes to  
Consolidated  
Financial  
Statements

The accompanying notes are an integral part of these consolidated financial statements.

5

---



Table of Contents

**F5 NETWORKS, INC.**  
**CONSOLIDATED STATEMENT OF SHAREHOLDERS EQUITY**  
(unaudited, in thousands)

	Six Months Ended March 31, 2006				
	Common Stock		Accumulated Other	Retained	Total
	Shares	Amount	Comprehensive Loss	Earnings	Shareholders Equity
<b>Balance, September 30, 2005</b>	38,593	\$ 412,419	\$ (1,430)	\$ 53,221	\$ 464,210
Cumulative effect of restatement (Note 2)		19,478		(23,521)	(4,043)
<b>Balance, September 30, 2005 (as restated)(1)</b>	38,593	431,897	(1,430)	29,700	460,167
Exercise of employee stock options	1,570	35,298			35,298
Issuance of stock under employee stock purchase plan	62	2,229			2,229
Issuance of restricted stock	163				
Stock based compensation		10,843			10,843
Net income				31,288	
Foreign currency translation adjustment			(20)		
Unrealized loss on securities			(234)		
Comprehensive income					31,034
<b>Balance, March 31, 2006 (as restated)(1)</b>	40,388	\$ 480,267	\$ (1,684)	\$ 60,988	\$ 539,571

(1) See Note 2,  
Restatement of  
Previously  
Issued Financial  
Statements, of  
the Notes to  
Consolidated  
Financial  
Statements

The accompanying notes are an integral part of these consolidated financial statements.

**Table of Contents**

**F5 NETWORKS, INC.**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**  
(unaudited, in thousands)

	<b>Six months ended</b>	
	<b>March 31,</b>	
	<b>2006</b>	<b>2005</b>
		<b>(as</b>
		<b>restated)(1)</b>
<b>Operating activities</b>		
Net income	\$ 31,288	\$ 19,302
Adjustments to reconcile net income to net cash provided by operating activities:		
Loss on disposition of assets	37	38
Stock based compensation	10,843	690
Provisions for doubtful accounts and sales returns	(397)	547
Depreciation and amortization	5,017	3,261
Deferred income taxes	18,973	(12,264)
Tax benefit from employee stock option plans		24,240
Changes in operating assets and liabilities, net of amounts acquired:		
Accounts receivable	(9,560)	(12,703)
Inventories	(258)	(398)
Other current assets	(1,736)	(1,218)
Other assets	(1,392)	(120)
Accounts payable and accrued liabilities	8,923	5,279
Deferred revenue	8,353	4,414
Net cash provided by operating activities	70,091	31,068
<b>Investing activities</b>		
Purchases of investments	(240,444)	(198,264)
Sales of investments	156,222	122,726
Investment of restricted cash	2	29
Acquisition of business, net of cash acquired	(42,778)	(395)
Purchases of property and equipment	(9,047)	(3,491)
Net cash used in investing activities	(136,045)	(79,395)
<b>Financing activities</b>		
Proceeds from the exercise of stock options and purchases of stock under employee stock purchase plan	37,077	45,125
Net cash provided by financing activities	37,077	45,125
Net decrease in cash and cash equivalents	(28,877)	(3,202)
Effect of exchange rate changes on cash and cash equivalents	13	93
Cash and cash equivalents, beginning of period	51,867	24,901
Cash and cash equivalents, end of period	\$ 23,003	\$ 21,792

- (1) See Note 2,  
Restatement of  
Previously  
Issued Financial  
Statements, of  
the Notes to  
Consolidated  
Financial  
Statements

The accompanying notes are an integral part of these consolidated financial statements.

7

---

**Table of Contents****F5 NETWORKS, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (unaudited)****1. Summary of Significant Accounting Policies****Description of Business**

F5 Networks, Inc., (the Company) provides products and services to help companies efficiently and securely manage their Internet Protocol (IP) traffic. The Company's products improve the performance, availability and security of applications running on Internet-based networks. Internet traffic between servers running applications and clients using these applications passes through the Company's products where the content is inspected to ensure that it is safe and modified as necessary to ensure that it is delivered securely and in a way that optimizes the performance of both the network and the applications. The Company also offers a broad range of services such as consulting, training, installation, maintenance, and other technical support services.

**Acquisition**

On October 4, 2005, the Company acquired all of the capital stock of Swan Labs, Inc. (Swan Labs), a privately held Delaware corporation headquartered in San Jose, California for \$43.0 million in cash. The Company also incurred \$3.2 million of direct transaction costs for a total purchase price of approximately \$46.2 million. Swan Labs provides WAN (Wide Area Network) optimization and application acceleration products and services. The addition of Swan Labs is intended to allow the Company to quickly enter the WAN optimization market, broaden the Company's customer base, and augment the Company's existing product line. Refer to Note 5, Business Combinations, for additional information related to the acquisition.

**Basis of Presentation**

In the opinion of management, the unaudited consolidated financial statements reflect all adjustments, consisting only of normal recurring adjustments, necessary for their fair statement in conformity with accounting principles generally accepted in the United States of America. Certain information and footnote disclosures normally included in annual financial statements have been condensed or omitted in accordance with the rules and regulations of the Securities and Exchange Commission. The information included in this Form 10-Q should be read in conjunction with Management's Discussion and Analysis of Financial Condition and Results of Operations and financial statements and notes thereto included in the Company's Annual Report on Form 10-K for the fiscal year ended September 30, 2005.

**Revenue Recognition**

The Company's products are integrated with software that is essential to the functionality of the equipment. Accordingly, the Company recognizes revenue in accordance with the guidance provided under Statement of Position (SOP) No. 97-2, Software Revenue Recognition, and SOP No. 98-9 Modification of SOP No. 97-2, Software Revenue Recognition, with Respect to Certain Transactions, Statement of Financial Accounting Standards (SFAS) No. 48, Revenue Recognition When Right of Return Exists, and SEC Staff Accounting Bulletin (SAB) No. 104, Revenue Recognition.

The Company sells products through distributors, resellers, and directly to end users. The Company recognizes product revenue upon shipment, net of estimated returns, provided that collection is determined to be probable and no significant obligations remain. In certain regions where the Company does not have the ability to reasonably estimate returns, the Company defers revenue on sales to our distributors until it has received information from the channel partner indicating that the distributor has sold the product to its customer. Payment terms to domestic customers are generally net 45 days. Payment terms to international customers range from net 30 to 90 days based on normal and customary trade practices in the individual markets. The Company has offered extended payment terms ranging from three to six months to certain customers, in which case, revenue is recognized when payments are received.

**Table of Contents**

Whenever a software license, hardware, installation and post-contract customer support ( PCS ), elements are sold together, a portion of the sales price is allocated to each element based on their respective fair values as determined when the individual elements are sold separately. Revenues from the license of software are recognized when the software has been shipped and the customer is obligated to pay for the software. When rights of return are present and the Company cannot estimate returns, it recognizes revenue when such rights of return lapse. Revenues for PCS are recognized on a straight-line basis over the service contract term. PCS includes rights to upgrades, when and if available, a limited period of telephone support, updates, and bug fixes. Installation revenue is recognized when the product has been installed at the customer's site. Consulting services are customarily billed at fixed rates, plus out-of-pocket expenses, and revenues are recognized when the consulting has been completed. Training revenue is recognized when the training has been completed.

**Goodwill**

Goodwill represents the excess purchase price over the estimated fair value of net assets acquired as of the acquisition date. The Company has adopted the requirements of SFAS No. 142, *Goodwill and Other Intangible Assets* (SFAS No. 142). SFAS No. 142 requires goodwill to be tested for impairment on an annual basis and between annual tests in certain circumstances, and written down when impaired. Goodwill of \$24.2 million was recorded in connection with the acquisition of uRoam, Inc. in fiscal year 2003, goodwill of \$25.5 million was recorded in connection with the acquisition of MagniFire Websystems Inc. in fiscal year 2004 and goodwill of \$32.0 million was recorded in connection with the acquisition of Swan Labs, Inc in first fiscal quarter 2006. The Company completes its annual impairment test in the second quarter of each fiscal year and when events or conditions indicate that impairment may have occurred. There was no impairment of goodwill during the three months ended March 31, 2006 and 2005, respectively.

**Stock-Based Compensation**

On July 1, 2005, the Company adopted the fair value recognition provisions of Financial Accounting Standards Board ( FASB ) Statement No. 123(R), *Share-Based Payment*, ( FAS 123R ). Prior to July 1, 2005, the Company accounted for share-based payments under the recognition and measurement provisions of APB Opinion No. 25, *Accounting for Stock Issued to Employees* ( APB 25 ), and related Interpretations, as permitted by FASB Statement No. 123, *Accounting for Stock-Based Compensation* ( FAS 123 ). In accordance with APB 25 no compensation cost was required to be recognized for options granted that had an exercise price equal to the market value of the underlying common stock on the date of grant.

The Company adopted FAS 123R using the modified-prospective-transition method. Accordingly, compensation cost recognized for the three month and six month periods ended March 31, 2006 include: a) compensation cost for all share-based payments granted prior to, but not yet vested as of July 1, 2005, based on the grant-date fair value estimated in accordance with the original provisions of FAS 123, and b) compensation cost for all share-based payments granted subsequent to July 1, 2005, based on the grant-date fair value estimated in accordance with the provisions of FAS 123R. The results for the prior periods have not been restated.

Effective July 1, 2005, the Company adopted the straight-line attribution method for recognizing compensation expense. Previously under the disclosure-only provisions of FAS 123, the Company used the accelerated method of expense recognition pursuant to FASB Interpretation No. 28, *Accounting for Stock Appreciation Rights and Other Variable Stock Option or Award Plans* ( FIN 28 ). For all unvested options outstanding as of July 1, 2005, the previously measured but unrecognized compensation expense, based on the fair value at the original grant date, will be recognized on an accelerated basis over the remaining vesting period. For share-based payments granted subsequent to July 1, 2005, compensation expense, based on the fair value on the date of grant, will be recognized on a straight-line basis over the vesting period.

The fair value of restricted stock units is based on the price of a share of our common stock on the date of grant. In determining the fair value of stock options, the Company uses the Black-Scholes option pricing model which is affected by its stock price as well as assumptions regarding a number of highly complex and subjective variables. These variables include, but are not limited to the risk free interest rate; the Company's expected stock price volatility over the term of the option and actual and projected employee stock option exercise behaviors.

The risk-free rate is based on the U.S. Treasury yield curve in effect at the time of grant. The Company does not anticipate declaring dividends in the foreseeable future. Expected volatility is based on the annualized daily historical volatility of our stock price commensurate with the expected life of the option. For the period ended March 31, 2006, the expected term of the option is based on the vesting terms of the option and a contractual life of ten years using the simplified method calculation as defined by Staff Accounting Bulletin 107. For the period ended March 31, 2005, the expected term of the option is based on an evaluation of the historical employee stock option exercise behavior, the vesting terms of the respective option and a contractual life of ten years. The Company's stock price volatility and option lives involve management's best estimates at that time, both of which impact the fair

**Table of Contents**

value of the option calculated under the Black- Scholes methodology and, ultimately, the expense that will be recognized over the life of the option. FAS 123R also requires that the Company recognize compensation expense for only the portion of options or stock units that are expected to vest. Therefore, the Company applies an estimated forfeiture rate that is derived from historical employee termination behavior. The estimated forfeiture rate in the second quarter of fiscal year 2006 is 5%. If the actual number of forfeitures differs from those estimated by management, additional adjustments to compensation expense may be required in future periods.

The following table shows the pro forma effect on the Company's net income and net income per share for the three months and six months ended March 31, 2005, had compensation expense been determined based upon the fair value at the grant date for awards consistent with the methodology prescribed by FAS 123. Stock-based compensation for the three months and six months ended March 31, 2006 has been included in statements of income. The pro forma effect may not be representative of expense in future periods since the estimated fair value of stock options on the date of grant is amortized to expense over the vesting period, and additional options may be granted or options may be cancelled in future years (in thousands, except per share data):

	<b>Three months ended March 31, 2005 (as restated)(1)</b>	<b>Six months ended March 31, 2005 (as restated)(1)</b>
Net income, as reported	\$ 10,964	\$ 19,302
Add : Stock-based employee compensation expense under APB No. 25 included in reported net income, net of tax effect	168	690
Deduct : Total stock-based employee compensation expense determined under the fair value methods, net of tax effect	(2,460)	(5,298)
Pro forma net income	\$ 8,672	\$ 14,694
Net income per share:		
As reported basic	\$ 0.30	\$ 0.53
Pro forma basic	\$ 0.23	\$ 0.41
As reported diluted	\$ 0.28	\$ 0.50
Pro forma diluted	\$ 0.22	\$ 0.38

(1) See Note 2, Restatement of Previously Issued Financial Statements, of the Notes to Consolidated Financial Statements

**Earnings Per Share**

Basic net income per share is computed by dividing net income by the weighted average number of common shares outstanding during the period. Diluted net income per share is computed by dividing net income by the weighted average number of common and dilutive common stock equivalent shares outstanding during the period.

Edgar Filing: F5 NETWORKS INC - Form 10-Q/A

The following table sets forth the computation of basic and diluted net income per share (in thousands, except per share data):

	Three months ended March 31,		Six months ended March 31,	
	2006	2005 (as restated)(1)	2006	2005 (as restated)(1)
<b>Numerator</b>				
Net income	\$ 16,067	\$ 10,964	\$ 31,288	\$ 19,302
<b>Denominator</b>				
Weighted average shares outstanding basic	40,120	36,905	39,636	36,234
Dilutive effect of common shares from stock options and restricted stock units	1,507	2,034	1,642	2,185
Weighted average shares outstanding diluted	41,627	38,939	41,278	38,419
Basic net income per share	\$ 0.40	\$ 0.30	\$ 0.79	\$ 0.53
Diluted net income per share	\$ 0.39	\$ 0.28	\$ 0.76	\$ 0.50

(1) See Note 2, Restatement of Previously Issued Financial Statements, of the Notes to Consolidated Financial Statements

Approximately 117,000 and 319,000 of common shares potentially issuable from stock options for the three months ended March 31, 2006 and 2005, respectively, are excluded from the calculation of diluted earnings per share because the exercise price was greater than the average market price of the common stock for the respective period. Approximately 246,000 and 422,000 of common shares potentially issuable from stock options for the six months ended March 31, 2006 and 2005, respectively, are excluded from the calculation of diluted earnings per share because the exercise price was greater than the average market price of the common stock for the respective period.



**Table of Contents****2. Restatement of Previously Issued Financial Statements**

On May 16, 2006, the Center for Financial Research and Analysis ( CFRA ) issued a report entitled Options Backdating, Which Companies Are At Risk? (the CFRA Report ) in which CFRA reviewed the option prices of 100 public companies and, based upon an analysis of the exercise prices of option grants with reference to the companies stock prices, concluded that 17% of the subject companies were, in CFRA s view, at risk for having backdated option grants during the period 1997 to 2002. The Company was among the 17 companies so identified.

On May 18, 2006, the Company was contacted by the Securities and Exchange Commission ( SEC ) as part of an informal inquiry entitled *In the Matter of F5 Networks, Inc.*, (SEC File No. MHO-10462). On May 19, 2006, the Company received a grand jury subpoena issued by the U.S. District Court for the Eastern District of New York requesting documents related to the granting of stock options from 1995 through the present in connection with an inquiry into the Company s stock option practices by the United States Attorney s Office for the Eastern District of New York (the Department of Justice ). The Company voluntarily produced documents in response to these requests and is continuing to cooperate fully with the SEC regarding these inquiries.

On May 22, 2006, the Company s Board of Directors (the Board of Directors ) formed a special committee of outside directors with broad authority to conduct a review of the Company s stock option practices, including a review of the Company s underlying stock option documentation and procedures (the Special Committee ). At that time, the Special Committee was composed of three members of the Board of Directors, one of which was also on the Audit Committee, Karl Guelich, Rich Malone and Gary Ames. In July 2006, the Special Committee was reconstituted to consist of two independent members of the Board of Directors, Gary Ames and Deborah Bevier (who joined the Company s Board of Directors on July 14, 2006). The Special Committee retained the law firm of Wilson Sonsini Goodrich & Rosati P.C. ( Wilson Sonsini ) as its independent outside legal counsel. Wilson Sonsini engaged Deloitte Financial Advisory Services LLP as independent accounting experts to aid in its investigation.

In the course of responding to the SEC and the Department of Justice s inquiries, the Company determined that there were potential problems with the accounting treatment of certain stock option grants. On July 20, 2006, the Company announced that the Audit Committee of the Board of Directors (the Audit Committee ) had determined, after consultation with management, that the Company s financial statements and all earnings releases and similar communications relating to fiscal periods beginning on or after October 1, 2000, the first day of its fiscal year 2001, should no longer be relied upon.

In October 2006, the Special Committee determined that the recorded grant dates for certain stock options granted during fiscal years 1999 through 2004 should not be relied upon as the measurement date for accounting purposes and that the accounting treatment used for the vesting of certain stock options was incorrect. Because the prices at the originally stated grant dates were lower than the prices on the actual measurement dates, the Company determined it should have recognized material amounts of stock-based compensation expense which were not accounted for in the Company s previously issued financial statements. Therefore, the Audit Committee after consultation with management concluded that the Company s previously filed unaudited interim and audited financial statement for the years ended September 30, 2005, 2004, 2003, 2002, 2001, 2000 and 1999 as well as the unaudited interim financial statements for the first and second quarters ended December 31, 2005 and March 31, 2006, should no longer be relied upon because these financial statements contained material misstatements and would need to be restated.

***Special Committee and Company Findings***

On November 8, 2006, the Company announced that the Special Committee had completed its review of the Company s stock option practices and reported its final findings to the Board of Directors.

The Special Committee concluded that there were options grants where the Company (i) used improper measurement dates in connection with certain annual stock option grants to employees because the number of shares certain individual employees were entitled to receive was not determined until after the original grant date, (ii) granted options to certain new employees and board members prior to their start dates, (iii) did not have sufficient documentation to support certain measurement dates and did not obtain the required approvals for stock options issued to certain individuals, (iv) did not properly account for stock option grants issued to a consultant who later became an employee, and (v) did not properly account for stock options of certain individuals that were modified after the grant date. Based on its investigations, the Special Committee concluded that it continued to have confidence in the ability

of the Company's current senior management to serve in their positions with integrity at the Company. The Special Committee was unable to reach any conclusions regarding the intent of former officers, directors and employees. Based on the Special Committee's findings, the Company has adopted and is implementing a number of remedial measures designed to improve its policies, controls, processes and procedures relating to the granting and modification of stock-based compensation and will provide additional training for personnel responsible for administration of the Company's equity compensation plans.

As a result of the Special Committee's investigation, as well as the Company's internal review of its stock option practices and historical financial statements, the Company has determined the following:

*Improper Measurement Dates for Annual Stock Option Grants.* In connection with the Company's annual stock option grants to certain employees in 2000, 2001, 2003 and 2004, the number of shares that certain individual employees were entitled to receive was not determined until after the original grant date, and therefore the measurement date for such options was subsequent to the original grant date. In addition, in connection with the Company's annual stock option grant to employees in 2000, the exercise price was not set in accordance with APB Opinion No. 25, *Accounting for Stock Issued to Employees*

**Table of Contents**

( APB 25 ) and related interpretations. As a result, the Company has restated its historical financial statements to increase stock-based compensation expense by approximately \$14.3 million recognized over the applicable vesting periods.

*Improper Measurement Dates for Other Stock Option.* Certain options to new employees and board members were granted on dates other than their respective start date with us. As a result, the Company has restated its historical financial statements to increase stock-based compensation expense by approximately \$1.3 million recognized over the applicable vesting periods.

*Incomplete Documentation or Approval for Stock Option Grants.* In 2000 and 2001 the Company did not have sufficient documentation to support certain measurement dates and did not obtain the required approvals for stock options issued to certain individuals. As a result, the Company has restated its historical financial statements to increase stock-based compensation expense by approximately \$4.6 million recognized over the applicable vesting periods.

*Stock Options Grants to Non-employees.* In 2000, the Company did not properly account for stock option grants issued to a consultant who later became an employee. The Company erroneously accounted for the grant in accordance with APB No. 25 rather than FASB Statement No. 123, *Accounting for Stock-Based Compensation* ( FAS 123 ) and related interpretations. As a result, the Company has restated its historical financial statements to increase stock-based compensation expense by approximately \$3.0 million.

*Modifications to Stock Option Grants.* From 1999 through 2002, the Company did not properly account for stock options for certain individuals that were modified after the grant date. Some of these modifications were not identified in the Company's financial reporting processes and were therefore not properly reflected in its financial statements. As a result, the Company has restated its historical financial statements to increase stock-based compensation expense by approximately \$843,000 recognized as of the date of the respective modifications.

As a result of the above, the Company has recorded additional non-cash stock-based compensation expense of approximately \$24.1 million on stock option grants made from 1999 through 2004. In addition, the Company recorded approximately \$1.7 million of additional compensation expense in 2005 related to its obligation under pre-existing commitments to reimburse employees for penalties incurred resulting from receipt of in-the-money option grants. Tax impacts of these additional expenses include; a reclassification of windfall tax benefits of \$4.8 million which were previously recognized in paid-in-capital and now are required to be recognized as a tax benefit and additional tax expenses resulting from non-deductible employee compensation of \$2.5 million, which together result in a net benefit of \$2.3 million.

As a result of these findings the Company's restated consolidated financial statements reflect a decrease in net income of approximately \$23.5 million for the periods 1999 through 2005. These charges had no impact on the Company's reported net sales or cash and cash equivalents.

The cumulative effect of the restatement adjustments on the Company's consolidated balance sheet at September 30, 2005 resulted in a decrease in retained earnings of \$23.5 million partially offset an increase in additional paid-in capital of \$19.5 million, which results in a net decrease in total shareholders' equity of \$4.0 million. All of the restatements of financial statements, financial data and related disclosures described in these Consolidated Financial Statements are collectively referred to elsewhere in these Consolidated Financial Statements as the restatement.

For explanatory purposes, the Company has classified the stock-based compensation and other adjustments that were affected by the restatement into the aforementioned categories as presented below. The classified amounts involve certain subjective judgments by management to the extent particular stock option related accounting errors may fall within more than one category to avoid double counting the adjustment amounts between categories (e.g., a stock option that is subject to date changes and/or combined with expenses resulting from consulting, transition or

advisory roles). As such, the table below should be considered a reasonable representation of the magnitude of expenses in each category.

**Table of Contents**

<b>Adjustments to Stock Based Compensation by Category</b>	<b>Years Ended September 30,</b> <b>(in thousands)</b>			<b>Cumulative effect 1999-2002</b>
	<b>2005</b>	<b>2004</b>	<b>2003</b>	
Improper measurement dates for annual stock option grants	\$ 464	\$ 719	\$ 1,407	\$ 11,717
Modifications to stock option grants	335	356	152	
Incomplete documentation or approval for stock option grants				4,625
Improper measurement dates for other stock option grants	34	107	272	904
Stock option grants to non-employees				2,988
Total adjustment to income before income taxes	833	1,182	1,831	20,234
Payroll related liabilities	1,700			
Total adjustments to net income	2,533	1,182	1,831	20,234
Income tax impact of restatement adjustments	2,298	(4,557)		
Total adjustments to net income	\$ 4,831	\$ (3,375)	\$ 1,831	\$ 20,234

The following tables set forth the effects of the restatement on certain line items within the Company's consolidated statements of operations for the three and six months ended March 31, 2005, and the consolidated balance sheets as of March 31, 2006 and September 30, 2005 (in thousands):

	<b>Three months ended March 31, 2005</b>	<b>Six months ended March 31, 2005</b>
<b>Consolidated Statement of Operations:</b>		
Cost of revenues product		
As previously reported	\$ 11,820	\$ 22,348
As restated	\$ 11,822	\$ 22,352
Cost of revenues services		
As previously reported	\$ 3,908	\$ 7,294
As restated	\$ 3,915	\$ 7,310
Gross Profit		
As previously reported	\$ 52,002	\$ 98,097
As restated	\$ 51,993	\$ 98,077
Sales and marketing		
As previously reported	\$ 20,885	\$ 40,525
As restated	\$ 20,988	\$ 41,072
Research and development		
As previously reported	\$ 7,789	\$ 14,763
As restated	\$ 7,834	\$ 14,866
General and administrative		
As previously reported	\$ 5,854	\$ 10,860
As restated	\$ 6,341	\$ 11,832
Income from operations		
As previously reported	\$ 17,474	\$ 31,949

Edgar Filing: F5 NETWORKS INC - Form 10-Q/A

As restated	\$ 16,830	\$ 30,307
Income before income taxes		
As previously reported	\$ 19,115	\$ 34,977
As restated	\$ 18,471	\$ 33,335
Provision for income taxes		
As previously reported	\$ 7,003	\$ 12,872
As restated	\$ 7,507	\$ 14,033
Net income		
As previously reported	\$ 12,112	\$ 22,105
As restated	\$ 10,964	\$ 19,302
Basic net income per share		
As previously reported	\$ 0.33	\$ 0.61
As restated	\$ 0.30	\$ 0.53
Diluted net income per share		
As previously reported	\$ 0.31	\$ 0.58
As restated	\$ 0.28	\$ 0.50

**Table of Contents**

	<b>As of March 31, 2006</b>	<b>As of September 30, 2005</b>
<b>Consolidated Balance Sheet:</b>		
Deferred tax asset		
As previously reported	\$ 3,942	\$ 3,935
As restated	\$ 4,182	\$ 4,175
Accrued liabilities		
As previously reported	\$ 23,042	\$ 19,648
As restated	\$ 27,325	\$ 23,931
Common stock		
As previously reported	\$ 460,789	\$ 412,419
As restated	\$ 480,267	\$ 431,897
Retained earnings		
As previously reported	\$ 84,509	\$ 53,221
As restated	\$ 60,988	\$ 29,700
Shareholders equity		
As previously reported	\$ 543,614	\$ 464,210
As restated	\$ 539,571	\$ 460,167

These adjustments, along with the stock-based items referenced above, did not affect the Company's previously reported cash and cash equivalents and investments balances in prior periods. In addition, these adjustments had no impact on reported net cash flows from operating activities.

The following table sets forth the impact of the restatement on the pro forma effect on the Company's net income and net income per share for the quarter ended March 31, 2005, had compensation expense been determined based upon the fair value at the grant date for awards consistent with the methodology prescribed by SFAS 123 (in thousands, except per share data):

	<b>Three months ended March 31, 2005</b>	<b>Six months ended March 31, 2005</b>
Pro forma net income		
As previously reported	\$ 9,721	\$ 16,968
As restated	\$ 8,672	\$ 14,694
Pro forma net income per share basic		
As previously reported	\$ 0.26	\$ 0.47
As restated	\$ 0.23	\$ 0.41
Pro forma net income per share diluted		
As previously reported	\$ 0.25	\$ 0.44
As restated	\$ 0.22	\$ 0.38

### **3. Commitments and Contingencies**

#### **Guarantees and Product Warranties**

In the normal course of business to facilitate sales of the Company's products, the Company indemnifies other parties, including customers, resellers, lessors, and parties to other transactions with them, with respect to certain matters. The Company has agreed to hold the other party harmless against losses arising from a breach of representations or covenants, or out of intellectual property infringement or other claims made against certain parties. These agreements may limit the time within which an indemnification claim can be made and the amount of the claim.

In addition, the Company has entered into indemnification agreements with the Company's officers and directors, and the Company's bylaws contain similar indemnification obligations to the Company's agents. It is not possible to determine the maximum potential amount under these indemnification agreements due to the limited history of prior indemnification claims and the unique facts and circumstances involved in each particular agreement.

The Company generally offers warranties of one year for hardware with the option of purchasing additional warranty coverage in increments of one year. The Company accrues for warranty costs as part of its cost of sales based on associated material product costs and technical support labor costs. The following table summarizes the activity related to product warranties during the three months ended March 31, 2006 and 2005 (in thousands):

	<b>Three months ended</b>		<b>Six months ended</b>	
	<b>March 31,</b>		<b>March 31,</b>	
	<b>2006</b>	<b>2005</b>	<b>2006</b>	<b>2005</b>
Balance, beginning of period	\$ 1,575	\$ 1,062	\$ 1,565	\$ 1,062
Provision for warranties issued	320	272	700	538
Payments	(313)	(271)	(683)	(537)
Balance, end of period	\$ 1,582	\$ 1,063	\$ 1,582	\$ 1,063

### **Purchase Commitments**

The Company currently has arrangements with contract manufacturers and other suppliers for the manufacture of the Company's products. The arrangement with the primary contract manufacturer allows them to procure component inventory on the Company's behalf based on a rolling production forecast provided by the Company. The Company is obligated to the purchase of component inventory that the contract manufacturer procures in accordance with the forecast, unless they give notice of order cancellation in advance of applicable lead times. As of March 31, 2006, the Company was committed to purchase approximately \$16.3 million of such inventory during the next quarter.

### **Legal Proceedings**

*Internal Revenue Service Audit.* We received a notice from the Internal Revenue Service (the IRS) indicating the IRS would be auditing our tax returns for the 2002, 2003, and 2004. We have produced documents and other information to the IRS and are currently in discussions with the IRS to resolve all issues arising from this audit. We do not believe this audit and any settlement with the IRS will have a material adverse impact on our consolidated financial position or results of operations.



**Table of Contents**

*Derivative Suits.* On May 24, 2006, a shareholder action captioned Adams v. Amdahl et al. was filed against certain of our current and former officers and directors in the King County Superior Court in Washington. The complaint generally alleges that the defendants breached their fiduciary duties to us in connection with the granting of certain stock options. Five additional shareholder derivative complaints, based on substantially the same allegations, were subsequently filed in the Washington federal and state courts. Although litigation is subject to inherent uncertainties, we do not believe the results of these pending actions will, individually or in the aggregate, have a material adverse impact on our consolidated financial position or results of operations.

*Nasdaq Delisting.* On July 20, 2006 we announced that it would be unlikely that the Special Committee's review would be completed in time for us to file our Form 10-Q for the quarter ended June 30, 2006, by the SEC's deadline of August 14, 2006. In August 2006, we failed to timely file our Form 10-Q for the period ended June 30, 2006 as a result of the ongoing Special Committee investigation. On August 14, 2006, we received a written Staff Determination Notice from The Nasdaq Stock Market (Nasdaq) stating that we are not in compliance with Nasdaq's Marketplace Rule 4310(c)(14) because we have not timely filed our Quarterly Report on Form 10-Q for the quarter ended June 30, 2006, and that, therefore, our securities are subject to delisting. On August 18, 2006, we appealed Nasdaq's Staff's delisting determination to the Nasdaq Listings Qualification Panel (Panel) and requested an oral hearing before the Panel. On August 23, 2006, Nasdaq's Staff stayed the delisting action pending a final written decision on our appeal by the Panel. A hearing before the Panel occurred on September 22, 2006. On November 28, 2006, the Company's received notice that the Panel had granted our request for continued listing on the Nasdaq Global Market, subject to certain conditions the Company expects to satisfy within the time period requested by the Panel.

As of March 31, 2006, the Company was not aware of any other pending legal proceedings, other than that mention above that, individually or in the aggregate, would have a material adverse effect on the Company's business, operating results, or financial condition. The Company may in the future be party to litigation arising in the ordinary course of business, including claims that allegedly infringe upon third-party trademarks or other intellectual property rights. Such claims, even if not meritorious, could result in the expenditure of significant financial and managerial resources.

**4. Geographic Sales and Significant Customers**

Operating segments are defined as components of an enterprise for which separate financial information is available and evaluated regularly by the chief operating decision-maker, or decision-making group, in deciding how to allocate resources and in assessing performance. The Company is organized as, and operates in, one reportable segment: the development, marketing and selling of a comprehensive suite of application networking solutions that helps customers efficiently and securely manage application traffic on their Internet-based networks. The Company manages its business based on four geographic regions: the Americas (primarily the United States); Europe, the Middle East, and Africa (EMEA); Japan; and Asia Pacific. The Company's chief operating decision-making group reviews financial information presented on a consolidated basis accompanied by information about revenues by geographic region. The Company's foreign offices conduct sales, marketing and support activities. The Company's management evaluates performance based primarily on revenues in the geographic locations in which it operates. Revenues are attributed by geographic location based on the location of the customer. The Company's assets are primarily located in the United States and not allocated to any specific region. Therefore, geographic information is presented only for net product revenue.

The following presents revenues by geographic region (in thousands):

	Three months ended		Six months ended	
	March 31,		March 31,	
	2006	2005	2006	2005
Americas	\$ 52,549	\$ 37,479	\$ 104,754	\$ 72,676
EMEA	16,787	10,702	31,903	21,736
Japan	14,602	12,283	25,915	20,882
Asia Pacific	10,178	7,266	19,631	12,445

\$ 94,116      \$ 67,730      \$ 182,203      \$ 127,739

Net revenues from international customers are primarily denominated in U.S. dollars and totaled \$41.6 million and \$30.3 million for the three months ended March 31, 2006 and 2005, respectively, and \$77.4 and \$55.1 million for the six months ended March 31, 2006 and 2005, respectively. Two domestic distributors accounted for 24.3% and 24.4% of total net revenue for the three and six month periods ended March 31, 2006, respectively. One domestic distributor accounted for 17.8% and 16.9% of total net revenue for the three and six month periods ended March 31, 2005, respectively. One domestic distributor accounted for 10.7% and 24.8% of accounts receivable as of March 31, 2006 and 2005, respectively.

**Table of Contents****5. Business Combinations**

On October 4, 2005, the Company acquired all of the capital stock of Swan Labs, a privately held Delaware corporation headquartered in San Jose, California for \$43.0 million in cash. The Company also incurred \$3.2 million of direct transaction costs for a total purchase price of approximately \$46.2 million. As a result of the merger, the Company acquired all the assets of Swan Labs, all property, equipment and other assets that Swan Labs used in its business and assumed all the liabilities of Swan Labs. Swan Labs provides WAN (Wide Area Network) optimization and application acceleration products and services. The addition of Swan Labs is intended to allow us to quickly enter the WAN optimization market, broaden the Company's customer base, and augment the Company's existing product line. The results of operations of Swan Labs have been included in the Company's consolidated financial statements from the date of acquisition.

The Company accounted for the acquisition under the purchase method of accounting in accordance with Statement of Financial Accounting Standards No. 141, Business Combinations. The total purchase price is allocated to the tangible and intangible assets acquired and the liabilities assumed based on their estimated fair values. The excess of the purchase price over those fair values is recorded as goodwill. The fair value assigned to the tangible and intangible assets acquired and liabilities assumed are based on estimates and assumptions provided by management, and other information compiled by management, including independent valuations, prepared by valuation specialists that utilize established valuation techniques appropriate for the technology industry. In accordance with Statement of Financial Accounting Standards No. 142, Goodwill and Other Intangible Assets, goodwill is not amortized but instead is tested for impairment at least annually.

The purchase price allocation is as follows (in thousands):

**Assets acquired**

Cash	\$ 3,448
Fair value of tangible assets	1,497
Deferred tax assets, net	2,341
Developed technology and customer relationships	8,589
Goodwill	31,975
 Total assets acquired	 \$ 47,850

**Liabilities assumed**

Accrued liabilities	\$ (1,405)
Deferred revenue	(229)
 Total liabilities assumed	 (1,634)
 Net assets acquired	 \$ 46,216

Of the total estimated purchase price, \$8.0 million and \$0.6 million was allocated to developed technology and customer relationships, respectively. To determine the value of the developed technology, a combination of cost and market approaches were used. The cost approach required an estimation of the costs required to reproduce the developed technology. The market approach measures the fair value of the technology through an analysis of recent comparable transactions. To determine the value of customer relationships, the income approach was used. The income approach estimates the fair value based on the earnings and cash flow capacity of an asset. The \$8.6 million allocated to developed technology and customer relationships will be amortized on a straight-line basis over an estimated useful life of five years.

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

The statements contained below that are not purely historical are forward-looking statements within the meaning of Section 21E of the Securities Exchange Act of 1934 and Section 27A of the Securities Act of 1933. These statements include, but are not limited to, statements about our plans, objectives, expectations, strategies, intentions or other characterizations of future events or circumstances and are generally identified by the words expects, anticipates, intends, plans, believes, seeks, estimates, and similar expressions. Because these forward-looking statements are subject to a number of risks and uncertainties, our actual results could differ materially from those expressed or implied by these forward-looking statements. Factors that could cause or contribute to such differences include, but are not limited to, those discussed under the heading Risk Factors that May Affect Future Results below and in other documents we file from time to time with the Securities and Exchange Commission. All forward-looking statements set forth below are based on information available to us on the date hereof. Our business and the associated risks may have changed since the date this report was filed with the SEC. We assume no obligation to update any such forward-looking statements. Further, except for the forward-looking statements included in Item 4, Controls and Procedures and under the heading Restatement of Consolidated Financial Statements, Special Committee and Company Findings, Internal Controls, Remedial Measures and Related Proceedings and Risk Factors that May Affect Future Results under this Item 2, all forward-looking statements contained in this Amendment, unless they are specifically otherwise stated to be made as of a different date, are made as of May 9, 2006, the original filing date of our Quarterly Report on Form 10-Q for the quarter ended March 31, 2005. In addition, except for the sections of this Amendment entitled Restatement of Consolidated Financial Statements, Special Committee and Company Findings, Internal Controls, Remedial Measures and Related Proceedings and Risk Factors that May Affect Future Results (included in this Item 2), Item 4, Controls and Procedures, and Note 2 and Note 6 of the Notes to Condensed Consolidated Financial Statements, this Amendment does not reflect events occurring after the filing of our Quarterly Report on Form 10-Q filed on May 9, 2006, other than the Restatement, and we undertake no obligation to update the forward-looking statements in this Amendment.

The discussion and analysis set forth below in this Item 2 has been amended to reflect the restatement as described above in the Explanation of Amendment to this Amendment and in Note 2, Restatement of Previously Issued Financial Statements, to the Notes to Consolidated Financial Statements. For this reason, the data set forth in this section may not be comparable to discussions and data in our previously filed Quarterly Reports.

**Restatement of Consolidated Financial Statements, Special Committee and Company Findings, Internal Controls, Remedial Measures and Related Proceedings*****Restatement of Consolidated Financial Statements***

On May 16, 2006, the Center for Financial Research and Analysis (CFRA) issued a report entitled Options Backdating, Which Companies Are At Risk? (the CFRA Report) in which CFRA reviewed the option prices of 100 public companies and, based upon an analysis of the exercise prices of option grants with reference to the companies stock prices, concluded that 17% of the subject

**Table of Contents**

companies were, in CFRA's view, at risk for having backdated option grants during the period 1997 to 2002. We were among the 17 companies so identified.

On May 18, 2006, we were contacted by the Securities and Exchange Commission (SEC) as part of an informal inquiry entitled *In the Matter of F5 Networks, Inc.* (SEC File No. MHO-10462). On May 19, 2006, we received a grand jury subpoena issued by the U.S. District Court for the Eastern District of New York requesting documents related to the granting of stock options from 1995 through the present in connection with an inquiry into our stock option practices by the United States Attorney's Office for the Eastern District of New York (the Department of Justice). We produced documents in response to these requests and are continuing to cooperate fully with the SEC regarding these inquiries.

On May 22, 2006, our Board of Directors formed a special committee of outside directors with broad authority to conduct a review of our stock option practices, including a review of our underlying stock option documentation and procedures (the Special Committee). The Special Committee was originally composed of three members of our Board of Directors, one of which was also on the Audit Committee, Karl Guelich, Rich Malone and Gary Ames. In July 2006, the Special Committee was reconstituted to consist of two independent members of our Board of Directors, Gary Ames and Deborah Bevier (who joined our Board of Directors on July 14, 2006). The Special Committee retained the law firm of Wilson Sonsini Goodrich & Rosati P.C. (Wilson Sonsini) as its independent outside legal counsel. Wilson Sonsini engaged Deloitte Financial Advisory Services LLP as independent accounting experts to aid in its investigation.

In the course of responding to the SEC and the Department of Justice's inquiries, we determined that there were potential problems with the accounting treatment of certain stock option grants. On July 20, 2006, we announced that the Audit Committee of our Board of Directors (the Audit Committee) had determined, after consultation with management, that our financial statements and all earnings releases and similar communications relating to fiscal periods beginning on or after October 1, 2000, the first day of our fiscal year 2001, should be restated.

In October 2006, the Special Committee determined that the recorded grant dates for certain stock options granted during fiscal years 1999 through 2004 should not be relied upon as the measurement date for accounting purposes and that the accounting treatment used for the vesting of certain stock options was incorrect. Because the prices at the originally stated grant dates were lower than the prices on the actual dates of determination, we determined we should have recognized material amounts of stock-based compensation expense which were not accounted for in our previously issued financial statements. Therefore, the Audit Committee after consultation with management, concluded that our previously filed unaudited interim and audited financial statement for the years ended September 30, 2005, 2004, 2003, 2002, 2001, 2000 and 1999, as well as the unaudited interim financial statements for the quarters ended December 31, 2005 and March 31, 2006, should be restated relied upon because these financial statements contained material misstatements and would need to be restated.

***Special Committee and Company Findings***

On November 8, 2006, we announced that the Special Committee had completed its review of our stock option practices and reported its final findings to our Board of Directors.

The Special Committee concluded that there were options where the Company (i) used improper measurement dates in connection with certain annual stock option grants to employees because the number of shares certain individual employees were entitled to receive was not determined until after the original grant date, (ii) granted options to certain new employees and board members prior to their start dates, (iii) did not have sufficient documentation to support certain measurement dates and did not obtain the necessary approvals for stock options issued to certain individuals, (iv) did not properly account for stock option grants issued to a consultant who later became an employee, and (v) did not properly account for stock options of certain individuals that were modified after the grant date. Based on its investigation, the Special Committee concluded that it continued to have confidence in the ability of the Company's current senior management to serve in their positions with integrity at the Company. The Special Committee was unable to reach any conclusions regarding the intent of former officers, directors and employees. Based on the Special Committee's findings, the Company has adopted and is implementing a number of remedial measures designed to improve its policies, controls, processes and procedures relating to the granting and modification of stock-based compensation and will provide additional training for personnel responsible for administration of the

Company's equity compensation plans.

As a result of the Special Committee's investigation, as well as our internal review of our stock option practices and historical financial statements, we have determined the following:

*Improper Measurement Dates for Annual Stock Option Grants.* In connection with our annual stock option grants to some employees in 2000, 2001, 2003 and 2004, the number of shares that certain individual employees were entitled to receive was not determined until after the original grant date, and therefore the measurement date for such options was subsequent to the original grant date. In addition, in connection with our annual stock option grant to employees in 2000, the exercise price was not set in accordance with APB Opinion No. 25, *Accounting for Stock Issued to Employees* ( APB 25 ) and related interpretations. As a result, we have restated our historical financial statements to increase stock-based compensation expense by approximately \$14.3 million recognized over the applicable vesting periods.

*Improper Measurement Dates for Other Stock Option Grants.* Certain options to new employees and board members were granted on dates other than their respective start date with us. As a result, we have restated our historical financial statements to increase stock-based compensation expense by approximately \$1.3 million recognized over the applicable vesting periods.

*Incomplete Documentation or Approval for Stock Option Grants.* In 2000 and 2001, we did not have sufficient documentation to support certain measurement dates and did not obtain the required approvals for stock options issued to certain individuals. As a result, we have restated

**Table of Contents**

our historical financial statements to increase stock-based compensation expense by approximately \$4.6 million recognized over the applicable vesting periods.

*Stock Options Grants to Non-employees.* In 2000, we did not properly account for stock option grants issued to a consultant who later became an employee. We accounted for the grants in accordance with APB No. 25 rather than FASB Statement No. 123, *Accounting for Stock-Based Compensation* ( FAS 123 ) and related interpretations. As a result, we have restated our historical financial statements to increase stock-based compensation expense by approximately \$3.0 million.

*Modifications to Stock Option Grants.* From 1999 through 2002, we did not properly account for stock options for certain individuals that were modified after the grant date. Some of these modifications were not identified in our financial reporting processes and were therefore not properly reflected in our financial statements. As a result, we have restated our historical financial statements to increase stock-based compensation expense by approximately \$843,000 recognized as of the date of the respective modifications.

As a result of the above, we have recorded additional non-cash stock-based compensation expense of approximately \$24.1 million on stock option grants made from 1999 through 2004. In addition, the Company recorded approximately \$1.7 million of additional compensation expense in 2005 related to its obligation under pre-existing commitments to reimburse employees for penalties incurred resulting from receipt of in-the-money option grants. As a result of the previously mentioned Restatement, additional tax related expenses include; a reclassification of windfall tax benefits of \$4.8 million which were previously recognized in paid-in-capital and now are required to be recognized as a tax benefit and additional tax expenses resulting from non-deductible employee compensation of \$2.5 million which resulted in a net benefit of \$2.3 million.

As a result of these findings our restated consolidated financial statements reflect a decrease in net income of approximately \$23.5 million for the periods 1999 through 2005. These charges had no impact on our reported net sales or cash and cash equivalents.

The cumulative effect of the restatement adjustments on our consolidated balance sheet at September 30, 2005 resulted in a decrease in retained earnings of \$23.5 million partially offset by an increase in additional paid-in capital of \$19.5 million, which results in a net decrease in total shareholders' equity of \$4.0 million.

## **Table of Contents**

### ***Internal Controls***

Based on the definition of material weakness in the Public Company Accounting Oversight Board's Auditing Standard No. 2, An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements, the restatement of financial statements in prior filings with the SEC is a strong indicator of the existence of a material weakness in the design or operation of internal control over financial reporting. Based on this definition, management has concluded the issues identified above resulted in a material weakness in our internal control over financial reporting for stock-based compensation as of September 30, 2005 and has disclosed this to the Audit Committee and to our independent registered public accountants. A further discussion of this material weakness, as well as management's remedial measures regarding this material weakness, is set forth in Item 4, Controls and Procedures.

### ***Remedial Measures***

In connection with the conclusion of its review, the Special Committee recommended that our Board of Directors, and its compensation and audit committees, consider and adopt certain additional remedial measures related to the issues raised in the Special Committee's investigation, including:

A best practices review and evaluation of our equity compensation controls, processes and procedures;

A best practices review and evaluation of our controls, process and procedures for documentation of corporate actions, including drafting and finalizing minutes, unanimous written consents and other similar corporate documentation;

The adoption of a policy requiring that all equity compensation awards to the board members, officers and employees be granted and priced according to a predetermined schedule; and

The implementation of a cross-functional training program for certain key employees concerning (i) our equity compensation programs and related improvements to equity compensation controls, processes and procedures; (ii) the accounting implications of our equity compensation programs; and (iii) the legal implications our equity compensation programs.

In addition, at the recommendation of the Special Committee, we have identified and hired an interim general counsel to replace our previous general counsel, who has tendered her resignation.

Management along with our Board of Directors has implemented, or is in the process of implementing, such remedial measures.

### ***Related Proceedings***

*Internal Revenue Service Audit.* We received a notice from the Internal Revenue Service (the IRS) indicating the IRS would be auditing our tax returns for the 2002, 2003, and 2004. We have produced documents and other information to the IRS and are currently in discussions with the IRS to resolve all issues arising from this audit. We do not believe this audit and any settlement with the IRS will have a material adverse impact on our consolidated financial position or results of operations.

*Derivative Suits.* On May 24, 2006, a shareholder action captioned Adams v. Amdahl et al. was filed against certain of our current and former officers and directors in the King County Superior Court in Washington. The complaint generally alleges that the defendants breached their fiduciary duties to us in connection with the granting of certain stock options. Five additional shareholder derivative complaints, based on substantially the same allegations, were subsequently filed in the Washington federal and state courts. Although litigation is subject to inherent uncertainties, we do not believe the results of these pending actions will, individually or in the aggregate, have a material adverse impact on our consolidated financial position or results of operations.

*Nasdaq Delisting.* On July 20, 2006 we announced that it would be unlikely that the Special Committee's review would be completed in time for us to file our Form 10-Q for the quarter ended June 30, 2006, by the SEC's deadline of August 14, 2006. In August 2006, we failed to timely file our Form 10-Q for the period ended June 30, 2006 as a result of the ongoing Special Committee investigation. On August 14, 2006, we received a written Staff Determination Notice from Nasdaq stating that we are not in compliance with Nasdaq's Marketplace Rule 4310(c)(14) because we



have not timely filed our Quarterly Report on Form 10-Q for the quarter ended June 30, 2006, and that, therefore, our securities are subject to delisting. On August 18, 2006, we appealed Nasdaq's Staff's delisting determination to the Panel and requested an oral hearing before the Panel. On August 23, 2006, Nasdaq's Staff stayed the delisting action pending a final written decision on our appeal by the Panel. A hearing before the Panel occurred on September 22, 2006. On November 28, 2006, we received notice that the Panel had granted our request for continued listing on the Nasdaq Stock Market, subject to certain conditions we expect to satisfy within the time period requested by the Panel.

**Table of Contents**

There is no assurance that we will not be subject to inquiries related to our stock option grant practices by other federal, state or foreign regulatory agencies.

*Cost of Related Proceedings and Restated Financial Statements.* We have incurred substantial expenses for legal, accounting, tax and other professional services in connection with the Special Committee investigation, our internal review of our historical stock option practices and financial statements, the preparation of the restated financial statements, the SEC and Department of Justice investigation and inquiries from other government agencies, and the related derivative litigation. We estimate these expenses were approximately \$7.0 million in aggregate through the quarter ended September 30, 2006.

**Overview**

We are a global provider of software and hardware products and services that help companies efficiently and securely manage their Internet traffic. Our products enhance the delivery, optimization and security of application traffic on Internet-based networks. We market and sell our products primarily through indirect sales channels in the Americas (primarily the United States); Europe, the Middle East, and Africa (EMEA); Japan; and the Asia Pacific region. Enterprise customers (Fortune 1000 or Business Week Global 1000 companies) in financial services, transportation, government and telecommunications industries continue to make up the largest percentage of our customer base.

Our management monitors and analyzes a number of key performance indicators in order to manage our business and evaluate our financial and operating performance. Those indicators include:

*Revenues.* The majority of our revenues are derived from sales of our Application Security, Application Optimization, and Application Availability platforms. We also derive revenues from the sales of services including annual maintenance contracts, installation, training and consulting services. We carefully monitor the sales mix of our revenues within each reporting period. We believe customer acceptance rates of our new products and feature enhancements are key indicators of future trends. We also consider overall revenue concentration by customer and by geographic region as additional indicators of current and future trends.

*Cost of revenues and gross margins.* We strive to control our cost of revenues and thereby maintain our gross margins. Significant items impacting cost of revenues are hardware costs paid to our contract manufacturers, third-party software license fees, amortization of developed technology, and personnel and overhead expenses. Our margins have remained relatively stable over the past two years; however factors such as sales price, product mix, inventory obsolescence, returns, component price increases, and warranty costs could significantly impact our gross margins from quarter to quarter and represent the significant indicators we monitor on a regular basis.

*Operating expenses.* Operating expenses are substantially driven by personnel and related overhead expenses. Existing headcount and future hiring plans are the predominant factors in analyzing and forecasting future operating expense trends. Other significant operating expenses that we monitor include marketing and promotions, travel, professional fees, computer costs related to the development of new products, facilities and depreciation expenses.

*Liquidity and cash flows.* Our financial condition remains strong with significant cash and investments and no long term debt. The increase in cash and investments for the first six months of fiscal year 2006 was primarily due to net income from operations, with operating activities providing cash of \$70.1 million. Going forward, we believe the primary driver of cash flows will be net income from operations. Capital expenditures for the first six months of fiscal year 2006 were comprised primarily of tenant improvements and information technology infrastructure and equipment to support the growth of our core business activities. We will continue to evaluate possible acquisitions of or investments in businesses, products, or technologies that we believe are strategic, which may require the use of cash.

*Balance sheet.* We view cash, short-term and long-term investments, deferred revenue, accounts receivable balances and day's sales outstanding as important indicators of our financial health. Deferred revenues continued to increase due to the growth in the amount of annual maintenance contracts purchased on new products and maintenance renewal contracts related to our existing product installation base. Our day's sales outstanding for the second quarter of fiscal year 2006 was 50. We expect to maintain this metric going forward.

**Table of Contents****Critical Accounting Policies and Estimates**

Our consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities. We base our estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances. Actual results may differ from these estimates under different assumptions or conditions.

We believe the following critical accounting policies affect the more significant estimates and judgments used in the preparation of our financial statements. These critical accounting policies are consistent with those disclosed in our Annual Report on Form 10-K.

*Revenue Recognition.* We recognize revenue in accordance with the guidance provided under Statement of Position ( SOP ) No. 97-2, Software Revenue Recognition, and SOP No. 98-9 Modification of SOP No. 97-2, Software Revenue Recognition, with Respect to Certain Transactions, Statement of Financial Accounting Standards ( SFAS ) No. 48, Revenue Recognition When Right of Return Exists, and SEC Staff Accounting Bulletin ( SAB ) No. 101, Revenue Recognition in Financial Statements, and SAB No. 104, Revenue Recognition.

We sell products through distributors, resellers, and directly to end users. We recognize product revenue upon shipment, net of estimated returns, provided that collection is determined to be probable and no significant obligations remain. In certain regions where we do not have the ability to reasonably estimate returns, revenue is recognized upon sale to the end user. In this situation, we receive a sales report from the channel partner to determine when the sales transaction to the end user has occurred. Payment terms to domestic customers are generally net 30 to net 45 days. Payment terms to international customers range from net 30 to net 90 days based on normal and customary trade practices in the individual markets. We have offered extended payment terms to certain customers, in which case, revenue is recognized when payments are received.

Whenever a software license, hardware, installation and post-contract customer support (PCS) elements are combined into a package with a single bundled price, a portion of the sales price is allocated to each element of the bundled package based on their respective fair values as determined when the individual elements are sold separately. Revenues from the license of software are recognized when the software has been shipped and the customer is obligated to pay for the software. When rights of return are present and we cannot estimate returns, we recognize revenue when such rights of return lapse. Revenues for PCS are recognized on a straight-line basis over the service contract term. PCS includes rights to upgrades, when and if available, a limited period of telephone support, updates, and bug fixes. Installation revenue is recognized when the product has been installed at the customer's site. Consulting services are customarily billed at fixed rates, plus out-of-pocket expenses, and revenues are recognized when the consulting has been completed. Training revenue is recognized when the training has been completed.

*Reserve for Doubtful Accounts.* Estimates are used in determining our allowance for doubtful accounts and are based upon an assessment of selected accounts and as a percentage of our remaining accounts receivable by aging category. In determining these percentages, we evaluate historical write-offs, current trends in the credit quality of our customer base, as well as changes in the credit policies. We perform ongoing credit evaluations of our customers financial condition and do not require any collateral. If there is deterioration of a major customer's credit worthiness or actual defaults are higher than our historical experience, our allowance for doubtful accounts may not be sufficient.

*Reserve for Product Returns.* In some instances, product revenue from distributors is subject to agreements allowing rights of return. Product returns are estimated based on historical experience and are recorded at the time revenues are recognized. Accordingly, we reduce recognized revenue for estimated future returns at the time revenue is recorded. When rights of return are present and we cannot estimate returns, revenue is recognized when such rights lapse. The estimates for returns are adjusted periodically based upon changes in historical rates of returns and other related factors. It is possible that these estimates will change in the future or that the actual amounts could vary from our estimates.

*Reserve for Warranties.* A warranty reserve is established based on our historical experience and an estimate of the amounts necessary to settle future and existing claims on products sold as of the balance sheet date. While we believe that our warranty reserve is adequate and that the judgment applied is appropriate, such amounts estimated to be due

and payable could differ materially from what will actually transpire in the future.

*Accounting for Income Taxes.* We utilize the liability method of accounting for income taxes as set forth by SFAS No. 109, Accounting for Income Taxes, or SFAS 109. Accordingly, we are required to estimate our income taxes in each of the jurisdictions in which we operate as part of the process of preparing our consolidated financial statements. This process involves estimating our actual current tax exposure, together with assessing temporary differences resulting from the different treatment of items for tax and

**Table of Contents**

accounting purposes in each geographic region. These differences result in deferred tax assets and liabilities. Due to the evolving nature and complexity of tax rules combined with the large number of jurisdictions in which we operate, it is possible that our estimates of our tax liability could change in the future, which may result in additional tax liabilities and adversely affect our results of operations, financial condition and cash flows.

*Stock-based Compensation.* We adopted the fair value recognition provisions of Financial Accounting Standards Board ( FASB ) Statement No. 123(R), *Share-Based Payment*, ( FAS 123R ) on July 1, 2005. We recognized \$5.2 million and \$10.1 million of expense related to stock-based compensation charges included in operating expenses for the three months and six months ended March 31, 2006, respectively. Prior to July 1, 2005, we accounted for share-based payments under the recognition and measurement provisions of APB Opinion No. 25, *Accounting for Stock Issued to Employees* ( APB 25 ), and related Interpretations, as permitted by FASB Statement No. 123, *Accounting for Stock-Based Compensation* ( FAS 123 ). In accordance with APB 25 no compensation cost was required to be recognized for options granted that had an exercise price equal to the market value of the underlying common stock on the date of grant.

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

Effective July 1, 2005 we adopted the straight-line attribution method for recognizing compensation expense. Previously under the disclosure-only provisions of FAS 123, we used the accelerated method of expense recognition pursuant to FASB Interpretation No. 28, *Accounting for Stock Appreciation Rights and Other Variable Stock Option or Award Plans* ( FIN 28 ). For all unvested options outstanding as of July 1, 2005, the previously measured but unrecognized compensation expense, based on the fair value at the original grant date, will be recognized on an accelerated basis over the remaining vesting period. For share-based payments granted subsequent to July 1, 2005, compensation expense, based on the fair value on the date of grant, will be recognized on a straight-line basis over the vesting period. As of March 31, 2006, there was \$28.1 million of total unrecognized compensation cost, the majority of which will be recognized ratably over the next two years. Going forward, stock compensation expenses may increase as we issue additional equity-based awards to continue to attract and retain key employees.

In addition, we recently modified the method in which we issue incentive awards to our employees through stock-based compensation. In prior years, stock-based compensation consisted only of stock options. Beginning in the fourth quarter of fiscal year 2005, we began to grant restricted stock unit awards instead of stock options. The value of restricted stock units is determined by the number of shares granted and the quoted price of our common stock on the date of grant. Alternatively, in determining the fair value of stock options, we use the Black-Scholes option pricing model that employs the following key assumptions: expected volatility is based on the annualized daily historical volatility of our stock price, over the expected life of the option and; expected term of the option is based on historical employee stock option exercise behavior, the vesting terms of the respective option and a contractual life of ten years. Our stock price volatility and option lives involve management's best estimates at that time, both of which impact the fair value of the option calculated under the Black-Scholes methodology and, ultimately, the expense that will be recognized over the life of the option.

FAS 123R also requires that we recognize compensation expense for only the portion of options or stock units that are expected to vest. Therefore, we apply estimated forfeiture rates that are derived from historical employee termination behavior. Our estimated forfeiture rate in the second quarter of fiscal year 2006 is 5%. If the actual number of forfeitures differs from those estimated by management, additional adjustments to compensation expense may be required in future periods.

*Goodwill Impairments.* Goodwill represents the excess purchase price over the estimated fair value of net assets acquired as of the acquisition date. We have adopted the requirements of SFAS No. 142, *Goodwill and Other Intangible Assets* ( SFAS No. 142 ). SFAS No. 142 requires goodwill to be tested for impairment on an annual basis and between annual tests in certain circumstances, and written down when impaired. Goodwill of \$24.2 million was

recorded in connection with the acquisition of uRoam, Inc. in fiscal year 2003, goodwill of \$25.5 million was recorded in connection with the acquisition of MagniFire Websystems Inc. in fiscal year 2004 and goodwill of \$32.0 million was recorded in connection with the acquisition of Swan Labs in fiscal year 2006. We complete our annual impairment test in the second quarter of each fiscal year and when events or conditions indicate that an impairment may have occurred. There was no impairment of goodwill during the six months ended March 31, 2006 and 2005, respectively.

**Results of Operations**

The following discussion and analysis should be read in conjunction with our consolidated financial statements, related notes and risk factors included elsewhere in this Quarterly Report on Form 10-Q/A.

**Table of Contents**

	<b>Three months ended March 31,</b>		<b>Six months ended March 31,</b>	
	<b>2006</b>	<b>2005</b>	<b>2006</b>	<b>2005</b>
	<b>(in thousands, except percentages)</b>			
<b>Net Revenues</b>				
Products	\$ 72,775	\$ 53,332	\$ 141,366	\$ 99,729
Services	21,341	14,398	40,837	28,010
Total	\$ 94,116	\$ 67,730	\$ 182,203	\$ 127,739
<b>Percentage of net revenues</b>				
Products	77.3%	78.7%	77.6%	78.1%
Services	22.7	21.3	22.4	21.9
Total	100.0%	100.0%	100.0%	100.0%

*Net revenues.* Total net revenues increased 39.0% and 42.6% for the three and six months ended March 31, 2006, respectively, up from the comparable periods in the prior year. The improvement was due to increased demand for our application delivery networking products and higher services revenues resulting from our increased installed base of products. During the three and six months ended March 31, 2006, each of our primary geographic regions reported higher revenues compared to the prior period. International revenues were 44.2% and 42.5% of total net revenues for the three and six months ended March 31, 2006, respectively, compared to 44.7% and 43.1% for the three and six months ended March 31, 2005, respectively. We expect international sales will continue to represent a significant portion of net revenues, although we cannot provide assurance that international revenues as a percentage of net revenues will remain at current levels.

Net product revenues increased 36.5% and 41.8% for the three and six months ended March 31, 2006, respectively up from the comparable periods in the prior year. The increase in the six months ended March 31, 2006, was primarily due to absolute growth in the volume of product sales of our Application Traffic Management (ATM), product line as well as incremental revenues derived from sales of our FirePass and TrafficShield product lines. Sales of our ATM family of application delivery networking products represented 89.5% and 89.4% of product revenues for the three months ended March 31, 2006 and 2005, respectively, and 90.5% and 89.9% of product revenue for the six months ended March 31, 2006 and 2005, respectively.

Net service revenues increased 48.2% and 45.8% for the three month and six months ended March 31, 2006, respectively, up from the comparable periods in the prior year. The increase in services revenue was primarily due to increases in the purchase or renewal of maintenance contracts as our installed base of products increased.

Ingram Micro Inc. and GE Access, two of our domestic distributors, accounted for 12.6% and 11.7% of our total net revenue for the three months ended March 31, 2006, respectively, and 13.7% and 10.7% of our total net revenue for the six months ended March 31, 2006, respectively. Ingram Micro Inc., accounted for 17.8% and 16.9% of our total net revenues for the three and six month periods ended March 31, 2005, respectively. GE Access accounted for 10.7% of our accounts receivable as of March 31, 2006.

	<b>Three months ended March 31,</b>		<b>Six months ended March 31,</b>	
	<b>2006</b>	<b>2005</b>	<b>2006</b>	<b>2005</b>
	<b>(in thousands, except percentages)</b>			
		(as restated)		(as restated)
		(1)		(1)

**Cost of net revenues and gross profit**

Edgar Filing: F5 NETWORKS INC - Form 10-Q/A

Products	\$ 15,441	\$ 11,822	\$ 30,034	\$ 22,352
Services	5,846	3,915	10,820	7,310
Total	21,287	15,737	40,854	29,662
Gross profit	\$ 72,829	\$ 51,993	\$ 141,349	\$ 98,077
<b>Cost of net revenues and gross profit (as a percentage of related net revenue)</b>				
Products	21.2%	22.2%	21.2%	22.4%
Services	27.4	27.2	26.5	26.1
Total	22.6	23.2	22.4	23.2
Gross profit	77.4%	76.8%	77.6%	76.8%

(1) See Note 2, Restatement of Previously Issued Financial Statements, of the Notes to Consolidated Financial Statements.

*Cost of Net Product Revenues.* Cost of net product revenues consist of finished products purchased from our contract manufacturers, manufacturing overhead, freight, warranty, provisions for excess and obsolete inventory, and amortization expenses in connection with developed technology from acquisitions. Our product margins remained stable for all periods presented at 77% to 78%. In absolute dollars, cost of net product revenues increased to \$15.4 million and \$30.0 million for the three and six months ended March 31, 2006, respectively, up from \$11.8 million and \$22.4 million for the three and six months ended March 31, 2005, respectively. The increases were primarily due to the higher volume of units shipped.



**Table of Contents**

*Cost of Net Service Revenues.* Cost of net service revenues consist of the salaries and related benefits of our professional services staff, travel, facilities, and depreciation expenses. For the three months and six months ended March 31, 2006, cost of net services revenues as a percentage of net service revenues remained relatively stable as compared to the periods in the prior year at 27.4% and 26.5%, respectively, and increased in absolute dollars primarily as a result of recent growth in professional services headcount. Professional services headcount at the end of March 2006 increased to 176 from 123 at the end of March 2005. Going forward, we expect to continue to increase our cost of service revenues to support our expanded product lines and growing customer base.

We expect to maintain our gross margins in the near term; however, gross margins could be adversely affected by increased material cost, component shortages, excess and obsolete inventory charges and heightened sales price competition.

	<b>Three months ended March 31,</b>		<b>Six months ended March 31,</b>	
	<b>2006</b>	<b>2005</b>	<b>2006</b>	<b>2005</b>
	<b>(in thousands, except percentages)</b>			
	<b>(as restated)(1)</b>		<b>(as restated)(1)</b>	
<b>Operating expenses</b>				
Sales and marketing	\$ 31,162	\$ 20,988	\$ 60,027	\$ 41,072
Research and development	12,276	7,834	22,754	14,866
General and administrative	7,148	6,341	14,545	11,832
 Total	 \$ 50,586	 \$ 35,163	 \$ 97,326	 \$ 67,770
 <b>Operating expenses (as a percentage of net revenue)</b>				
Sales and marketing	33.1%	31.0%	32.9%	32.2%
Research and development	13.0	11.6	12.5	11.6
General and administrative	7.6	9.4	8.0	9.3
 Total	 53.7%	 51.9%	 53.4%	 53.1%

(1) See Note 2  
Restatement of  
Previously  
Issued Financial  
Statements, of  
the Notes to  
Consolidated  
Financial  
Statements

*Sales and marketing.* Sales and marketing expenses consist of salaries, commissions and related benefits of our sales and marketing staff, the costs of our marketing programs, including public relations, advertising and trade shows, facilities and depreciation expenses. In absolute dollars, sales and marketing expenses increased 48.5% and 46.2% for the three and six months ended months ended March 31, 2006, respectively, from the comparable periods in the prior year. The increase in sales and marketing expense was primarily due to increased sales and marketing commissions and personnel costs of \$4.9 million and \$10.1 million for the three and six months ended March 31, 2006, respectively. The increased commissions and personnel costs were driven by growth in sales and marketing

employee headcount and increased revenue for the respective periods. Sales and marketing headcount at the end of March 2006 increased to 398 from 293 at the end of March 2005. In addition, sales and marketing expense includes stock-based compensation expense of \$2.2 million and \$4.3 million for the three and six months ended March 31, 2006, respectively, due to the adoption of FAS 123R in the fourth quarter of fiscal year 2005. We expect to continue to increase sales and marketing expenses in absolute dollars in order to grow revenues and increase our market share.

*Research and development.* Research and development expenses consist of the salaries and related benefits for our product development personnel, prototype materials and expenses related to the development of new and improved products, facilities and depreciation expenses. In absolute dollars, research and development expenses increased 56.7% and 53.1% for the three and six months ended months ended March 31, 2006, respectively, from the comparable periods in the prior year. The increase in research and development expenses was primarily due to higher research and development salary and benefit expenses of \$2.2 million and \$3.7 million for the three and six months ended March 31, 2006, respectively. Research and development headcount at the end of March 2006 increased to 278 from 205 at the end of March 2005. The growth in research and development employee headcount was primarily related to enhancement of our current products and our ability to develop new, technologically advanced products that meet the changing needs of our customers. In addition, research and development expense includes stock-based compensation expense of \$1.5 million and \$3.0 million for the three and six months ended March 31, 2006, respectively, due to the adoption of FAS 123R in the fourth quarter of fiscal year 2005. We expect to continue to increase research and development expenses as our future success is dependent on the continued development of our products.

*General and administrative.* General and administrative expenses consist of the salaries, benefits and related costs of our executive, finance, information technology, human resource and legal personnel, third-party professional service fees, bad debt charges, facilities, and depreciation expenses. In absolute dollars, general and administrative expenses increased 12.7% and 22.9% for the three and six months ended months ended March 31, 2006, respectively, from the comparable period in the prior year. The

**Table of Contents**

increase in general and administrative expenses was primarily due to stock-based compensation expense of \$1.5 million and \$2.9 million for the three and six months ended March 31, 2006, respectively, due to the adoption of FAS 123R in the fourth quarter of fiscal year 2005. In addition, general and administrative salary and benefit expenses increased \$0.9 million and \$1.4 million for the three and six months ended March 31, 2006, respectively. General and administrative headcount at the end of March 2006 increased to 121 from 89 at the end of March 2005. These increases in general and administrative expenses were partially offset by a decrease in bad debt expense. General and administrative expense is expected to remain at these increased levels as we continue to build our infrastructure to support the worldwide growth of our business.

	<b>Three months ended</b>		<b>Six months ended</b>	
	<b>March 31,</b>		<b>March 31,</b>	
	<b>2006</b>	<b>2005</b>	<b>2006</b>	<b>2005</b>
	<b>(in thousands, except percentages)</b>			
		<b>(as</b>		<b>(as</b>
		<b>restated)(1)</b>		<b>restated)(1)</b>
<b>Other Income and Income Taxes</b>				
Income from operations	\$ 22,243	\$ 16,830	\$ 44,023	\$ 30,307
Other income, net	3,877	1,641	6,847	3,028
Income before income taxes	26,120	18,471	50,870	33,335
Provision for income taxes	10,053	7,507	19,582	14,033
Net income	\$ 16,067	\$ 10,964	\$ 31,288	\$ 19,302
<b>Other income and income taxes (as percentage of net revenue)</b>				
Income from operations	23.6%	24.8%	24.2%	23.7%
Other income, net	4.1	2.4	3.8	2.4
Income before income taxes	27.8	27.3	27.9	26.1
Provision for income taxes	10.7	11.1	10.7	11.0
Net income	17.1%	16.2%	17.2%	15.1%

(1) See Note 2, Restatement of Previously Issued Financial Statements, of the Note to Consolidated Financial Statements

*Other income, net.* Other income, net, consists of interest income and foreign currency transaction gains and losses. For the three months ended March 31, 2006, other income, net, increased 136.3% compared with the prior period. For the six months ended March 31, 2006, other income, net, increased 126.1% compared with the prior period. The significant increase was due to a combination of higher yields and increased investment balances. The increased investment balances are the result of cash provided from operating and financing activities.

*Provision for Income taxes.* We recorded a 38.5% provision for income taxes during the current period. As of March 31, 2006 we do not have a valuation allowance on any of our deferred tax assets in any of the jurisdictions in which we operate because we believe that the assets are more likely than not to be realized. In making this determination we have considered projected future taxable income and ongoing prudent and feasible tax planning strategies in assessing the appropriateness of a valuation allowance. Our net deferred tax assets at March 31, 2006 and March 31, 2005 were \$23.9 million and \$43.9 million, respectively. Our world wide effective tax rate may fluctuate based on a number of factors including variations in projected taxable income in our geographic locations, changes in the valuation of our net deferred tax assets, resolution of potential exposures or establishment of potential exposures, introduction of new accounting standards or changes in tax laws or interpretations thereof in any of our geographic locations. Significant judgment is required in evaluating our tax positions and determining our provision for income taxes. During the ordinary course of business, there are many transactions and calculations for which the ultimate tax determination is uncertain. We establish reserves for tax-related uncertainties based on judgment of whether, and the extent to which, additional taxes and interest may be due. These reserves are established when, despite our belief that our tax return positions are fully supportable, we believe that certain positions may be challenged and may not be sustained on review by tax authorities. We adjust these reserves in light of changing facts and circumstances, such as the closing of a tax audit or changes in tax laws or interpretations thereof. The provision for income taxes includes the impact of reserve provisions and changes to reserves that are considered appropriate. The ultimate resolution of these potential exposures may be greater or less than the liabilities recorded which could result in an adjustment to our future tax expense and a fluctuation in our effective tax rate.

#### **Liquidity and Capital Resources**

Cash and cash equivalents, short-term investments and long-term investments were \$420.0 million as of March 31, 2006 compared to \$365.0 million as of September 30, 2005, representing an increase of \$55.0 million. The increase was primarily due to cash provided by operating activities of \$70.1 million for the six months ended March 31, 2006 compared to \$31.1 million for the same period in the prior year. The increase in cash flow from operations for the first six months of fiscal year 2006 resulted from increased net income combined with changes in operating assets and liabilities, as adjusted for various non-cash items including stock based compensation, depreciation and amortization charges.

**Table of Contents**

Cash used in investing activities was \$136.0 million for the six months ended March 31, 2006 compared to \$79.4 million for the same period in the prior year. The significant amount of cash used in investing activities for the first six months of fiscal year 2006 was primarily due to the purchase of investments partially offset by the sale of investments and \$42.8 million of cash payments, net of cash acquired, to shareholders of Swan Labs, which was acquired in October 2005.

Cash provided by financing activities for the six months ended March 31, 2006 was \$37.1 million compared to \$45.1 million for the same period in the prior year. Our financing activities for the six months ended March 31, 2006 and 2005 consisted of cash received from the exercise of employee stock options and purchases under our employee stock purchase plan. Based on our current operating and capital expenditure forecasts, we believe that our existing cash and investment balances together with cash generated from operations should be sufficient to meet our operating requirements for the foreseeable future.

As of March 31, 2006, our principal commitments consisted of obligations outstanding under operating leases. We lease our facilities under operating leases that expire at various dates through 2012. There have been no material changes in our principal lease commitments compared to those discussed in our Annual Report on Form 10-K for the year ended September 30, 2005. In connection with the lease agreement for our corporate headquarters we established a restricted escrow account collateralized by a certificate of deposit that has been included on our balance sheet as a component of restricted cash. The total amount required in escrow reduces at various dates as set forth by the lease agreement. The amount required in escrow at March 31, 2006 was \$3.6 million as set forth by the lease agreement.

We outsource the manufacturing of our pre-configured hardware platforms to contract manufacturers who assemble each product to our specifications. Our agreement with our largest contract manufacturer allows them to procure component inventory on our behalf based upon a rolling production forecast. We are contractually obligated to purchase the component inventory in accordance with the forecast, unless we give notice of order cancellation in advance of applicable lead times. As of March 31, 2006, we were committed to purchase approximately \$16.3 million of such inventory during the next quarter. Committed purchases includes additional component inventory due to the anticipated Restriction of Hazardous Substances Directive (RoHS) requirements in the European Union which become effective July 1, 2006.

**Risk Factors that May Affect Future Results**

This Quarterly Report on Form 10-Q contains forward-looking statements that involve risks and uncertainties. Our business, operating results, financial performance, and share price may be materially adversely affected by a number of factors, including but not limited to the following risk factors, any one of which could cause actual results to vary materially from anticipated results or from those expressed in any forward-looking statements made by us in this Quarterly Report on Form 10-Q or in other reports, press releases or other statements issued from time to time. Additional factors that may cause such a difference are set forth elsewhere in this Quarterly Report on Form 10-Q.

**Our success depends on our timely development of new products and features, market acceptance of new product offerings and proper management of the timing of the life cycle of our products**

We expect the application delivery networking market to be characterized by rapid technological change, frequent new product introductions, changes in customer requirements and evolving industry standards. Our continued success depends on our ability to identify and develop new products and new features for our existing products to meet the demands of these changes, and for those products and features to be accepted by our existing and target customers. If we are unable to identify, develop and deploy new products and new product features on a timely basis, our business and results of operations may be harmed.

In September 2004, we announced the release of our next-generation BIG-IP product featuring the Traffic Management Operating System, or TMOS. This major new version of BIG-IP represented the culmination of over two years of research and development efforts. TMOS is specifically designed to facilitate the development and integration of application delivery functions as modules that can be added to BIG-IP's core functionality to keep pace with rapidly evolving customer needs. We currently offer software modules as add-ons for this product and our continued success depends significantly on our ability to integrate new modules and functionality onto this platform and the acceptance of the new hardware and software platforms associated with this release by our existing and target customers.

The current life cycle of our products is typically 12 to 24 months. The introduction of new products or product enhancements may shorten the life cycle of our existing products, or replace sales of some of our current products, thereby offsetting the benefit of even a successful product introduction, and may cause customers to defer purchasing our existing products in anticipation of the new

**Table of Contents**

products. This could harm our operating results by decreasing sales, increasing our inventory levels of older products and exposing us to greater risk of product obsolescence. We have also experienced, and may in the future experience, delays in developing and releasing new products and product enhancements. This has led to, and may in the future lead to, delayed sales, increased expenses and lower quarterly revenue than anticipated. Also, in the development of our products, we have experienced delays in the prototyping of our products, which in turn has led to delays in product introductions. In addition, complexity and difficulties in managing product transitions at the end-of-life stage of a product can create excess inventory of components associated with the outgoing product that can lead to increased expenses. Any or all of the above problems could materially harm our business and operating results.

**Our success depends on sales and continued innovation of our BIG-IP product lines**

For the fiscal year ended September 30, 2005, we derived 89.1% of our product revenues from sales of our BIG-IP family of application delivery networking product lines. We expect to derive a significant portion of our net revenues from sales of our BIG-IP products in the future. Implementation of our strategy depends upon BIG-IP being able to solve critical network availability and performance problems of our customers. If BIG-IP is unable to solve these problems for our customers or if we are unable to sustain the high levels of innovation in BIG-IP's product feature set needed to maintain leadership in what will continue to be a competitive market environment, our business and results of operations will be harmed.

**We may not be able to compete effectively in the emerging application delivery networking market**

The markets we serve are new, rapidly evolving and highly competitive, and we expect competition to persist and intensify in the future. Our principal competitors in the application delivery networking market include Cisco Systems, Inc., Nortel Networks Corporation, Foundry Networks, Inc., Citrix Systems, Inc., Radware Ltd. and Juniper Networks, Inc. We expect to continue to face additional competition as new participants enter our market. In addition, larger companies with significant resources, brand recognition and sales channels may form alliances with or acquire competing application delivery networking solutions and emerge as significant competitors. Potential competitors may bundle their products or incorporate an Internet traffic management or security component into existing products in a manner that discourages users from purchasing our products.

**Table of Contents****Our quarterly and annual operating results are volatile and may cause our stock price to fluctuate**

Our quarterly and annual operating results have varied significantly in the past and will vary significantly in the future, which makes it difficult for us to predict our future operating results. In particular, we anticipate that the size of customer orders may increase as we continue to focus on larger business accounts. A delay in the recognition of revenue, even from just one account, may have a significant negative impact on our results of operations for a given period. In the past, a majority of our sales have been realized near the end of a quarter. Accordingly, a delay in an anticipated sale past the end of a particular quarter may negatively impact our results of operations for that quarter, or in some cases, that year. Additionally, we have exposure to the credit risks of some of our customers and sub-tenants. Although we have programs in place that are designed to monitor and mitigate the associated risk, there can be no assurance that such programs will be effective in reducing our credit risks adequately. We monitor individual payment capability in granting credit arrangements, seek to limit the total credit to amounts we believe our customers can pay, and maintain reserves we believe are adequate to cover exposure for potential losses. If there is a deterioration of a sub-tenant's or major customer's creditworthiness or actual defaults are higher than expected future resulting losses, if incurred, could harm our business and have a material adverse effect on our operating results.

Further, our operating results may be below the expectations of securities analysts and investors in future quarters or years. Our failure to meet these expectations will likely harm the market price of our common stock.

**The average selling price of our products may decrease and our costs may increase, which may negatively impact gross profits**

It is possible that the average selling prices of our products will decrease in the future in response to competitive pricing pressures, increased sales discounts, new product introductions by us or our competitors or other factors. Therefore, in order to maintain our gross profits, we must develop and introduce new products and product enhancements on a timely basis and continually reduce our product costs. Our failure to do so will cause our net revenue and gross profits to decline, which will harm our business and results of operations. In addition, we may experience substantial period-to-period fluctuations in future operating results due to the erosion of our average selling prices.

**It is difficult to predict our future operating results because we have an unpredictable sales cycle**

Our products have a lengthy sales cycle, which is difficult to predict. Historically, our sales cycle has ranged from approximately two to three months and has tended to lengthen as we have increasingly focused our sales efforts on the enterprise market. Also, as our distribution strategy has evolved into more of a channel model, utilizing value-added resellers, distributors and systems integrators, the level of variability in the length of sales cycle across transactions has increased and made it more difficult to predict the timing of many of our sales transactions. Sales of our products require us to educate potential customers in their use and benefits. Sales of our products are subject to delays from the lengthy internal budgeting, approval and competitive evaluation processes that large corporations and governmental entities may require. For example, customers frequently begin by evaluating our products on a limited basis and devote time and resources to testing our products before they decide whether or not to purchase. Customers may also defer orders as a result of anticipated releases of new products or enhancements by our competitors or us. As a result, our products have an unpredictable sales cycle that contributes to the uncertainty of our future operating results.

**Our business may be harmed if our contract manufacturers are not able to provide us with adequate supplies of our products or if a single source of hardware assembly is lost or impaired**

We rely on third party contract manufacturers to assemble our products. We outsource the manufacturing of our hardware platforms to contract manufacturers who assemble these hardware platforms to our specifications. We have experienced minor delays in shipments from contract manufacturers in the past. However, if we experience major delays in the future or other problems, such as inferior quality and insufficient quantity of product, any one or a combination of these factors may harm our business and results of operations. The inability of our contract manufacturers to provide us with adequate supplies of our products or the loss of our contract manufacturer may cause a delay in our ability to fulfill orders while we obtain a replacement manufacturer and may harm our business and results of operations. In particular, because we subcontract substantially all of our manufacturing to a single contract manufacturer, with whom we do not have a long-term contract, any termination, loss or impairment in our arrangement with this single source of hardware assembly, or any impairment of their facilities or operations, would



harm our business, financial condition and results of operation.

**Table of Contents**

If the demand for our products grows, we will need to increase our raw material and component purchases, contract manufacturing capacity and internal test and quality control functions. Any disruptions in product flow may limit our revenue, may harm our competitive position and may result in additional costs or cancellation of orders by our customers.

**Our business could suffer if there are any interruptions or delays in the supply of hardware components from our third-party sources**

We currently purchase several hardware components used in the assembly of our products from a number of single or limited sources. Lead times for these components vary significantly. The unavailability of suitable components, any interruption or delay in the supply of any of these hardware components, or the inability to procure a similar component from alternate sources at acceptable prices within a reasonable time, may delay assembly and sales of our products and, hence, our revenues, and may harm our business and results of operations.

**We may not adequately protect our intellectual property and our products may infringe on the intellectual property rights of third parties**

We rely on a combination of patent, copyright, trademark and trade secret laws and restrictions on disclosure of confidential and proprietary information to protect our intellectual property rights. Despite our efforts to protect our proprietary rights, unauthorized parties may attempt to copy or otherwise obtain and use our products or technology. Monitoring unauthorized use of our products is difficult, and we cannot be certain that the steps we have taken will prevent misappropriation of our technology, particularly in foreign countries where the laws may not protect our proprietary rights as fully as in the United States.

Our industry is characterized by the existence of a large number of patents and frequent claims and related litigation regarding patent and other intellectual property rights. In the ordinary course of our business, we are involved in disputes and licensing discussions with others regarding their claimed proprietary rights and cannot assure you that we will always successfully defend ourselves against such claims. If we are found to infringe the proprietary rights of others, or if we otherwise settle such claims, we could be compelled to pay damages or royalties and either obtain a license to those intellectual property rights or alter our products so that they no longer infringe upon such proprietary rights. Any license could be very expensive to obtain or may not be available at all. Similarly, changing our products or processes to avoid infringing the rights of others may be costly or impractical. In addition, we have initiated, and may in the future initiate, claims or litigation against third parties for infringement of our proprietary rights, to determine the scope and validity of our proprietary rights or those of our competitors. Any of these claims, whether claims that we are infringing the proprietary rights of others, or vice versa, with or without merit, may be time-consuming, result in costly litigation and diversion of technical and management personnel or require us to cease using infringing technology, develop non-infringing technology or enter into royalty or licensing agreements. Further, our license agreements typically require us to indemnify our customers, distributors and resellers for infringement actions related to our technology, which could cause us to become involved in infringement claims made against our customers, distributors or resellers. Any of the above-described circumstances relating to intellectual property rights disputes could result in our business and results of operations being harmed.

Many of our products include intellectual property licensed from third parties. In the future, it may be necessary to renew licenses for third party intellectual property or obtain new licenses for other technology. These third party licenses may not be available to us on acceptable terms, if at all. The inability to obtain certain licenses, or litigation regarding the interpretation or enforcement of license rights and related intellectual property issues, could have a material adverse effect on our business, operating results and financial condition. Furthermore, we license some third party intellectual property on a non-exclusive basis and this may limit our ability to protect our intellectual property rights in our products.

**We may not be able to sustain or develop new distribution relationships and a reduction or delay in sales to a significant distribution partner could hurt our business**

Our sales strategy requires that we establish and maintain multiple distribution channels in the United States and internationally through leading industry resellers, systems integrators, Internet service providers and other channel partners. We have a limited number of agreements with companies in these channels, and we may not be able to increase our number of distribution relationships or maintain our existing relationships. If we are unable to establish or

maintain our indirect sales channels, our business and results of operations will be harmed. In addition, one domestic distributor of our products accounted for 18.6% and 19.1% of our total net revenue for the fiscal years 2005 and 2004, respectively. A substantial reduction or delay in sales of our products to this or any other key distribution partner could harm our business, operating results and financial condition.

**Table of Contents****Undetected software errors may harm our business and results of operations**

Software products frequently contain undetected errors when first introduced or as new versions are released. We have experienced these errors in the past in connection with new products and product upgrades. We expect that these errors will be found from time to time in new or enhanced products after commencement of commercial shipments. These problems may cause us to incur significant warranty and repair costs, divert the attention of our engineering personnel from our product development efforts and cause significant customer relations problems. We may also be subject to liability claims for damages related to product errors. While we carry insurance policies covering this type of liability, these policies may not provide sufficient protection should a claim be asserted. A material product liability claim may harm our business and results of operations.

Our products must successfully operate with products from other vendors. As a result, when problems occur in a network, it may be difficult to identify the source of the problem. The occurrence of software errors, whether caused by our products or another vendor's products, may result in the delay or loss of market acceptance of our products. The occurrence of any of these problems may harm our business and results of operations.

**Our operating results are exposed to risks associated with international commerce**

As our international sales increase, our operating results become more exposed to international operating risks. These risks include risks related to potential recessions in economies outside the United States, foreign currency exchange rates, managing foreign sales offices, regulatory, political, or economic conditions in specific countries, military conflict or terrorist activities, changes in laws and tariffs, inadequate protection of intellectual property rights in foreign countries, foreign regulatory requirements, and natural disasters. All of these factors could have a material adverse effect on our business. We intend to continue expanding into international markets. International sales represented 40.5% and 39.4% of our net revenues for the fiscal years ended September 30, 2005 and 2004, respectively. In particular, in fiscal year 2005, we derived 13.7% of our total revenue from the Japanese market. This revenue is dependent on a number of factors outside our control, including the viability and success of our resellers and the strength of the Japanese economy.

**Changes in governmental regulations could negatively affect our revenues**

Our products are subject to various regulations promulgated by the United States and various foreign governments including, but not limited to, environmental regulations and regulations implementing export license requirements and restrictions on the import or export of some technologies, especially encryption technology. Changes in governmental regulation and our inability or failure to obtain required approvals, permits or registrations could harm our international and domestic sales and adversely affect our revenues, business and operations.

**Acquisitions, including our recent acquisition of Swan Labs, present many risks and we may not realize the financial and strategic goals that are contemplated at the time of the transaction**

With respect to our acquisitions, as well as any other future acquisitions we may undertake, we may find that the acquired assets do not further our business strategy as expected, or that we paid more than what the assets are later worth, or that economic conditions change, all of which may generate future impairment charges. There may be difficulty integrating the operations and personnel of the acquired business, and we may have difficulty retaining the key personnel of the acquired business. We may have difficulty in incorporating the acquired technologies or products with our existing product lines. Our ongoing business and management's attention may be disrupted or diverted by transition or integration issues and the complexity of managing geographically and culturally diverse locations. We may have difficulty maintaining uniform standards, controls, procedures and policies across locations. We may experience significant problems or liabilities associated with the product quality, technology and other matters.

Our inability to successfully operate and integrate newly-acquired businesses appropriately, effectively and in a timely manner, or to retain key personnel of any acquired business, could have a material adverse effect on our ability to take advantage of further growth in demand for integrated traffic management and security solutions and other advances in technology, as well as on our revenues, gross margins and expenses.

**Table of Contents****Our success depends on our key personnel and our ability to attract and retain qualified sales and marketing, operations, product development and professional services personnel**

Our success depends to a significant degree upon the continued contributions of our key management, product development, sales, marketing and finance personnel, many of whom may be difficult to replace. The complexity of our application delivery networking products and their integration into existing networks and ongoing support, as well as the sophistication of our sales and marketing effort, requires us to retain highly trained professional services, customer support and sales personnel. Competition for qualified professional services, customer support and sales personnel in our industry is intense because of the limited number of people available with the necessary technical skills and understanding of our products. Our ability to retain and hire these personnel may be adversely affected by volatility or reductions in the price of our common stock, since these employees are generally granted stock options. The loss of services of any of our key personnel, the inability to retain and attract qualified personnel in the future or delays in hiring qualified personnel, may harm our business and results of operations.

**We face litigation risks**

We are a party to lawsuits in the normal course of our business. Litigation in general and intellectual property and securities litigation in particular, can be expensive, lengthy and disruptive to normal business operations. Moreover, the results of complex legal proceedings are difficult to predict. Responding to the allegations has been, and will likely continue to be, expensive and time-consuming for us. An unfavorable resolution of the lawsuits could adversely affect our business, results of operations, or financial condition.

Our historical stock option practices and the restatement of our prior financial statements have exposed us to greater risks associated with litigation. In May 2006, several derivative actions were filed against certain current and former directors and officers based on allegations relating to our historical stock option practices. We cannot assure you that this current litigation will result in the same conclusions reached by the Special Committee.

We may in the future be subject to additional litigation arising in relation to our historical stock option practices and the restatement of our prior period financial statements. Litigation may be time consuming, expensive and distracting for management from the conduct of our business. The adverse resolution of any lawsuit could have a material adverse effect on our business, financial condition and results of operations. We cannot assure you that any future litigation relating to our historical stock option practices will result in the same conclusions reached by the Special Committee. Furthermore, if we are subject to adverse findings in any of these matters, we could be required to pay damages or penalties or have other remedies imposed upon us which could adversely affect our business, results of operations, or financial condition.

**The matters relating to the Special Committee's review of our historical stock option practices and the restatement of our consolidated financial statements has resulted in regulatory proceedings against us and may result in future regulatory proceedings, which could have a material adverse impact on our financial condition**

On November 8, 2006, we announced that the Special Committee had completed its review of our historical stock option practices. Upon completion of its review, the Special Committee found that the recorded grant dates for certain stock options granted during fiscal years 1999 to 2004 should not be relied upon as the measurement date for accounting purposes and the accounting treatment used for the vesting of certain stock options was incorrect. Based on the Special Committee's review, to correct the accounting treatment, we have amended the Original Report, our Quarterly Report on Form 10-Q for the three months ended December 31, 2005 and our Annual Report on Form 10-K/A (as amended) for the year ended September 30, 2005, to restate the consolidated financial statements contained in those reports.

We have received notice from both the SEC and the Department of Justice that they are conducting informal inquiries into our historical stock option practices, and we have continually cooperated with both agencies. Considerable legal and accounting expenses related to our historical stock option practices have already been incurred to date and significant expenditures may continue to be incurred in the future. We may in the future be subject to additional regulatory proceedings or actions arising in relation to our historical stock option practices and the restatement of our prior period financial statements. Any potential regulatory proceeding or action may be time consuming, expensive and distracting for management from the conduct of our business. The adverse resolution of any potential regulatory proceeding or action could adversely affect our business, results of operations, or financial

condition. We cannot assure you that the SEC and Department of Justice inquiries, or any future regulatory action relating to our historical stock option practices, will result in the same conclusions reached by the Special Committee. Furthermore, if we are subject to adverse findings in any of these matters, we could be required to pay damages or penalties or have other remedies imposed upon us, including

**Table of Contents**

criminal penalties, which could adversely affect our business, results of operations, or financial condition.

**As a result of our delayed filing of our Form 10-Q for the quarter ended June 30, 2006, our inability to maintain our Form S-3 eligibility may adversely affect our ability to raise future capital**

As a result of our delayed filing of our Quarterly Report on Form 10-Q for the quarter ended June 30, 2006, we will be ineligible to register our securities on Form S-3 for sale by us or resale by other security holders until we have timely filed all periodic reports under the Securities Exchange Act of 1934 for one year from the date our Quarterly Report on Form 10-Q for the quarter ended June 30, 2006 was originally due. In the meantime, we have the ability to use Form S-1 to raise capital or complete acquisitions, which could increase the transaction costs and adversely affect our ability to raise capital or complete acquisitions of other companies during this period.

**Anti-takeover provisions could make it more difficult for a third party to acquire us**

Our Board of Directors has the authority to issue up to 10,000,000 shares of preferred stock and to determine the price, rights, preferences, privileges and restrictions, including voting rights, of those shares without any further vote or action by the shareholders. The rights of the holders of common stock may be subject to, and may be adversely affected by, the rights of the holders of any preferred stock that may be issued in the future. The issuance of preferred stock may have the effect of delaying, deferring or preventing a change of control of our company without further action by our shareholders and may adversely affect the voting and other rights of the holders of common stock. Further, certain provisions of our bylaws, including a provision limiting the ability of shareholders to raise matters at a meeting of shareholders without giving advance notice, may have the effect of delaying or preventing changes in control or management of our company, which could have an adverse effect on the market price of our common stock. In addition, our articles of incorporation provide for a staggered board, which may make it more difficult for a third party to gain control of our board of directors. Similarly, state anti-takeover laws in the State of Washington related to corporate takeovers may prevent or delay a change of control of our company.

**Item 3. Quantitative and Qualitative Disclosures About Market Risk**

Management believes there have been no material changes to our quantitative and qualitative disclosures about market risk during the six month period ended March 31, 2006, compared to those discussed in our Annual Report on Form 10-K No. 2 for the year ended September 30, 2005.

**Item 4. Controls and Procedures**

**Evaluation of Disclosure Controls and Procedures**

The Company maintains disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the Exchange Act)) that are designed to ensure that required information is recorded, processed, summarized and reported within the required timeframe, as specified in the rules set forth by the Securities and Exchange Commission. Our disclosure controls and procedures are also designed to ensure that information required to be disclosed is accumulated and communicated to management, including the Chief Executive Officer and Chief Accounting Officer, to allow timely decisions regarding required disclosures.

Our management, with the participation of our Chief Executive Officer and Chief Accounting Officer, evaluated the effectiveness of our disclosure controls and procedures as of March 31, 2006 and, based on this evaluation, our Chief Executive Officer and Chief Accounting Officer had previously concluded that our disclosure controls and procedures were effective as of March 31, 2006. Subsequent to that evaluation, our Chief Executive Officer and Chief Accounting Officer concluded that our disclosure controls and procedures were not effective at a reasonable assurance level, as of March 31, 2006, due to the existence of the material weakness described below.

A material weakness is a control deficiency, or combination of control deficiencies, that results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected. In connection with the restatement discussed under the heading Restatement of Previously Issued Financial Statements in Note 2 to our consolidated financial statements included in this Quarterly Report on Form 10-Q/A, the following material weakness was identified in the Company's internal control over financial reporting as of September 30, 2005 that continued to exist as of March 31, 2006. We did not maintain effective controls over our granting and modification of stock options and the related accounting for and disclosure of stock-based compensation expense. Specifically, effective controls, including monitoring, were not designed and in place to ensure the existence, completeness, accuracy, valuation and presentation of activity related to our granting and modification of stock

options. This control deficiency resulted in the misstatement of our stock-based compensation expense, additional paid-in capital and related income tax accounts and related disclosures, and in the restatement of our 2005, 2004 and 2003 annual consolidated financial statements and the interim consolidated financial statements for the first and second quarters of 2006 and all quarters of 2005 and 2004 and an audit adjustment to the interim consolidated financial statements for the third quarter of 2006. Further, this control deficiency could result in misstatements of the aforementioned accounts and disclosures that would result in a material misstatement of our annual or interim consolidated financial statements that would not be prevented or detected.



**Table of Contents**

**Remediation of Material Weakness**

Management is committed to remediating the material weakness described above by implementing changes to our internal control over financial reporting.

On July 1, 2005, we adopted the fair value recognition provision of FAS 123(R). We also began granting restricted stock unit awards instead of stock options in the fourth quarter of fiscal 2005 as our primary form of stock-based compensation. FAS 123(R) requires the recognition as expense of all stock-based compensation. In connection with the adoption of FAS 123(R) we revised certain of our policies, processes, procedures and controls relating to grants of stock-based compensation.

Although improvements were made to our internal control over financial reporting, as they relate to the granting and modification of stock-based compensation, in connection with the adoption of FAS 123(R), as of March 31, 2006, we had not fully remediated the material weakness describe above.

Subsequent to the initiation of our investigation into our stock-option granting practices in May 2006, we considered the effectiveness of both the design and operation of our internal control over financial reporting, as they relate to the granting and modification of stock-based compensation. We implemented a number of significant improvements in our internal control over financial reporting during the fourth quarter of 2006. In particular, we developed and implemented the following policies, processes, procedures and controls over the granting and modification of stock-based compensation:

Review and approval of all stock-based compensation awards by the accounting and finance function.

Enhanced and standardized documentation required to be maintained for the granting of all such stock-based compensation awards.

Enhanced and standardized documentation required to be maintained for the exercise and/or cancellation of all such stock-based compensation awards.

A quarterly review and reconciliation of all such stock-based compensation awards by the accounting and finance function.

Formal communication to all relevant personnel involved in the stock-based compensation process regarding the importance of the accounting and legal implications of the Company's stock-based compensation process.

As of September 30, 2006, management has implemented these additional policies, procedures and controls. Additionally, we have evaluated the design of these new controls, which have been placed into operation for a sufficient period of time, and tested their operating effectiveness. We consider that the steps identified and implemented above have improved the effectiveness of our internal control over financial reporting and, as of September 30, 2006, have remediated the material weakness described above.

**Changes in Internal Control over Financial Reporting**

There have been no changes in our internal control over financial reporting that occurred during the quarter ended March 31, 2006, that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

**PART II OTHER INFORMATION**

**Item 1. Legal Proceedings**

Information about legal proceedings is set forth in Note 3 to the unaudited consolidated financial statements included in this Amendment. Reference is also made to Item 3, Legal Proceedings in our Annual Report on Form 10-K/A No. 2 for the year ended

**Table of Contents**

September 30, 2005, filed December 12, 2006 (the 2005 10-K Amendment ) for descriptions of our legal proceedings. We continue to believe that the resolution of these legal proceedings will not have a material adverse effect on us and there have been no material developments since the filing of the 2005 10-K Amendment.

We are not aware of any other pending legal proceedings that, individually or in the aggregate, would have a material adverse effect on our business, operating results, or financial condition. We may in the future be party to litigation arising in the ordinary course of business, including claims that allegedly infringe upon third-party trademarks or other intellectual property rights. Such claims, even if not meritorious, could result in the expenditure of significant financial and managerial resources.

**Item 4. Submission of Matters to a Vote of Security Holders**

We held our Annual Meeting of Shareholders on March 2, 2006, to elect two Class I directors to hold office until the Annual Meeting of Shareholders for the fiscal year end 2008 or until their successors are duly elected and qualified. At the Annual Meeting, the following nominees were elected as follows:

	<b>Votes</b>	
	<b>For</b>	<b>Withheld</b>
Karl D. Guelich	33,589,979	2,860,914
Keith D. Grinstein	34,579,504	1,871,889
<u>Directors with continuing terms:</u>		
John McAdam		
Alan J. Higginson		
Rich Malone		
A. Gary Ames		

**Table of Contents**

**Item 6. Exhibits**

**Exhibit  
Number**

**Exhibit Description**

3.1	Second Amended and Restated Articles of Incorporation of the Registrant (1)
3.2	Amended and Restated Bylaws of the Registrant (1)
4.1	Specimen Common Stock Certificate (1)
31.1*	Certification Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.2*	Certification Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32.1*	Certification Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

\* Filed herewith.

(1) Incorporated by  
reference from  
Registration  
Statement on  
Form S-1, File  
No. 333-75817.

**Table of Contents**

**SIGNATURES**

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized on this 13th day of December, 2006.

F5 NETWORKS, INC.

By: /s/ JOHN RODRIGUEZ  
John Rodriguez  
Chief Accounting Officer  
(Duly Authorized Officer and  
Principal Financial and Accounting  
Officer)  
37

---

**Table of Contents**

**EXHIBIT INDEX**

<b>Exhibit Number</b>	<b>Exhibit Description</b>
3.1	Second Amended and Restated Articles of Incorporation of the Registrant (1)
3.2	Amended and Restated Bylaws of the Registrant (1)
4.1	Specimen Common Stock Certificate (1)
31.1*	Certification Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.2*	Certification Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32.1*	Certification Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

\* Filed herewith.

(1) Incorporated by reference from Registration Statement on Form S-1, File No. 333-75817.