F5 NETWORKS INC
Form 10-Q
February 08, 2007

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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 December 31, 2006

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 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 þ Accelerated filer o Non-accelerated filer o

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 February 5, 2007 was 41,279,447.

F5 NETWORKS, INC.
QUARTERLY REPORT ON FORM 10-Q
For the Quarter Ended December 31, 2006
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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

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

	December 31, 2006	September 30, 2006
ASSETS		
Current assets		
Cash and cash equivalents	$ 31,085	$ 37,746
Short-term investments	384,238	336,427
Accounts receivable, net of allowances of $3,056 and $2,858	67,246	62,750
Inventories	5,730	5,763
Deferred tax assets	4,943	4,682
Other current assets	14,166	15,607
Total current assets	507,408	462,975
Restricted cash	3,941	3,929
Property and equipment, net	29,951	29,951
Long-term investments	129,943	118,003
Deferred tax assets	20,108	18,657
Goodwill	81,701	81,701
Other assets, net	14,518	14,295
Total assets	$ 787,570	$ 729,511
LIABILITIES AND SHAREHOLDERS EQUITY		
Current liabilities		
Accounts payable	$ 12,879	$ 13,174
Accrued liabilities	41,094	31,583
Deferred revenue	61,156	54,880
Total current liabilities	115,129	99,637
Other long-term liabilities	8,385	7,976
Deferred revenue, long-term	7,512	5,440
Total long-term liabilities	15,897	13,416
Commitments and contingencies		
Shareholders equity		
Preferred stock, no par value; 10,000 shares authorized, no shares outstanding		
Common stock, no par value; 100,000 shares authorized, 41,118 and 40,778 shares issued and outstanding	539,220	521,791
Accumulated other comprehensive loss	(734)	(1,038)

Retained earnings		118,058		95,705
Total shareholders equity		656,544		616,458
Total liabilities and shareholders equity	$	787,570	$	729,511

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

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

	Three months ended December 31, 2006	Three months ended December 31, 2005
Net revenues		
Products	$ 92,062	$ 68,591
Services	27,968	19,496
Total	120,030	88,087
Cost of net revenues		
Products	19,216	14,593
Services	7,308	4,974
Total	26,524	19,567
Gross profit	93,506	68,520
Operating expenses		
Sales and marketing	39,055	28,865
Research and development	14,539	10,478
General and administrative	12,818	7,397
Total	66,412	46,740
Income from operations	27,094	21,780
Other income, net	6,431	2,970
Income before income taxes	33,525	24,750
Provision for income taxes	11,172	9,529
Net income	$ 22,353	$ 15,221
Net income per share basic	$ 0.54	$ 0.39
Weighted average shares basic	41,031	39,163
Net income per share diluted	$ 0.53	$ 0.37
Weighted average shares diluted	42,318	40,805

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

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

	Three Months Ended December 31, 2006				
	Common Stock		Accumulated Other Comprehensive	Retained	Total Shareholders
	Shares	Amount	Loss	Earnings	Equity
Balance, September 30, 2006	40,778	$ 521,791	$ (1,038)	$ 95,705	$ 616,458
Exercise of employee stock options	139	3,789			3,789
Issuance of stock under employee stock purchase plan	66	3,296			3,296
Issuance of restricted stock	135				
Tax benefit from employee stock transactions		1,615			1,615
Stock-based compensation		8,729			8,729
Comprehensive income:					
Net income				22,353	
Foreign currency translation adjustment			(120)		
Unrealized loss on securities			424		
Total comprehensive income					22,657
Balance, December 31, 2006	41,118	$ 539,220	$ (734)	$ 118,058	$ 656,544

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

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

	Three months ended December 31, 2006	2005
Operating activities		
Net income	$ 22,353	$ 15,221
Adjustments to reconcile net income to net cash provided by operating activities:		
Loss on disposition of assets	1	4
Loss on disposition of investments	(2)	
Stock-based compensation	8,729	5,250
Provisions for doubtful accounts and sales returns	724	273
Depreciation and amortization	3,611	2,396
Deferred income taxes	(1,419)	9,262
Changes in operating assets and liabilities, net of amounts acquired:		
Accounts receivable	(5,214)	(7,481)
Inventories	32	68
Other current assets	1,418	317
Other assets	(1,209)	(259)
Accounts payable and accrued liabilities	9,466	5,643
Deferred revenue	8,348	3,779
Net cash provided by operating activities	46,838	34,473
Investing activities		
Purchases of investments	(180,572)	(98,560)
Sales of investments	120,968	57,618
Investment of restricted cash	(8)	4
Acquisition of business, net of cash acquired		(42,778)
Purchases of property and equipment	(2,605)	(3,874)
Net cash used in investing activities	(62,217)	(87,590)
Financing activities		
Tax benefit from nonqualified stock options	1,615	
Proceeds from the exercise of stock options and purchases of stock under employee stock purchase plan	7,131	19,949
Net cash provided by financing activities	8,746	19,949
Net decrease in cash and cash equivalents	(6,633)	(33,168)
Effect of exchange rate changes on cash and cash equivalents	(28)	31
Cash and cash equivalents, beginning of period	37,746	51,867
Cash and cash equivalents, end of period	$ 31,085	$ 18,730

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

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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.

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, 2006.

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 reasonably assured and no significant performance obligations remain. 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 distributor has sold the product to its customer. Payment terms to domestic customers are generally net 30 to 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. The Company offers 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 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 a limited period of telephone support updates, bug fixes and rights to upgrades, when and if available. 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.

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Stock-Based Compensation

The Company accounts for stock-based compensation in accordance with Financial Accounting Standards Board (FASB) Statement No. 123(R), *Share-Based Payment* (FAS 123R), using the straight-line attribution method for recognizing compensation expense. The Company recognized $8.7 million and $5.3 million of stock-based compensation expense for the three months ended December 31, 2006 and 2005, respectively. As of December 31, 2006, there was $46.6 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 we issue 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 stock options and restricted stock units (RSU s). The value of RSU s is determined using the intrinsic 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. Alternatively, in determining the fair value of stock options, the Company uses the Black-Scholes option pricing model that employs the following key assumptions. Expected volatility is based on the annualized daily historical volatility of the Company s stock price over the expected life of the option. 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. The Company s 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 the Company recognize compensation expense for only the portion of stock options or RSU s that are expected to vest. Therefore, the Company applies estimated forfeiture rates that are derived from historical employee termination behavior. The Company s estimated forfeiture rate in the first quarter of fiscal 2007 is 5%. If the actual number of forfeitures differs from those estimated by management, additional adjustments to stock-based compensation expense may be required in future periods.

Compensation cost recognized for the three month period ended December 31, 2006 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 FASB Statement No. 123, *Accounting for Stock-Based Compensation* 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.

In December 2006, the Company granted 228,000 RSU s to certain current executive officers. Fifty percent of the aggregate number of RSU s granted at such time vest in equal quarterly increments over two years, until such portion of the grant is fully vested on November 1, 2008. Twenty five percent of the RSU grant is subject to the Company achieving specified percentage increases in total revenue for fiscal year 2007, relative to fiscal year 2006. The remaining twenty five percent is subject to the Company meeting specified performance criteria for fiscal year 2008 to be set by the Compensation Committee of the Company s Board of Directors.

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

	Three months ended December 31,	
	2006	2005
Numerator		
Net income	$ 22,353	$ 15,221
Denominator		
Weighted average shares outstanding basic	41,031	39,163
Dilutive effect of common shares from stock options and restricted stock units	1,287	1,642
Weighted average shares outstanding diluted	42,318	40,805
Basic net income per share	$ 0.54	$ 0.39
Diluted net income per share	$ 0.53	$ 0.37

Approximately 0.1 million and 0.4 million of common shares potentially issuable from stock options for the three months ended December 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 commons stock for the respective period.

Comprehensive Income

Comprehensive income includes certain changes in equity that are excluded from net income. Specifically, unrealized 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 December 31,	
	2006	2005
Net income	$ 22,353	$ 15,221
Unrealized loss on securities	424	38
Foreign currency translation adjustment	(120)	(68)
Total comprehensive income	$ 22,657	$ 15,191

Recent Accounting Pronouncements

In September 2006, the FASB, issued SFAS, No. 157, *Fair Value Measurements* (SFAS 157), which defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements. SFAS 157 is effective for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. The Company is currently assessing the potential effect if any of implementing this standard.

In September 2006, the SEC issued, No. 108, *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements* (SAB 108), which is effective for fiscal years ending after November 15, 2006. SAB 108 provides interpretive guidance on the consideration of the effects of prior year misstatements in quantifying current year misstatements for the purpose of a materiality assessment. We do not expect the adoption of SAB 108 to have a material impact on our consolidated financial statements.

In June 2006, the FASB issued FIN, No. 48, *Accounting for Uncertainty in Income Taxes* (FIN 48). FIN 48 clarifies the application of SFAS No. 109 by providing detailed guidance for the financial statement recognition, measurement and disclosure of uncertain tax positions recognized in an enterprise s financial statements. Tax positions must meet a more-likely-than-not recognition threshold at the effective date to be recognized upon the adoption of FIN 48 and in subsequent periods. FIN 48 will be effective for fiscal years beginning after December 15, 2006. We are currently evaluating the potential effects, if any, of FIN 48 on its consolidated financial statements.

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2. 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):

	Three Months Ended December 31,	
	2006	**2005**
Finished goods	$ 3,274	$ 2,592
Raw materials	2,456	105
	$ 5,730	$ 2,697

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 their officers and directors, and their 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 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. The following table summarizes the activity related to product warranties for the three months ended December 31, 2006 and 2005 (in thousands):

	Three months ended December 31,	
	2006	**2005**
Balance, beginning of period	$ 1,582	$ 1,565
Provision for warranties issued	623	380
Payments	(623)	(370)
Balance, end of period	$ 1,582	$ 1,575

Purchase Commitments

The Company currently has arrangements with contract manufacturers and other suppliers for the manufacture of its products. The arrangement with the primary contract manufacturer allows them to procure component inventory on their 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 December 31, 2006, the Company was committed to purchase approximately $15.0 million of such inventory during the next quarter.

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Legal Proceedings

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

Derivative Suits. Beginning on or about May 24, 2006, several derivative actions were filed against certain current and former directors and officers of the Company. These derivative lawsuits were filed in: (1) the Superior Court of King County, Washington, as Adams v. Amdahl, et al. (Case No. 06-2-17195-1 SEA), Wright v. Amdahl, et al. (Case No. 06-2-19159-5 SEA), and Sommer v. McAdam, et al. (Case No. 06-2-26248-4 SEA); and (2) in the U.S. District Court for the Western District of Washington, as In re F5 Networks, Inc. Derivative Litigation, Master File No. C06-0794RSL, which consolidates Hutton v. McAdam, et al. (Case No. 06-794RSL), Locals 302 and 612 of the International Union of Operating Engineers-Employers Construction Industry Retirement Trust v. McAdam et al. (Case No. C06-1057RSL), and Easton v. McAdam et al. (Case No. C06-1145RSL). The complaints generally allege that certain of the Company s current and former directors and officers, including, in general, each of the Company s current outside directors (other than Deborah L. Bevier who joined the Company s Board of Directors in July 2006) breached their fiduciary duties to the Company by engaging in alleged wrongful conduct concerning the manipulation of certain stock option grant dates. The Company is named solely as a nominal defendant against whom the plaintiffs seek no recovery. Although litigation is subject to inherent uncertainties, the Company does not believe the results of these pending actions will, individually or in the aggregate, have a material adverse impact on the consolidated financial position or results of operations.

Nasdaq Listing. On December 26, 2006, the Company announced that it had been formally notified by the Nasdaq Listing Qualifications Panel that the Company is now in compliance with The Nasdaq Stock Market s requirements for continued listing on the Nasdaq Global Market.

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 have fully 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. Although regulatory proceedings are subject to inherent uncertainties, the Company does not believe the results of any pending actions will, individually or in the aggregate, have a material adverse impact on the consolidated financial position or results of operations.

The Company is not aware of any other pending legal proceedings than those mentioned 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. Income Taxes

The effective tax rate was 33.3% and 38.5% for the three months ended December 31, 2006 and 2005, respectively. On December 20, 2006 the President of the United States signed into law the 2006 Tax Relief and Health Care Act. The law reinstated the tax credit for increasing research activities retroactively for qualifying expenses paid or incurred after December 31, 2005 and before January 1, 2008. Prior to the President s signing into law this Act the tax credit for increasing research activities had expired on December 31, 2005. As a result of the retroactive reinstatement of the tax credit for increasing research activities for qualifying expenses paid or incurred after December 31, 2005 the Company realized a one time benefit in its effective tax rate of 4.8%. Excluding this one time benefit the Company would have recorded a 38.1% provision for income taxes during the current period. The current extension of the tax credit is for two years but legislation has extended these tax credits for relatively short periods of time in the past.

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5. 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 the Asia Pacific region. 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 December 31,	
	2006	2005
Americas	$ 72,439	$ 52,205
EMEA	20,014	15,116
Japan	14,701	11,313
Asia Pacific	12,876	9,453
	$ 120,030	$ 88,087

Net revenues from international customers are primarily denominated in U.S. dollars and totaled $47.6 million and $35.9 million for the three months ended December 31, 2006 and 2005, respectively. Two domestic distributors accounted for 26.0% of total net revenue for the three month period ended December 31, 2006. One domestic distributor accounted for 14.1% of total net revenue for the three month period ended December 31, 2005.

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.

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.

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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 core products; BIG-IP Local Traffic Manager; BIG-IP Global Traffic Manager; BIG-IP ISP Traffic Manager; TrafficShield Application Firewall, WANJet, WebAccelerator; and FirePass SSL VPN servers. 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 three months of fiscal year 2007 was primarily due to net income from operations, with operating activities providing cash of $46.8 million. Going forward, we believe the primary driver of cash flows will be net income from operations. Capital expenditures for the first three months of fiscal year 2007 were comprised primarily of tenant improvements and information technology infrastructure and equipment to support the growth of our core business activities.

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 first quarter of fiscal year 2007 was 50. We expect to maintain this metric in the low to mid 50 day range going forward.

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; and goodwill impairment. Each of these accounting policies and estimates , which nave not significantly changed since our annual report on Form 10-K for the year ended September 30, 2006 (the Form 10-K), 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.

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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 December 31, 2006	2005
	(in thousands, except percentages)	
Net Revenues		
Products	$ 92,062	$ 68,591
Services	27,968	19,496
Total	$ 120,030	$ 88,087
Percentage of net revenues		
Products	76.7%	77.9%
Services	23.3	22.1
Total	100.0%	100.0%

Net revenues. Total net revenues increased 36.3%, to $120.0 million for the three months ended December 31, 2006 from $88.1 million for the same period 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. International revenues were 39.6% of total net revenues for the three months ended December 31, 2006 compared to 40.7% for the same period in the prior year. 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 34.2%, to $92.1 million for the three months ended December 31, 2006 from $68.6 million for the same period in the prior year. The increase in the three months ended December 31, 2006, was primarily due to 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 Wide Area Networks (WAN), FirePass and TrafficShield product lines. Sales of our ATM family of application delivery networking products represented 89.6% and 91.5% of product revenues for the three months ended December 31, 2006 and 2005, respectively.

Net service revenues increased 43.5%, to $28.0 million for the three months ended December 31, 2006 from $19.5 million for the same period 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.

Avnet Technology Solutions and Ingram Micro Inc., two of our domestic distributors, accounted for 14.1% and 11.8% of our total net revenue for the three months ended December 31, 2006, respectively. Ingram Micro Inc., accounted for 14.9% of our total net revenues for the three month period ended December 31, 2005.

	Three months ended December 31, 2006	2005
	(in thousands, except percentages)	
Cost of net revenues and gross profit		
Products	$ 19,216	$ 14,593
Services	7,308	4,974

Total		26,524		19,567
Gross profit	$	93,506	$	68,520
Cost of net revenues and gross profit (as a percentage of related net revenue)				
Products		20.9%		21.3%
Services		26.1		25.5
Total		22.1		22.2
Gross profit		77.9%		77.8%

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,

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and amortization expenses in connection with developed technology from acquisitions. Our product margins remained stable for all periods presented at approximately 78%. Cost of net product revenues increased to $19.2 million for the three months ended December 31, 2006 from $14.6 million for the same period in the prior year. The increases were primarily due to the higher volume of units shipped.

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 ended December 31, 2006, cost of net services revenues as a percentage of net service revenues increased to 26.1% compared to 25.5% for the same period in the prior year. Cost of net service revenues increased primarily as a result of recent growth in professional services headcount. Professional services headcount at the end of December 2006 increased to 223 from 161 at the end of December 2005. Going forward, we expect to continue to increase our cost of service revenues to support our expanded product lines and growing customer base.

	Three months ended December 31,	
	2006	**2005**
	(in thousands, except percentages)	
Operating expenses		
Sales and marketing	$ 39,055	$ 28,865
Research and development	14,539	10,478
General and administrative	12,818	7,397
Total	$ 66,412	$ 46,740
Operating expenses (as a percentage of net revenue)		
Sales and marketing	32.5%	32.8%
Research and development	12.1	11.9
General and administrative	10.7	8.4
Total	55.3%	53.1%

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. Sales and marketing expenses increased 35.3% for the three months ended December 31, 2006 from the comparable period in the prior year. The increase in sales and marketing expense was primarily due to increased commissions and personnel costs of $4.4 million and an increase in stock-based compensation expense of $1.3 million. 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 December 2006 increased to 489 from 380 at the end of December 2005. We expect to continue to increase sales and marketing expenses 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. Research and development expenses increased 38.8% for the three months ended months ended December 31, 2006 from the comparable period in the prior year. The increase in research and development expenses was primarily due to increased salary and benefit expenses of $2.1 million and an increase in stock-based compensation expense of $0.9 million. Research and development headcount at the end of December 2006 increased to 298 from 245 at the end of December 2005. The growth in 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. 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. General and administrative expenses increased 73.3% for the three months ended December 31, 2006 from the comparable period in the prior year. The increase in general and administrative expenses was primarily due to expenses incurred by third parties for legal, accounting, tax and other professional services in connection with the review of our stock option practices conducted by the special committee of outside directors formed by our Board of Directors (the Special Committee) of $2.6 million, an increase in stock-based compensation expense of $1.0 million and increased salary and benefit expenses of $0.7 million. General and administrative headcount at the end of December 2006 increased to 145 from 105 at the end of December 2005. 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.

	Three months ended December 31, 2006	Three months ended December 31, 2005
	(in thousands, except percentages)	
Other Income and Income Taxes		
Income from operations	$ 27,094	$ 21,780
Other income, net	6,431	2,970
Income before income taxes	33,525	24,750
Provision for income taxes	11,172	9,529
Net income	$ 22,353	$ 15,221
Other income and income taxes (as percentage of revenue)		
Income from operations	22.6%	24.7%
Other income, net	5.4	3.4
Income before income taxes	27.9	28.1
Provision for income taxes	9.3	10.8
Net income	18.6%	17.3%

Other income, net. Other income, net, consists of interest income and foreign currency transaction gains and losses. Other income, net, increased 116.5% compared to the same period in the prior year. 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 33.3% provision for income taxes during the current period. As of December 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 these 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 December 31, 2006 and December 31, 2005 were $25.1 million and $33.5 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. On December 20, 2006 the President of the United States signed into law the 2006 Tax Relief and Health Care Act. The law reinstated the tax credit for increasing research activities retroactively for qualifying expenses paid or incurred after December 31, 2005 and before January 1, 2008. Prior to the President s signing into law this Act, the tax credit for increasing research activities had expired on December 31, 2005. As a result of the retroactive reinstatement of the tax credit for increasing research activities for qualifying expenses paid or incurred after December 31, 2005, the Company realized a one time benefit in its effective tax rate of 4.8%. Excluding this one time benefit, the Company would have recorded a 38.1% provision for income taxes during the current period. The current extension of the tax credit is for two years but legislation has extended these tax credits for relatively short periods of time in the past.

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Liquidity and Capital Resources

Cash and cash equivalents, short-term investments and long-term investments were $545.3 million as of December 31, 2006 compared to $492.2 million as of September 30, 2006, representing an increase of $53.1 million. The increase was primarily due to cash provided by operating activities of $46.8 million for the three months ended December 31, 2006 compared to $34.5 million for the same period in the prior year. The increase in cash flow from operations for the first three months of fiscal year 2007 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. 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.

Cash used in investing activities was $62.2 million for the three months ended December 31, 2006 compared to $87.6 million for the same period in the prior year. The significant amount of cash used in investing activities for the first three months of fiscal year 2007 was primarily due to the purchase of investments partially offset by the sale of investments.

Cash provided by financing activities for the three months ended December 31, 2006 was $8.7 million compared to $19.9 million for the same period in the prior year. Our financing activities for the three months ended December 31, 2006 and 2005 consisted primarily of cash received from the exercise of employee stock options and purchases under our employee stock purchase plan.

As of December 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 the Form 10-K. 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 December 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 December 31, 2006, we were committed to purchase approximately $15.0 million of such inventory during the next quarter.

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 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, 2006, we derived 89.4% 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.

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.

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.

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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 13.6% and 18.6% of our total net revenue for the fiscal years 2006 and 2005, 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.

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 42.6% and 40.5% of our net revenues for the fiscal years ended September 30, 2006 and 2005, respectively. In particular, in fiscal year 2006, we derived 13.1% 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 Corporation, 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.

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 our Quarterly Reports on Form 10-Q for the three months ended December 31, 2005 and March 31, 2006 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 Securities Exchange Commission (SEC) and the United States Attorney s Office for the Eastern District of New York (the Department of Justice) that they are conducting informal inquiries into our historical stock option practices, and have fully 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

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damages or penalties or have other remedies imposed upon us, including criminal penalties, which could adversely affect our business, results of operations, or financial condition.

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 three month period ended December 31, 2006, compared to those discussed in our Annual Report on Form 10-K for the year ended September 30, 2006.

Item 4. Controls and Procedures

Our 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)) are designed to ensure that required information is properly recorded, processed, summarized and reported within the required timeframe, as specified in the rules set forth by the SEC. Our disclosure controls and procedures are also designed to ensure that information required to be disclosed is accumulated and communicated to management, including our 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 December 31, 2006. Based upon that evaluation, our Chief Executive Officer and Chief Accounting Officer have concluded that our disclosure controls and procedures were effective as of December 31, 2006.

There were no changes in our internal control over financial reporting (as defined in Rules 13a-15(f) or 15d-15(f) of the Exchange Act) during the period covered by this quarterly report 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

We are not aware of any 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.

Reference is made to Item 3, Legal Proceedings, in the Form 10-K, filed December 14, 2006 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 time of the 10-K filing.

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Item 1A. Risk Factors

Information regarding risk factors appears in Part I Item 2 of this Quarterly Report on Form 10-Q, Management s Discussion and Analysis of Financial Condition and Results of Operations Risk Factors that May Affect Future Results and in Part I Item 1A of the Form 10-K. There have been no material changes from the risk factors previously disclosed in the Form 10-K.

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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.

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SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized on this 8th day of February, 2007.

F5 NETWORKS, INC.

By: /s/ JOHN RODRIGUEZ

John Rodriguez
Chief Accounting Officer (Duly Authorized
Officer and Principal Financial and Accounting
Officer)

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