F5 NETWORKS INC
Form 10-Q
August 05, 2011

Table of Contents

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

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

For the quarterly period ended June 30, 2011

OR

o **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	**91-1714307**
(State or other jurisdiction of incorporation or organization)	(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 þ No o

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes þ No o

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

Large accelerated filer þ	Accelerated filer o	Non-accelerated filer o	Smaller reporting company o
		(Do not check if a smaller reporting company)	

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

The number of shares outstanding of the registrant s common stock as of August 2, 2011 was 80,726,859.

F5 NETWORKS, INC.
QUARTERLY REPORT ON FORM 10-Q
For the Quarter Ended June 30, 2011
Table of Contents

Table of Contents

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

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

	June 30, 2011	September 30, 2010
ASSETS		
Current assets		
Cash and cash equivalents	$ 299,804	$ 168,754
Short-term investments	285,530	259,742
Accounts receivable, net of allowances of $2,821 and $4,319	154,741	112,132
Inventories	17,941	18,815
Deferred tax assets	9,197	8,767
Other current assets	30,015	37,745
Total current assets	797,228	605,955
Property and equipment, net	42,323	34,157
Long-term investments	471,567	433,570
Deferred tax assets	38,169	37,864
Goodwill	234,700	234,700
Other assets, net	13,147	15,946
Total assets	$ 1,597,134	$ 1,362,192
LIABILITIES AND SHAREHOLDERS EQUITY		
Current liabilities		
Accounts payable	$ 34,070	$ 21,180
Accrued liabilities	59,721	61,768
Deferred revenue	255,226	204,137
Total current liabilities	349,017	287,085
Other long-term liabilities	16,300	16,153
Deferred revenue, long-term	66,649	55,256
Total long-term liabilities	82,949	71,409
Commitments and contingencies (Note 5)		
Shareholders equity		
Preferred stock, no par value; 10,000 shares authorized, no shares outstanding		
Common stock, no par value; 200,000 shares authorized, 80,727 and 80,355 shares issued and outstanding	505,117	517,215
Accumulated other comprehensive loss	(3,460)	(3,241)
Retained earnings	663,511	489,724

Total shareholders equity	1,165,168	1,003,698
Total liabilities and shareholders equity	$ 1,597,134	$ 1,362,192

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

Table of Contents

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

	Three months ended June 30,		Nine months ended June 30,	
	2011	2010	2011	2010
Net revenues				
Products	$ 179,327	$ 147,393	$ 524,529	$ 396,170
Services	111,386	83,081	312,690	231,528
Total	290,713	230,474	837,219	627,698
Cost of net revenues				
Products	31,803	29,328	94,840	82,789
Services	20,645	15,251	57,244	42,335
Total	52,448	44,579	152,084	125,124
Gross profit	238,265	185,895	685,135	502,574
Operating expenses				
Sales and marketing	93,633	77,219	269,790	212,505
Research and development	35,245	30,889	102,358	86,743
General and administrative	21,126	17,658	61,656	49,627
Total	150,004	125,766	433,804	348,875
Income from operations	88,261	60,129	251,331	153,699
Other income, net	1,889	3,561	6,002	7,557
Income before income taxes	90,150	63,690	257,333	161,256
Provision for income taxes	27,601	23,195	83,546	58,338
Net income	$ 62,549	$ 40,495	$ 173,787	$ 102,918
Net income per share basic	$ 0.77	$ 0.51	$ 2.15	$ 1.30
Weighted average shares basic	80,866	79,864	80,773	79,386
Net income per share diluted	$ 0.77	$ 0.50	$ 2.13	$ 1.27
Weighted average shares diluted	81,497	81,031	81,655	80,870

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

Table of Contents

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

	Nine months ended June 30, 2011				
	Common Stock		Accumulated Other Comprehensive	Retained	Total Shareholders
	Shares	Amount	Income/(Loss)	Earnings	Equity
Balance, September 30, 2010	80,355	$ 517,215	$ (3,241)	$ 489,724	$ 1,003,698
Exercise of employee stock options	142	2,197			2,197
Issuance of stock under employee stock purchase plan	256	18,932			18,932
Issuance of restricted stock	1,048				
Repurchase of common stock	(1,074)	(121,526)			(121,526)
Tax benefit from employee stock transactions		20,686			20,686
Stock-based compensation		67,613			67,613
Comprehensive income:					
Net income				173,787	
Foreign currency translation adjustment			(529)		
Unrealized gain on securities, net of tax			310		
Comprehensive income					173,568
Balance, June 30, 2011	80,727	$ 505,117	$ (3,460)	$ 663,511	$ 1,165,168

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)

	Nine months ended June 30, 2011	Nine months ended June 30, 2010
Operating activities		
Net income	$ 173,787	$ 102,918
Adjustments to reconcile net income to net cash provided by operating activities:		
Realized gain on disposition of assets and investments	(203)	(117)
Stock-based compensation	67,613	50,991
Provisions for doubtful accounts and sales returns	453	794
Depreciation and amortization	15,715	17,923
Deferred income taxes	(387)	10,659
Gain on auction rate securities put option		(1,491)
Loss on trading auction rate securities		1,491
Changes in operating assets and liabilities, net of amounts acquired:		
Accounts receivable	(43,062)	3,350
Inventories	874	(3,927)
Other current assets	8,452	(10,380)
Other assets	(365)	(1,651)
Accounts payable and accrued liabilities	10,086	154
Deferred revenue	62,481	56,507
Net cash provided by operating activities	295,444	227,221
Investing activities		
Purchases of investments	(692,812)	(571,072)
Sales and maturities of investments	629,766	397,702
Investment of restricted cash	(406)	(26)
Acquisition of intangible assets	(80)	
Purchases of property and equipment	(20,544)	(10,119)
Net cash used in investing activities	(84,076)	(183,515)
Financing activities		
Excess tax benefits from stock-based compensation	20,221	16,419
Proceeds from the exercise of stock options and purchases of stock under employee stock purchase plan	21,131	29,338
Repurchase of common stock	(121,526)	(55,000)
Net cash used in financing activities	(80,174)	(9,243)
Net increase in cash and cash equivalents	131,194	34,463
Effect of exchange rate changes on cash and cash equivalents	(144)	(1,487)
Cash and cash equivalents, beginning of period	168,754	110,837
Cash and cash equivalents, end of period	$ 299,804	$ 143,813

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

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 manage their Internet Protocol (IP) traffic and file storage infrastructure efficiently and securely. The Company s application delivery networking products improve the performance, availability and security of applications on Internet-based networks. Internet traffic between network-based applications and clients passes through these devices 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 s storage virtualization products simplify and reduce the cost of managing files and file storage devices, and ensure fast, secure, easy access to files for users and applications. The Company also offers a broad range of services that include consulting, training, maintenance and other technical support services.

Basis of Presentation

The year end condensed consolidated balance sheet data was derived from audited financial statements, but does not include all disclosures required by accounting principles generally accepted in the United States of America. 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, 2010.

Certain reclassifications have been made to the prior year s financial statements to conform to the fiscal year 2011 presentation. Such reclassifications did not affect total revenues, operating income or net income.

Revenue Recognition

The Company sells products through distributors, resellers, and directly to end users. Revenue is recognized provided that all of the following criteria have been met:

Persuasive evidence of an arrangement exists. Evidence of an arrangement generally consists of a purchase order issued pursuant to the terms and conditions of a distributor, reseller or end user agreement.

Delivery has occurred. The Company uses shipping or related documents, or written evidence of customer acceptance, when applicable, to verify delivery or completion of any performance terms.

The sales price is fixed or determinable. The Company assesses whether the sales price is fixed or determinable based on payment terms associated with the transaction and whether the sales price is subject to refund or adjustment.

Collectability is reasonable assured. The Company assesses collectability primarily based on the creditworthiness of the customer as determined by credit checks and related analysis, as well as the Customer s payment history.

In certain regions where the Company does not have the ability to reasonably estimate returns, the Company defers revenue on sales to its distributors until they have received information from the channel partner indicating that the product has been sold to the end-user customer. Payment terms to domestic customers are generally net 30 days to net 45 days. Payment terms to international customers range from net 30 days to net 120 days based on normal and customary trade practices in the individual markets. The Company offers extended payment terms to certain customers, in which case, revenue is recognized when payments are due.

Table of Contents

Whenever product, training services 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. Revenue from the sale of products is recognized when the product has been shipped and the customer is obligated to pay for the product. 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 a limited period of telephone support updates, repair or replacement of any failed product or component that fails during the term of the agreement, bug fixes and rights to upgrades, when and if available. Consulting services are customarily billed at fixed hourly 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.

In October 2009, the Financial Accounting Standards Board (FASB) amended the accounting standards for revenue recognition to remove from the scope of industry-specific software revenue recognition guidance any tangible products containing software components and non-software components that operate together to deliver the products essential functionality. In addition, the FASB amended the accounting standards for certain multiple element revenue arrangements to:

Provide updated guidance on whether multiple elements exist, how the elements in an arrangement should be separated, and how the arrangement consideration should be allocated to the separate elements;

Require an entity to allocate arrangement consideration to each element based on a selling price hierarchy, where the selling price for an element is based on vendor-specific objective evidence (VSOE), if available, third-party evidence (TPE), if available and VSOE is not available; or the best estimate of selling price (BESP), if neither VSOE or TPE is available; and

Eliminate the use of the residual method and require an entity to allocate arrangement consideration using the selling price hierarchy.

The Company adopted this guidance in the first quarter of fiscal year 2011 on a prospective basis for applicable arrangements originating or materially modified after October 1, 2010. The impact of this adoption was not material to the Company s financial position and results of operations for the three and nine months ended June 30, 2011.

The majority of the Company s products are hardware appliances which contain software essential to the overall functionality of the products. Accordingly, the Company no longer recognizes revenue on sales of these products in accordance with the industry-specific software revenue recognition guidance.

For all transactions entered into prior to the first quarter of fiscal year 2011 and for sales of nonessential and stand-alone software after October 1, 2010, the Company allocates revenue for arrangements with multiple elements based on the software revenue recognition guidance. Software revenue recognition guidance requires revenue earned on software arrangements involving multiple elements to be allocated to each element based on the relative fair values of those elements. The fair value of an element must be based on VSOE. Where fair value of certain elements is not available, revenue is recognized on the residual method based on the fair value of undelivered elements. If evidence of the fair value of one or more undelivered elements does not exist, all revenue is deferred and recognized at the earlier of the delivery of those elements or the establishment of fair value of the remaining undelivered elements.

For transactions entered into subsequent to the adoption of the amended revenue recognition standards that are multiple-element arrangements, the arrangement consideration is allocated to each element based on the relative selling prices of all of the elements in the arrangement using the fair value hierarchy in the amended revenue recognition guidance.

Consistent with the methodology used under the previous accounting guidance, the Company establishes VSOE for its products, training services, PCS and consulting services based on the sales price charged for each element when sold separately. The sales price is discounted from the applicable list price based on various factors including the type of customer, volume of sales, geographic region and program level. The Company s list prices are generally not fair value as discounts may be given based on the factors enumerated above. The Company believes that the fair value of its consulting services is represented by the billable consulting rate per hour, based on the rates they charge customers when they purchase standalone consulting services. The price of consulting services is not based on the type of customer, volume of sales, geographic region or program level.

Table of Contents

The Company uses historical sales transactions to determine whether VSOE can be established for each of the elements. In most instances, VSOE of fair value is the sales price of actual standalone (unbundled) transactions within the past 12 month period that are priced within a reasonable range, which the Company has determined to be plus or minus 15% of the median sales price of each respective price list.

VSOE of PCS is based on standalone sales since the Company does not provide stated renewal rates to its customers. In accordance with the Company s PCS pricing practice (supported by standalone renewal sales), renewal contracts are priced as a percentage of the undiscounted product list price. The PCS renewal percentages may vary, depending on the type and length of PCS purchased. The Company offers standard and premium PCS, and the term generally ranges from one to three years. The Company employs a bell-shaped-curve approach in evaluating VSOE of fair value of PCS. Under this approach, the Company considers VSOE of the fair value of PCS to exist when a substantial majority of its standalone PCS sales fall within a narrow range of pricing.

The Company is typically not able to determine TPE for its products or services. TPE is determined based on competitor prices for similar elements when sold separately. Generally, the Company s go-to-market strategy differs from that of other competitive products or services in its markets and the Company s offerings contain a significant level of differentiation such that the comparable pricing of products with similar functionality cannot be obtained. Furthermore, the Company is unable to reliably determine the selling prices on a stand-alone basis of similar products offered by its competitors.

When the Company is unable to establish selling price of its non-software elements using VSOE or TPE, the Company uses BESP in its allocation of arrangement consideration. The objective of BESP is to determine the price at which the Company would transact a sale if the product or service were sold on a stand-alone basis. The Company determines BESP for a product or service by considering multiple factors including, but not limited to, cost of products, gross margin objectives, pricing practices, geographies, customer classes and distribution channels.

The Company has established and regularly validates the VSOE of fair value and BESP for elements in its multiple element arrangements. The Company accounts for taxes collected from customers and remitted to governmental authorities on a net basis and excluded from revenues.

Goodwill

Goodwill represents the excess purchase price over the estimated fair value of net assets acquired as of the acquisition date. The Company tests goodwill for impairment on an annual basis and between annual tests when impairment indicators are identified, and goodwill is written down when impaired. Goodwill was recorded in connection with the acquisition of Acopia Networks, Inc. in fiscal year 2007, Swan Labs, Inc. in fiscal year 2006, MagniFire Websystems, Inc. in fiscal year 2004 and uRoam, Inc. in fiscal year 2003.

The Company performs its annual goodwill impairment test during the second fiscal quarter, or whenever events or changes in circumstances indicate that the carrying amount of goodwill may not be recoverable. The first step of the test identifies whether potential impairment may have occurred, while the second step of the test measures the amount of the impairment, if any. Impairment is recognized when the carrying amount of goodwill exceeds its fair value. For its annual goodwill impairment analysis, the Company operates under one reporting unit. The Company determined the fair value of its reporting unit based on the Company s enterprise value. In March 2011, the Company completed its annual impairment test and concluded there was no impairment of goodwill. The Company also considered potential impairment indicators at June 30, 2011 and noted no indicators of impairment.

Stock-Based Compensation

The Company accounts for stock-based compensation using the straight-line attribution method for recognizing compensation expense. The Company recognized $22.9 million and $17.4 million of stock-based compensation expense for the three months ended June 30, 2011 and 2010, respectively, and $67.6 million and $51.0 million for the nine months ended June 30, 2011 and 2010, respectively. As of June 30, 2011, there was $55.7 million of total unrecognized stock-based compensation cost, the majority of which will be recognized over the next two years. Going forward, stock-based compensation expenses may increase as the Company issues additional equity-based awards to continue to attract and retain key employees.

The Company issues incentive awards to its employees through stock-based compensation consisting of restricted stock units (RSUs). On July 29, 2011, the Company s Compensation Committee approved 833,739 RSUs to employees and executive officers pursuant to the Company s annual equity awards program. The value of RSUs is determined using the fair value method, which in this case, is based on the number of shares granted and the quoted price of the Company s common stock on the date of grant.

Table of Contents

The Company recognizes compensation expense for only the portion of restricted stock units that are expected to vest. Therefore, the Company applies estimated forfeiture rates that are derived from historical employee termination behavior. Based on historical differences with forfeitures of stock-based awards granted to the Company s executive officers and Board of Directors versus grants awarded to all other employees, the Company has developed separate forfeiture expectations for these two groups. The Company s estimated forfeiture rate in the third quarter of fiscal year 2011 is 2.7% for grants awarded to the Company s executive officers and Board of Directors, and 9.7% for grants awarded to all other employees. If the actual number of forfeitures differs from those estimated by management, additional adjustments to compensation expense may be required in future periods.

In August 2010, the Company granted 181,334 and 83,000 RSUs to certain current executive officers as part of the annual equity and retention awards programs, respectively. Fifty percent of the aggregate number of RSUs granted as part of the annual equity awards program vest in equal quarterly increments over three years, until such portion of the grant is fully vested on August 1, 2013. One-sixth of the annual equity awards RSU grant, or a portion thereof, was subject to the Company achieving specified quarterly revenue and EBITDA goals during the period beginning in the fourth quarter of fiscal year 2010 through the third quarter of fiscal year 2011. In each case, 50% of the quarterly performance stock grant is based on achieving at least 80% of the quarterly revenue goal and the other 50% is based on achieving at least 80% of the quarterly EBITDA goal. The quarterly performance stock grant is paid linearly above 80% of the targeted goals. At least 100% of both goals must be attained in order for the quarterly performance stock grant to be awarded over 100%. Each goal is evaluated individually and subject to the 80% achievement threshold and 100% over-achievement threshold. The remaining 33.33% of this annual equity awards RSU grant shall be subject to performance based vesting for each of the four quarter periods beginning with the fourth quarters of fiscal years 2011 and 2012 (16.66% in each period). The Compensation Committee of the Board of Directors will set applicable performance targets and vesting formulas for each of these periods. All RSUs granted as part of the retention awards program fully vest on August 1, 2013.

In August 2009, the Company granted 420,000 RSUs to certain current executive officers. Fifty percent of the aggregate number of RSUs granted at such time vest in equal quarterly increments over two years, until such portion of the grant is fully vested on August 1, 2011. Twenty-five percent of the RSU grant, or a portion thereof, was subject to the Company achieving specified quarterly revenue and EBITDA goals during the period beginning in the fourth quarter of fiscal year 2009 through the third quarter of fiscal year 2010 and the remaining twenty-five percent was subject to the Company achieving specified quarterly revenue and EBITDA goals during the period beginning in the fourth quarter of fiscal year 2010 through the third quarter of fiscal year 2011. In each case, 50% of the quarterly performance stock grant is based on achieving at least 80% of the quarterly revenue goal and the other 50% is based on achieving at least 80% of the quarterly EBITDA goal. The quarterly performance stock grant is paid linearly above 80% of the targeted goals. At least 100% of both goals must be attained in order for the quarterly performance stock grant to be awarded over 100%. Each goal is evaluated individually and subject to the 80% achievement threshold and 100% over-achievement threshold.

The Company recognizes compensation costs for awards with performance conditions when it concludes it is probable that the performance condition will be achieved. The Company reassesses the probability of vesting at each balance sheet date and adjusts compensation costs based on the probability assessment.

Common Stock Repurchase

On October 22, 2008, the Company announced that its Board of Directors approved a program to repurchase up to an additional $200 million of the Company s outstanding common stock. As of September 30, 2010, the Company had $37.6 million remaining to

Table of Contents

purchase shares as part of this repurchase program. On October 26, 2010, the Company announced that its Board of Directors approved a new program to repurchase up to an additional $200 million of the Company s outstanding common stock. Acquisitions for the share repurchase programs will be made from time to time in private transactions or open market purchases as permitted by securities laws and other legal requirements. The programs can be terminated at any time. As of August 2, 2011, the Company had repurchased and retired 5,666,566 shares at an average price of $51.09 per share and the Company had $110.2 million remaining to purchase shares as part of its repurchase programs.

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. The Company s nonvested restricted stock awards and restricted stock units do not have nonforfeitable rights to dividends or dividend equivalents.

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

	Three months ended June 30,		Nine months ended June 30,	
	2011	**2010**	**2011**	**2010**
Numerator				
Net income	$ 62,549	$ 40,495	$ 173,787	$ 102,918
Denominator				
Weighted average shares outstanding basic	80,866	79,864	80,773	79,386
Dilutive effect of common shares from stock options and restricted stock units	631	1,167	882	1,484
Weighted average shares outstanding diluted	81,497	81,031	81,655	80,870
Basic net income per share	$ 0.77	$ 0.51	$ 2.15	$ 1.30
Diluted net income per share	$ 0.77	$ 0.50	$ 2.13	$ 1.27

An immaterial amount of common shares potentially issuable from stock options for the three and nine months ended June 30, 2011 and 2010, are excluded from the calculation of diluted earnings per share because the exercise price was greater than the average market price of common stock for the respective periods.

Comprehensive Income

Comprehensive income includes certain changes in equity that are excluded from net income. Specifically, unrealized gains (losses) on securities and foreign currency translation adjustments are included in accumulated other comprehensive loss. Comprehensive income and its components were as follows (in thousands):

	Three months ended June 30,		Nine months ended June 30,	
	2011	**2010**	**2011**	**2010**
Net Income	$ 62,549	$ 40,495	$ 173,787	$ 102,918
Unrealized gain (loss) on securities, net of tax	1,273	(277)	310	(1,088)
Foreign currency translation adjustment	(101)	(724)	(529)	(1,170)
Total comprehensive income	$ 63,721	$ 39,494	$ 173,568	$ 100,660

Recent Accounting Pronouncements

Management believes there have been no significant changes during the nine months ended June 30, 2011, to the items disclosed as recently adopted accounting pronouncements in Management s Discussion and Analysis of Financial Condition and Results of Operations in the Company s Annual Report on Form 10-K for the year ended September 30, 2010. For a further discussion, refer to the Recent Accounting Pronouncements discussion contained therein.

2. Fair Value Measurements

In accordance with the authoritative guidance on fair value measurements and disclosure under GAAP, the Company determines fair value using a fair value hierarchy that distinguishes between market participant assumptions developed based on market data obtained from sources independent of the reporting entity, and the reporting entity s own assumptions about market participant assumptions developed based on the best information available in the circumstances and expands disclosure about fair value measurements.

Fair value is the price that would be received to sell an asset or paid to transfer a liability in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants at the measurement date, essentially the exit price.

The levels of fair value hierarchy are:

Level 1: Quoted prices in active markets for identical assets and liabilities at the measurement date.

Level 2: Observable inputs other than quoted prices included in Level 1, such as quoted prices for similar assets and liabilities in active markets; quoted prices for identical or similar assets and liabilities in markets that are not active; or other inputs that are observable or can be corroborated by observable market data.

Level 3: Unobservable inputs for which there is little or no market data available. These inputs reflect management s assumptions of what market participants would use in pricing the asset or liability.

Level 1 investments are valued based on quoted market prices in active markets and include the Company s cash equivalent investments. Level 2 investments, which include investments that are valued based on quoted prices in markets that are not active, broker or dealer quotations, or alternative pricing sources with reasonable levels of price transparency, include the Company s corporate bonds and notes, municipal bonds and notes, U.S. government securities and U.S. government agency securities. Fair values for the Company s level 2 investments are based on similar assets without applying significant judgments. In addition, all of the Company s level 2 investments have a sufficient level of trading volume to demonstrate that the fair values used are appropriate for these investments.

A financial instrument s level within the fair value hierarchy is based upon the lowest level of any input that is significant to the fair value measurement. However, the determination of what constitutes observable requires significant judgment by the Company. The Company considers observable data to be market data which is readily available, regularly distributed or updated, reliable and verifiable, not proprietary, and provided by independent sources that are actively involved in the relevant market.

The Company s financial assets measured at fair value on a recurring basis subject to the disclosure requirements at June 30, 2011, were as follows (in thousands):

	Fair Value Measurements at Reporting Date Using			
	Quoted Prices in Active Markets for Identical Securities (Level 1)	**Significant Other Observable Inputs (Level 2)**	**Significant Unobservable Inputs (Level 3)**	**Fair Value at June 30, 2011**
Cash equivalents	$ 132,226	$	$	$ 132,226
Short-term investments				
Available-for-sale securities corporate bonds and notes		111,223		111,223
Available-for-sale securities municipal bonds and notes		79,540		79,540
Available-for-sale securities U.S. government securities		799		799
Available-for-sale securities U.S. government agency securities		93,968		93,968
Long-term investments				

Available-for-sale securities corporate bonds and notes		154,424		154,424
Available-for-sale securities municipal bonds and notes		24,320		24,320
Available-for-sale securities U.S. government agency securities		279,833		279,833
Available-for-sale securities auction rate securities			12,990	12,990
Total	$ 132,226	$ 744,107	$ 12,990	$ 889,323

12

Table of Contents

The Company s financial assets measured at fair value on a recurring basis subject to the disclosure requirements at September 30, 2010, were as follows (in thousands):

	Fair Value Measurements at Reporting Date Using			
	Quoted Prices in Active Markets for Identical Securities (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Fair Value at September 30, 2010
Cash equivalents	$ 26,987	$	$	$ 26,987
Short-term investments				
Available-for-sale securities corporate bonds and notes		120,124		120,124
Available-for-sale securities municipal bonds and notes		77,063		77,063
Available-for-sale securities U.S. government agency securities		62,555		62,555
Long-term investments				
Available-for-sale securities corporate bonds and notes		174,053		174,053
Available-for-sale securities municipal bonds and notes		22,094		22,094
Available-for-sale securities U.S. government agency securities		221,380		221,380
Available-for-sale securities auction rate securities			16,043	16,043
Total	$ 26,987	$ 677,269	$ 16,043	$ 720,299

Due to the auction failures of the Company s auction rate securities (ARS) that began in the second quarter of fiscal year 2008, there are still no quoted prices in active markets for similar assets as of June 30, 2011. Therefore, the Company has classified its ARS as level 3 financial assets. The following table provides a reconciliation between the beginning and ending balances of items measured at fair value on a recurring basis in the table above that used significant unobservable inputs (Level 3) (in thousands):

	Three months ended June 30,		Nine months ended June 30,	
	2011	2010	2011	2010
Balance, beginning of period	$ 16,380	$ 37,453	$ 16,043	$ 41,595
Total losses realized or unrealized:				
Included in earnings (other income, net)		1,510		1,491
Included in other comprehensive income	610	(61)	947	347
Recognition of put option to earnings		(1,510)		(1,491)
Settlements	(4,000)	(21,500)	(4,000)	(26,050)
Transfers into and/or out of level 3				

Balance, end of period	$ 12,990	$ 15,892	$ 12,990	$ 15,892
Gains (losses) attributable to assets still held as of end of period	610	(61)	947	347

Financial assets are considered Level 3 when their fair values are determined using pricing models, discounted cash flow methodologies or similar techniques and at least one significant model assumption or input is unobservable or there is limited market activity such that the determination of fair value requires significant judgment or estimation. Level 3 investment securities primarily include certain ARS for which there was a decrease in the observation of market pricing. At June 30, 2011, the values of these securities were estimated primarily using discounted cash flow analysis that incorporated transaction details such as contractual terms, maturity, timing and amount of future cash flows, as well as assumptions about liquidity and credit valuation adjustments of marketplace participants at June 30, 2011.

The Company uses the fair value hierarchy for financial assets and liabilities. The Company s non-financial assets and liabilities, which include goodwill, intangible assets, and long-lived assets, are not required to be carried at fair value on a recurring basis. These non-financial assets and liabilities are measured at fair value on a non-recurring basis when there is an indicator of impairment, and they are recorded at fair value only when impairment is recognized. The Company reviews goodwill and intangible assets for impairment annually, during the second quarter of each fiscal year, or as circumstances indicate the possibility of impairment. The Company monitors the carrying value of long-lived assets for impairment whenever events or changes in circumstances indicate its carrying amount may not be recoverable. During the nine months ended June 30, 2011, the Company did not recognize any impairment charges related to goodwill, intangible assets, or long-lived assets.

3. Short-Term and Long-Term Investments

Short-term investments consist of the following (in thousands):

June 30, 2011	Cost or Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Corporate bonds and notes	$ 110,859	$ 371	$ (7)	$ 111,223
Municipal bonds and notes	79,494	58	(12)	79,540
U.S. government securities	799			799
U.S. government agency securities	93,935	50	(17)	93,968
	$ 285,087	$ 479	$ (36)	$ 285,530

September 30, 2010	Cost or Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Corporate bonds and notes	$ 119,829	$ 318	$ (23)	$ 120,124
Municipal bonds and notes	76,886	182	(5)	77,063
U.S. government agency securities	62,390	165		62,555
	$ 259,105	$ 665	$ (28)	$ 259,742

Long-term investments consist of the following (in thousands):

June 30, 2011	Cost or Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Corporate bonds and notes	$ 153,433	$ 1,041	$ (50)	$ 154,424
Municipal bonds and notes	24,183	137		24,320
Auction rate securities	15,000		(2,010)	12,990
U.S. government agency securities	279,498	405	(70)	279,833
	$ 472,114	$ 1,583	$ (2,130)	$ 471,567

September 30, 2010	Cost or Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Corporate bonds and notes	$ 172,493	$ 1,582	$ (22)	$ 174,053
Municipal bonds and notes	22,045	67	(18)	22,094
Auction rate securities	19,000		(2,957)	16,043
U.S. government agency securities	221,262	200	(82)	221,380
	$ 434,800	$ 1,849	$ (3,079)	$ 433,570

The amortized cost and fair value of fixed maturities at June 30, 2011, by contractual years-to-maturity, are presented below (in thousands):

	Cost or Amortized Cost	Fair Value
One year or less	$ 285,087	$ 285,530
Over one year	472,114	471,567
	$ 757,201	$ 757,097

The cost or amortized cost values of the Company s fixed maturities include $15.0 million and $19.0 million of available-for-sale ARS as of June 30, 2011 and September 30, 2010, respectively.

The following table summarizes investments that have been in a continuous unrealized loss position for less than 12 months and those that have been in a continuous unrealized loss position for more than 12 months as of June 30, 2011 (in thousands):

	Less Than 12 Months		12 Months or Greater		Total	
June 30, 2011	**Fair Value**	**Gross Unrealized Losses**	**Fair Value**	**Gross Unrealized Losses**	**Fair Value**	**Gross Unrealized Losses**
Corporate bonds and notes	$ 29,580	$ (56)	$ 3,209	$ (1)	$ 32,789	$ (57)
Municipal bonds and notes	7,174	(12)			7,174	(12)
Auction rate securities			12,990	(2,010)	12,990	(2,010)
U.S. government agency securities	79,130	(87)			79,130	(87)
Total	$ 115,884	$ (155)	$ 16,199	$ (2,011)	$ 132,083	$ (2,166)

The Company invests in securities that are rated investment grade or better. The unrealized losses on investments for the first nine months of fiscal year 2011 were primarily caused by reductions in the values of the ARS due to the illiquid markets and were partially offset by unrealized gains related to interest rate decreases.

ARS are variable-rate debt securities. The Company limits its investments in ARS to securities that carry an AAA/A- (or equivalent) rating from recognized rating agencies and limits the amount of credit exposure to any one issuer. At the time of the Company s initial investment and at the date of this report, all ARS were in compliance with the Company s investment policy. In the past, the auction process allowed investors to obtain immediate liquidity if so desired by selling the securities at their face amounts. Liquidity for these securities has historically been provided by an auction process that resets interest rates on these investments on average every 7-35 days. However, as has been reported in the financial press, the disruptions in the credit markets adversely affected the auction market for these types of securities.

Beginning in February 2008, auctions failed for approximately $53.4 million in par value of municipal ARS the Company held because sell orders exceeded buy orders. The funds associated with failed auctions will not be accessible until the issuer calls the security, a successful auction occurs, a buyer is found outside the auction process or the security otherwise matures.

4. Inventories

The Company outsources the manufacturing of its pre-configured hardware platforms to contract manufacturers, who assemble each product to the Company s specifications. As protection against component shortages and to provide replacement parts for its service teams, the Company also stocks limited supplies of certain key product components. The Company reduces inventory to net realizable value based on excess and obsolete inventories determined primarily by historical usage and forecasted demand. Inventories consist of hardware and related component parts and are recorded at the lower of cost or market (as determined by the first-in, first-out method).

Inventories consist of the following (in thousands):

	June 30, 2011	September 30, 2010
Finished goods	$ 13,883	$ 14,949
Raw materials	4,058	3,866
	$ 17,941	$ 18,815

5. Commitments and Contingencies

Guarantees and Product Warranties

In the normal course of business to facilitate sales of its products, the Company indemnifies other parties, including customers, resellers, lessors, and parties to other transactions with the Company, 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. The Company has entered into indemnification agreements with its 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 offers warranties of one year for hardware for those customers without service contracts, with the option of purchasing additional warranty coverage in yearly increments. The Company accrues for warranty costs as part of its cost of sales based on associated material product costs and technical support labor costs. Accrued warranty costs as of June 30, 2011 and June 30, 2010 were not material.

Purchase Commitments

The Company currently has arrangements with contract manufacturers and other suppliers for the manufacturing of its 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 June 30, 2011, the Company was committed to purchase approximately $13.5 million of such inventory during the next quarter.

Legal Proceedings

The Company is not aware of any pending legal proceedings 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 we allegedly infringe upon third-party intellectual property rights. Such claims, even if not meritorious, could result in the expenditure of significant financial and managerial resources.

6. Income Taxes

The effective tax rate was 30.6% and 36.4% for the three months ended June 30, 2011 and 2010, respectively. The decrease in effective tax rate was primarily due to an increased benefit resulting from the United States Domestic Production Activities deduction and a change in the Company s uncertain tax positions as a result of the settlement of audits and expiration of statutes of limitation in various jurisdictions.

At June 30, 2011, the Company has classified approximately $4.3 million of unrecognized tax liabilities as a non-current liability. It is reasonably possible that the Company s existing liabilities for uncertain tax benefits may change within the next twelve months primarily due to the progression of audits in progress or the expiration of statutes of limitation. Due to the nature of the various audits, the Company cannot reasonably estimate a range of potential changes in such benefits.

The Company recognizes interest and, if applicable, penalties for any uncertain tax positions. This interest and penalty expense will be a component of income tax expense. For the three and nine months ended June 30, 2011, the Company accrued an immaterial amount of interest expense related to its liability for unrecognized tax benefits. All unrecognized tax benefits, if recognized, would affect the effective tax rate.

The Company and its subsidiaries are subject to U.S. federal income tax as well as the income tax of multiple state and foreign jurisdictions. Major jurisdictions where there are wholly owned subsidiaries of F5 Networks, Inc. which require income tax filings include the United Kingdom, Japan, Australia and Germany. The earliest periods open for review by local taxing authorities are fiscal years 2008, 2010, 2007 and 2006 for the United Kingdom, Japan, Australia and Germany, respectively. Within the next four fiscal quarters, the statute of limitations will begin to close on the fiscal years ended 2007 and 2008 tax returns filed in various states and the fiscal year ended 2008 federal income tax return.

7. 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 does business in four main geographic regions: the Americas (primarily the United States); Europe, the Middle East, and Africa (EMEA); Japan; and the Asia Pacific region (APAC). 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. 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 revenue.

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

	Three months ended June 30,		Nine months ended June 30,	
	2011	2010	2011	2010
Americas	$ 165,119	$ 135,584	$ 486,840	$ 364,996
EMEA	58,704	50,900	178,290	146,504
Japan	21,499	15,185	53,624	43,112
Asia Pacific	45,391	28,805	118,465	73,086
	$ 290,713	$ 230,474	$ 837,219	$ 627,698

Two worldwide distributors of the Company s products accounted for 27.0% and 28.4% of total net revenue for the three and nine month periods ended June 30, 2011, respectively. One worldwide distributor accounted for 13.3% of total net revenue for the three month period ended June 30, 2010. Two worldwide distributors accounted for 23.3% of total net revenue for the nine month period ended June 30, 2010. Two worldwide distributors accounted for 26.8% of the Company s accounts receivable as of June 30, 2011. No other distributors accounted for more than 10% of total net revenue or receivables.

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

The following discussion of our financial condition and results of operations contains 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. These forward-lool statements are based on current information and expectations and 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 Item 1A. Risk Factors herein and in other documents we file from time to time with the Securities and Exchange Commission. We assume no obligation to revise or update any such forward-looking statements.

Overview

We are a global provider of appliances consisting of software and hardware and services that help companies efficiently and securely manage the delivery, optimization and security of application and data traffic on Internet-based networks, and to optimize the performance and utilization of data storage infrastructure and other network resources. We market and sell our products primarily through multiple indirect sales channels in the Americas (primarily the United States); Europe, the Middle East, and Africa (EMEA); Japan; and the Asia Pacific region (APAC). Enterprise customers (Fortune 1000 or Business Week Global 1000 companies) in the technology, telecommunications, financial services, transportation, education, manufacturing and health care industries, along with government customers, continue to make up the largest percentage of our customer base.

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

Revenues. The majority of our revenues are derived from sales of our Application Delivery Networking (ADN) products including our high end VIPRION chassis and related software modules; BIG-IP Local Traffic Manager, BIG-IP Global Traffic Manager, BIG-IP Link Controller, BIG-IP Application Security Manager, BIG-IP Edge Gateway, BIG-IP WAN Optimization module, BIG-IP Access Policy Manager, WebAccelerator, and FirePass SSL VPN appliance; and our ARX file virtualization products. We also derive revenues from the sales of services including annual maintenance contracts, 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 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; 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 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 nine months of fiscal year 2011 was primarily due to net income from operations, with operating activities providing cash of $295.4 million. This increase was partially offset by $121.5 million of cash used to repurchase outstanding common stock under our stock repurchase program in the first three quarters of fiscal year 2011. Going forward, we believe the primary driver of cash flows will be net income from operations. Capital expenditures for the first nine months of fiscal year 2011 were comprised primarily of 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 in the third quarter of fiscal year 2011 due to 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 third quarter of fiscal year 2011 was 48.

Summary of Critical Accounting Policies and Estimates

The preparation of our financial condition and results of operations requires us to make judgments and estimates that may have a significant impact upon our financial results. We believe that, of our significant accounting policies, the following require estimates and assumptions that require complex, subjective judgments by management, which can materially impact reported results: revenue recognition; reserve for doubtful accounts; reserve for product returns; reserve for warranties; accounting for income taxes; stock-based compensation; investments; goodwill impairment; and the fair value measurements of financial assets and liabilities. None of these accounting policies and estimates with the exception of the revenue recognition policy discussed below, have significantly changed since our annual report on Form 10-K for the year ended September 30, 2010 (Form 10-K). Critical accounting policies and estimates are more fully described in Management s Discussion and Analysis of Financial Condition and Results of Operations in the Form 10-K. Actual results may differ from these estimates under different assumptions or conditions.

We believe the following critical accounting policy, as well as those discussed in our Form 10-K, affect the more significant estimates and judgments used in the preparation of our financial statements.

Revenue Recognition

We sell products through distributors, resellers, and directly to end users. Revenue is recognized provided that all of the following criteria have been met:

Persuasive evidence of an arrangement exists. Evidence of an arrangement generally consists of a purchase order issued pursuant to the terms and conditions of a distributor, reseller or end user agreement.

Delivery has occurred. We use shipping or related documents, or written evidence of customer acceptance, when applicable, to verify delivery or completion of any performance terms.

The sales price is fixed or determinable. We assess whether the sales price is fixed or determinable based on payment terms associated with the transaction and whether the sales price is subject to refund or adjustment.

Collectability is reasonable assured. We assess collectability primarily based on the creditworthiness of the customer as determined by credit checks and related analysis, as well as the Customer s payment history.

In certain regions where we do not have the ability to reasonably estimate returns, we defer revenue on sales to our distributors until they have received information from the channel partner indicating that the product has been sold to the end-user customer. Payment terms to domestic customers are generally net 30 days to net 45 days. Payment terms to international customers range from net 30 days to net 120 days based on normal and customary trade practices in the individual markets. We offer extended payment terms to certain customers, in which case, revenue is recognized when payments are due.

Table of Contents

Whenever product, training services 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. Revenue from the sale of products is recognized when the product has been shipped and the customer is obligated to pay for the product. 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 a limited period of telephone support updates, repair or replacement of any failed product or component that fails during the term of the agreement, bug fixes and rights to upgrades, when and if available. Consulting services are customarily billed at fixed hourly 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.

In October 2009, the Financial Accounting Standards Board (FASB) amended the accounting standards for revenue recognition to remove from the scope of industry-specific software revenue recognition guidance any tangible products containing software components and non-software components that operate together to deliver the products essential functionality. In addition, the FASB amended the accounting standards for certain multiple element revenue arrangements to:

Provide updated guidance on whether multiple elements exist, how the elements in an arrangement should be separated, and how the arrangement consideration should be allocated to the separate elements;

Require an entity to allocate arrangement consideration to each element based on a selling price hierarchy, where the selling price for an element is based on vendor-specific objective evidence (VSOE), if available, third-party evidence (TPE), if available and VSOE is not available; or the best estimate of selling price (BESP), if neither VSOE or TPE is available; and

Eliminate the use of the residual method and require an entity to allocate arrangement consideration using the selling price hierarchy.

We adopted this guidance in the first quarter of fiscal year 2011 on a prospective basis for applicable arrangements originating or materially modified after October 1, 2010. The impact of this adoption was not material to our financial position and results of operations for the three and nine months ended June 30, 2011.

The majority of our products are hardware appliances which contain software essential to the overall functionality of the products. Accordingly, we no longer recognize revenue on sales of these products in accordance with the industry-specific software revenue recognition guidance.

For all transactions entered into prior to the first quarter of fiscal year 2011 and for sales of nonessential and stand-alone software after October 1, 2010, we allocate revenue for arrangements with multiple elements based on the software revenue recognition guidance. Software revenue recognition guidance requires revenue earned on software arrangements involving multiple elements to be allocated to each element based on the relative fair values of those elements. The fair value of an element must be based on VSOE. Where fair value of certain elements is not available, revenue is recognized on the residual method based on the fair value of undelivered elements. If evidence of the fair value of one or more undelivered elements does not exist, all revenue is deferred and recognized at the earlier of the delivery of those elements or the establishment of fair value of the remaining undelivered elements.

For transactions entered into subsequent to the adoption of the amended revenue recognition standards that are multiple-element arrangements, the arrangement consideration is allocated to each element based on the relative selling prices of all of the elements in the arrangement using the fair value hierarchy in the amended revenue recognition guidance.

Consistent with the methodology used under the previous accounting guidance, we establish VSOE for our products, training services, PCS and consulting services based on the sales price charged for each element when sold separately. The sales price is discounted from the applicable list price based on various factors including the type of customer, volume of sales, geographic region and program level. Our list prices are generally not fair value as discounts may be given based on the factors enumerated above. We believe that the fair value of our consulting services is represented by the billable consulting rate per hour, based on the rates we charge customers when they purchase standalone consulting services. The price of consulting services is not based on the type of customer, volume of sales, geographic region or program level.

Table of Contents

We use historical sales transactions to determine whether VSOE can be established for each of the elements. In most instances, VSOE of fair value is the sales price of actual standalone (unbundled) transactions within the past 12 month period that are priced within a reasonable range, which we have determined to be plus or minus 15% of the median sales price of each respective price list.

VSOE of PCS is based on standalone sales since we do not provide stated renewal rates to our customers. In accordance with our PCS pricing practice (supported by standalone renewal sales), renewal contracts are priced as a percentage of the undiscounted product list price. The PCS renewal percentages may vary, depending on the type and length of PCS purchased. We offer standard and premium PCS, and the term generally ranges from one to three years. We employ a bell-shaped-curve approach in evaluating VSOE of fair value of PCS. Under this approach, we consider VSOE of the fair value of PCS to exist when a substantial majority of our standalone PCS sales fall within a narrow range of pricing.

We are typically not able to determine TPE for our products or services. TPE is determined based on competitor prices for similar elements when sold separately. Generally, our go-to-market strategy differs from that of other competitive products or services in our markets and our offerings contain a significant level of differentiation such that the comparable pricing of products with similar functionality cannot be obtained. Furthermore, we are unable to reliably determine the selling prices on a stand-alone basis of similar products offered by our competitors.

When we are unable to establish selling price of our non-software elements using VSOE or TPE, we use BESP in our allocation of arrangement consideration. The objective of BESP is to determine the price at which we would transact a sale if the product or service were sold on a stand-alone basis. We determine BESP for a product or service by considering multiple factors including, but not limited to, cost of products, gross margin objectives, pricing practices, geographies, customer classes and distribution channels.

We have established and regularly validate the VSOE of fair value and BESP for elements in our multiple element arrangements. We account for taxes collected from customers and remitted to governmental authorities on a net basis and excluded from revenues.

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.

	Three months ended June 30,		**Nine months ended June 30,**	
	2011	**2010**	**2011**	**2010**
	(in thousands, except percentages)			
Net Revenues				
Products	$ 179,327	$ 147,393	$ 524,529	$ 396,170
Services	111,386	83,081	312,690	231,528
Total	$ 290,713	$ 230,474	$ 837,219	$ 627,698
Percentage of net revenues				
Products	61.7%	64.0%	62.7%	63.1%
Services	38.3	36.0	37.3	36.9
Total	100.0%	100.0%	100.0%	100.0%

Net revenues. Total net revenues increased 26.1% and 33.4% for the three and nine months ended June 30, 2011, respectively, from the same periods in the prior year. Overall revenue growth for the three and nine months ended June 30, 2011 was primarily due to increased service and product revenues as a result of our increased installed base of products and increased demand for our core ADN products, including application security and WAN optimization products. International revenues were 43.2% and 41.9% of total net revenues for the three and nine months ended

June 30, 2011, respectively, compared to 41.2% and 41.9% for the same periods in the prior year, 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 21.7% and 32.4% for the three and nine months ended June 30, 2011, respectively, from the same periods in the prior year. The increase in net product revenues for the three and nine months ended June 30, 2011 was primarily due to an increase of $30.6 million and $124.3 million in sales of our ADN products from the same periods in the prior year, respectively. Sales of our ADN products represented 96.9% and 97.2% of product revenues for the three and nine months ended June 30, 2011, respectively, compared to 97.1% and 97.3% of product revenues for the three and nine months ended June 30, 2010, respectively. We are now including our FirePass SSL VPN product as a component of ADN revenue.

Table of Contents

Net service revenues increased 34.1% and 35.1% for the three and nine months ended June 30, 2011, respectively, from the same periods in the prior year. The increase in net service revenues was primarily due to increases in the purchase or renewal of maintenance contracts driven by additions to our installed base of products.

Avnet Technology Solutions and Ingram Micro, two of our worldwide distributors, accounted for 16.4% and 10.6% of our total net revenue for the three months ended June 30, 2011, respectively. Avnet Technology Solutions and Ingram Micro accounted for 18.3% and 10.1% of our total net revenue for the nine months ended June 30, 2011, respectively. Avnet Technology Solutions accounted for 13.3% of our total net revenue for the three months ended June 30, 2010. Avnet Technology Solutions and Tech Data, another worldwide distributor, accounted for 13.0% and 10.3% of our total net revenue for the nine months ended June 30, 2010, respectively. Avnet Technology Solutions and Ingram Micro accounted for 11.1% and 15.7% of our account