

UNITED STATES SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549

**FORM 10-Q**

(Mark One)

☒ **Quarterly Report Pursuant to Section 13 or 15(D) of the Securities Exchange Act of 1934**  
For the quarterly period ended September 26, 2003

OR

☐ **Transition Report Pursuant to Section 13 or 15(D) of the Securities Exchange Act of 1934**  
For the transition period from \_\_\_\_\_ to \_\_\_\_\_ .

Commission File Number 0-15323

**NETWORK EQUIPMENT TECHNOLOGIES, INC.**  
(Exact name of registrant as specified in its charter)

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

**94-2904044**  
(I.R.S. Employer  
Identification Number)

**6900 Paseo Padre Parkway**  
**Fremont, CA 94555-3660**  
**(510) 713-730048213.09**  
(Address, including zip code, and telephone number  
including area code, of registrant's principal executive offices)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports) and (2) has been subject to such filing requirements for the past 90 days.

☒ Yes ☐ No

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act): ☒ Yes ☐ No

The number of shares outstanding of the registrant's Common Stock, par value \$.01, as of November 3, 2003 was 23,354,449.

# NETWORK EQUIPMENT TECHNOLOGIES, INC.

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## PART I - FINANCIAL INFORMATION

### ITEM 1. FINANCIAL STATEMENTS

#### NETWORK EQUIPMENT TECHNOLOGIES, INC.

##### Condensed Consolidated Balance Sheets

(Unaudited -- in thousands, except par value)

|  | <u>September 26,<br/>2003</u> | <u>March 28,<br/>2003</u> |
|--|-------------------------------|---------------------------|
| <b>ASSETS</b>  |                               |                           |
| Current assets:  |                               |                           |
| Cash and cash equivalents  | \$ 8,918                      | \$ 20,593                 |
| Restricted cash  | 1,360                         | 1,361                     |
| Short-term investments   | 84,085                        | 72,614                    |
| Accounts receivable, net of allowance for doubtful accounts of<br>\$624 at September 26, 2003 and \$846 at March 28, 2003                                    | 25,270                        | 14,574                    |
| Inventories  | 11,998                        | 14,569                    |
| Prepaid expenses and other assets  | 4,430                         | 4,110                     |
|  | <hr/>                         | <hr/>                     |
| Total current assets   | 136,061                       | 127,821                   |
| Property and equipment, net  | 33,246                        | 34,486                    |
| Software production costs, net   | -                             | 5                         |
| Other assets   | 2,260                         | 2,506                     |
|  | <hr/>                         | <hr/>                     |
| Total assets   | \$ 171,567                    | \$ 164,818                |
|  | <hr/>                         | <hr/>                     |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>  |                               |                           |
| Current liabilities:   |                               |                           |
| Accounts payable   | \$ 9,137                      | \$ 5,427                  |
| Accrued liabilities  | 16,045                        | 18,081                    |
|  | <hr/>                         | <hr/>                     |
| Total current liabilities  | 25,182                        | 23,508                    |
| Long-term liabilities:   |                               |                           |
| 7 1/4% redeemable convertible subordinated debentures  | 24,706                        | 24,706                    |
| Other long-term liabilities  | 1,930                         | 1,770                     |
|  | <hr/>                         | <hr/>                     |
| Total long-term liabilities  | 26,636                        | 26,476                    |
| Stockholders' equity:  |                               |                           |
| Preferred stock (\$0.01 par value; 5,000 shares authorized;<br>none outstanding)   | -                             | -                         |
| Common stock (\$0.01 par value; 50,000 shares authorized;<br>23,270 and 22,663 shares outstanding at September 26, 2003<br>and March 28, 2003, respectively) | 232                           | 226                       |
| Additional paid-in capital   | 187,113                       | 184,122                   |
| Treasury stock   | (3,408)                       | (3,408)                   |
| Accumulated other comprehensive loss   | (270)                         | (198)                     |
| Accumulated deficit  | (63,918)                      | (65,908)                  |
|  | <hr/>                         | <hr/>                     |
| Total stockholders' equity   | 119,749                       | 114,834                   |
|  | <hr/>                         | <hr/>                     |
| Total liabilities and stockholders' equity   | \$ 171,567                    | \$ 164,818                |
|  | <hr/>                         | <hr/>                     |

See accompanying notes to condensed consolidated financial statements

**NETWORK EQUIPMENT TECHNOLOGIES, INC.**  
**Condensed Consolidated Statements of Operations and Comprehensive Income (Loss)**  
(Unaudited -- in thousands, except per share amounts)

|  | <u>Quarter Ended</u>                |                                     | <u>Six Months Ended</u>             |                                     |
|--|-------------------------------------|-------------------------------------|-------------------------------------|-------------------------------------|
|  | <u>September</u><br><u>26, 2003</u> | <u>September</u><br><u>27, 2002</u> | <u>September</u><br><u>26, 2003</u> | <u>September</u><br><u>27, 2002</u> |
| <b>Revenue:</b>  |                                     |                                     |                                     |                                     |
| Product  | \$ 27,776                           | \$ 23,095                           | \$ 57,073                           | \$ 45,096                           |
| Service and other  | 4,164                               | 4,971                               | 8,968                               | 10,198                              |
| Total revenue  | <u>31,940</u>                       | <u>28,066</u>                       | <u>66,041</u>                       | <u>55,294</u>                       |
| <b>Costs of sales:</b>   |                                     |                                     |                                     |                                     |
| Cost of product revenue  | 11,013                              | 14,074                              | 23,367                              | 25,100                              |
| Cost of service and other revenue  | 3,607                               | 4,801                               | 7,565                               | 9,733                               |
| Total cost of sales  | <u>14,620</u>                       | <u>18,875</u>                       | <u>30,932</u>                       | <u>34,833</u>                       |
| <b>Gross margin</b>  | <u>17,320</u>                       | <u>9,191</u>                        | <u>35,109</u>                       | <u>20,461</u>                       |
| <b>Operating expenses:</b>   |                                     |                                     |                                     |                                     |
| Sales and marketing  | 7,264                               | 7,883                               | 15,118                              | 16,399                              |
| Research and development   | 6,949                               | 6,684                               | 13,789                              | 13,167                              |
| General and administrative   | 2,442                               | 2,907                               | 5,190                               | 5,772                               |
| Restructure costs  | -                                   | 1,002                               | 266                                 | 1,172                               |
| Total operating expenses   | <u>16,655</u>                       | <u>18,476</u>                       | <u>34,363</u>                       | <u>36,510</u>                       |
| <b>Income (loss) from operations</b>   | <u>665</u>                          | <u>(9,285)</u>                      | <u>746</u>                          | <u>(16,049)</u>                     |
| Interest income  | 327                                 | 616                                 | 744                                 | 1,363                               |
| Interest expense   | (524)                               | (504)                               | (1,034)                             | (1,013)                             |
| Gain on sale of Federal Services Business  | -                                   | -                                   | 1,500                               | 5,000                               |
| Other income (expense)   | (68)                                | (18)                                | 19                                  | 2,181                               |
| <b>Income (loss) before taxes</b>  | <u>400</u>                          | <u>(9,191)</u>                      | <u>1,975</u>                        | <u>(8,518)</u>                      |
| Income tax benefit   | -                                   | (2,304)                             | (15)                                | (2,329)                             |
| <b>Income (loss) before accounting change</b>  | <u>400</u>                          | <u>(6,887)</u>                      | <u>1,990</u>                        | <u>(6,189)</u>                      |
| Cumulative effect of change in accounting principle relating to goodwill                     | -                                   | -                                   | -                                   | (9,592)                             |
| <b>Net income (loss)</b>   | <u>\$ 400</u>                       | <u>\$ (6,887)</u>                   | <u>\$ 1,990</u>                     | <u>\$ (15,781)</u>                  |
| <b>Per share data:</b>   |                                     |                                     |                                     |                                     |
| Income (loss) before accounting change:  |                                     |                                     |                                     |                                     |
| Basic  | \$0.02                              | \$(0.31)                            | \$0.09                              | \$(0.28)                            |
| Diluted  | \$0.02                              | \$(0.31)                            | \$0.08                              | \$(0.28)                            |
| Cumulative effect of change in accounting principle relating to goodwill – basic and diluted | \$ -                                | \$ -                                | \$ -                                | \$(0.43)                            |
| Net income (loss):   |                                     |                                     |                                     |                                     |
| Basic  | \$0.02                              | \$(0.31)                            | \$0.09                              | \$(0.71)                            |
| Diluted  | \$0.02                              | \$(0.31)                            | \$0.08                              | \$(0.71)                            |
| <b>Common and common equivalent shares:</b>  |                                     |                                     |                                     |                                     |
| Basic  | 23,066                              | 22,376                              | 22,939                              | 22,336                              |
| Diluted  | 24,342                              | 22,376                              | 24,136                              | 22,336                              |

**NETWORK EQUIPMENT TECHNOLOGIES, INC.**  
**Condensed Consolidated Statements of Operations and Comprehensive Income (Loss)**, continued  
(Unaudited -- in thousands, except per share amounts)

|   | <u>Quarter Ended</u>   |                        | <u>Six Months Ended</u> |                        |
|---|------------------------|------------------------|-------------------------|------------------------|
|   | <u>September</u>       | <u>September</u>       | <u>September</u>        | <u>September</u>       |
| <b>Consolidated Statements of Comprehensive Income (Loss)</b> | <b><u>26, 2003</u></b> | <b><u>27, 2002</u></b> | <b><u>26, 2003</u></b>  | <b><u>27, 2002</u></b> |
| Net income (loss)   | \$ 400                 | \$ (6,887)             | \$ 1,990                | \$ (15,781)            |
| Other comprehensive income, net of tax:                       |                        |                        |                         |                        |
| Cumulative translation adjustments                            | (181)                  | 12                     | 73                      | 54                     |
| Net unrealized gain (loss) on securities                      | (160)                  | 222                    | (145)                   | 574                    |
|   | <u>          </u>      | <u>          </u>      | <u>          </u>       | <u>          </u>      |
| Comprehensive income (loss)                                   | \$ 59                  | \$ (6,653)             | \$ 1,918                | \$ (15,153)            |
|   | <u>          </u>      | <u>          </u>      | <u>          </u>       | <u>          </u>      |

See accompanying notes to condensed consolidated financial statements

**NETWORK EQUIPMENT TECHNOLOGIES, INC.**  
**Condensed Consolidated Statements of Cash Flows**  
(Unaudited -- in thousands)

|   | <b>Six Months Ended</b>       |                               |
|---|-------------------------------|-------------------------------|
|   | <b>September<br/>26, 2003</b> | <b>September<br/>27, 2002</b> |
| Cash and cash equivalents at beginning of period  | \$ 20,593                     | \$ 15,879                     |
| Cash flows from operating activities:   |                               |                               |
| Net income (loss)   | 1,990                         | (15,781)                      |
| Adjustments required to reconcile net income (loss) to net cash used in operating activities: |                               |                               |
| Depreciation and amortization   | 4,407                         | 4,722                         |
| Gain on sale of Federal Services Business   | (1,500)                       | (5,000)                       |
| Loss on disposition of property and equipment   | 74                            | 7                             |
| Gain on insurance settlement  | -                             | (2,187)                       |
| Proceeds from insurance settlement  | -                             | 3,258                         |
| Cumulative effect of change in accounting principle relating to goodwill                      | -                             | 9,592                         |
| Changes in assets and liabilities:  |                               |                               |
| Accounts receivable   | (10,696)                      | 1,286                         |
| Inventories   | 2,650                         | (834)                         |
| Prepaid expenses and other assets   | (358)                         | 767                           |
| Accounts payable  | 3,693                         | (1,432)                       |
| Accrued liabilities   | (1,916)                       | (3,529)                       |
| Net cash used in operating activities   | (1,656)                       | (9,131)                       |
| Cash flows from investing activities:   |                               |                               |
| Purchases of short-term investments   | (134,302)                     | (35,894)                      |
| Proceeds from maturities of short-term investments  | 122,686                       | 37,628                        |
| Purchases of property and equipment   | (3,297)                       | (3,561)                       |
| Proceeds from sale of Federal Services Business   | 1,500                         | 5,000                         |
| Decrease in restricted cash   | 1                             | 1,792                         |
| Other, net  | 226                           | 8                             |
| Net cash provided by (used in) investing activities   | (13,186)                      | 4,973                         |
| Cash flows from financing activities:   |                               |                               |
| Issuance of common stock  | 2,997                         | 883                           |
| Net cash provided by financing activities   | 2,997                         | 883                           |
| Effect of exchange rate changes on cash   | 170                           | (20)                          |
| Net decrease in cash and cash equivalents   | (11,675)                      | (3,295)                       |
| Cash and cash equivalents at end of period  | \$ 8,918                      | \$ 12,584                     |
| Other cash flow information:  |                               |                               |
| Cash paid (refunded) during the year for:   |                               |                               |
| Interest  | \$ 987                        | \$ 988                        |
| Income taxes  | \$ 28                         | \$ (1,067)                    |
| Non-cash investing and financing activities:  |                               |                               |
| Unrealized gain (loss) on available-for-sale securities                                       | \$ (145)                      | \$ 574                        |

See accompanying notes to the condensed consolidated financial statements

**NETWORK EQUIPMENT TECHNOLOGIES, INC.**  
**Notes to Condensed Consolidated Financial Statements**

***Note 1. Description of the Company***

Network Equipment Technologies, Inc., doing business as net.com (net.com or the Company), is a global provider of networking technology platforms that are used for mission-critical communications solutions. The Company's multiservice wide area networking (WAN) products, comprising the Promina product line, use circuit-switched technology to provide an effective platform for developing reliable and secure networks. In response to the growth of next-generation networks using packet-switching technologies and the Internet protocol (IP), the Company developed its service creation platforms for broadband, IP telephony, and multiservice networks. These platforms allow network service providers to rapidly create and deliver new service offerings that the Company believes can help them to accelerate the return on their network investment, reduce capital and operating expenditures, and achieve greater profits. Network Equipment Technologies, Inc. was founded in 1983 and has been doing business as net.com since 2000.

***Note 2. Summary of Significant Accounting Policies***

*Basis of Presentation.* The condensed consolidated financial statements include the accounts of net.com and its wholly owned subsidiaries. All significant intercompany balances and transactions have been eliminated.

In the opinion of management, the accompanying unaudited condensed consolidated financial statements contain all adjustments (consisting only of normal recurring adjustments) considered necessary to present fairly the financial position as of September 26, 2003, the results of operations for the quarters and six months ended September 26, 2003 and September 27, 2002, and the cash flows for the six months ended September 26, 2003 and September 27, 2002. These financial statements should be read in conjunction with the March 28, 2003 audited consolidated financial statements and notes thereto. The results of operations for the quarter and six months ended September 26, 2003 are not necessarily indicative of the results to be expected for the fiscal year ending March 26, 2004.

*Stock Based Compensation.* net.com accounts for its stock-based awards to employees using the intrinsic value method in accordance with Accounting Principles Board (APB) Opinion No. 25, Accounting for Stock Issued to Employees, and its related interpretations. Stock-based compensation related to non-employees is based on the fair value of the related stock or options in accordance with Statement of Financial Accounting Standards (SFAS) No. 123, Accounting for Stock Based Compensation. Expense associated with stock-based compensation is amortized on an accelerated basis under Financial Accounting Standards Board Interpretation (FIN) No. 28, Accounting for Stock Appreciation Rights and Other Variable Stock Option or Award Plans, over the vesting period of each individual award. In accordance with SFAS No. 148, Accounting for Stock-Based Compensation--Transition and Disclosures--an amendment to FASB Statement No. 123, the Company is required to disclose the effects on reported net income (loss) and basic and diluted net income (loss) per share as if the fair value based method had been applied to all awards. For the quarter and six months ended September 26, 2003 and September 27, 2002, had compensation cost been determined based on the fair value method pursuant to SFAS 123, the Company's net income (loss) would have been as follows (in thousands, except per share amounts):

|   | <u>Quarter Ended</u>          |                               | <u>Six Months Ended</u>       |                               |
|---|-------------------------------|-------------------------------|-------------------------------|-------------------------------|
|   | <u>September<br/>26, 2003</u> | <u>September<br/>27, 2002</u> | <u>September<br/>26, 2003</u> | <u>September<br/>27, 2002</u> |
| Net income (loss) -- as reported  | \$ 400                        | \$ (6,887 )                   | \$ 1,990                      | \$ (15,781 )                  |
| Less: Stock-based compensation expense determined<br>by the fair value method, net of tax | (1,119 )                      | (1,449 )                      | (2,268 )                      | (2,814 )                      |
| Net loss -- pro forma   | <u>\$ (719 )</u>              | <u>\$ (8,336 )</u>            | <u>\$ (278 )</u>              | <u>\$ (18,595 )</u>           |
| Basic income (loss) per share -- as reported  | \$ 0.02                       | \$ (0.31 )                    | \$ 0.09                       | \$ (0.71 )                    |
| Diluted income (loss) per share -- as reported  | \$ 0.02                       | \$ (0.31 )                    | \$ 0.08                       | \$ (0.71 )                    |
| Basic and diluted loss per share -- pro forma   | \$ (0.03 )                    | \$ (0.37 )                    | \$ (0.01 )                    | \$ (0.83 )                    |

*Recently Issued Accounting Standards.* In May 2003, the Financial Accounting Standards Board (FASB) issued SFAS No. 150, Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity. SFAS 150 requires that certain financial instruments, which under previous guidance were accounted for as equity, must now be accounted for as liabilities. The financial instruments affected include mandatory redeemable stock, certain financial instruments that require or may require the issuer to buy back some of its shares in exchange for cash or other assets and certain obligations that can be settled with shares of stock. SFAS 150 is effective for interim periods beginning after June 15, 2003. The Company does not expect the adoption of SFAS 150 to have a material effect on its results of operations or financial condition.

In April 2003, the FASB issued SFAS No. 149, Amendment of Statement 133 on Derivative Instruments and Hedging Activities. SFAS 149 amends and clarifies the accounting for derivative instruments, including certain derivative instruments embedded in other contracts, and for hedging activities under SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities. SFAS 149 is generally effective for contracts entered into or modified after June 30, 2003 and for hedging relationships designated after June 30, 2003. The Company adopted SFAS 149, and the adoption did not have a material impact on the Company's results of operations or financial condition.

In December 2002, FASB issued SFAS No. 148, Accounting for Stock-Based Compensation-Transition and Disclosure, which amends SFAS 123, Accounting for Stock-Based Compensation. SFAS 148 provides alternative methods of transition for a voluntary change to the fair value based method of accounting for stock-based employee compensation. In addition, SFAS 148 amends the disclosure requirements of SFAS 123 to require more prominent and more frequent disclosures in financial statements about the effects of stock-based compensation. SFAS 148 is effective for fiscal years ending after December 15, 2002. The Company adopted the disclosure provisions of SFAS 148 at March 28, 2003.

In November 2002, the FASB issued FIN 45, Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others, which elaborates on the disclosures to be made by a guarantor in its interim and annual financial statements about its obligations under certain guarantees that it has issued. The Company adopted the provisions of FIN 45 for guarantees issued or modified after December 31, 2002, and the adoption of FIN 45 did not have a material effect on the Company's results of operations or financial position.

### **Note 3. Inventories**

Inventories are stated at the lower of cost (first-in, first-out) or market and include material, labor and manufacturing overhead costs. Inventories at September 26, 2003 and March 28, 2003 consisted of the following (in thousands):

|                      | <b>September 26,<br/>2003</b> | <b>March 28,<br/>2003</b> |
|----------------------|-------------------------------|---------------------------|
| Purchased components | \$ 3,452                      | \$ 5,084                  |
| Work-in-process      | 7,190                         | 6,153                     |
| Finished goods       | 1,356                         | 3,332                     |
| Total                | <u>\$ 11,998</u>              | <u>\$ 14,569</u>          |



**Note 4. Income (Loss) Per Share**

The following table sets forth the computation of the numerator and denominator used in the computation of basic and diluted net income (loss) per share ( in thousands):

|   | <b><u>Quarter Ended</u></b>          |                                      | <b><u>Six Months Ended</u></b>       |                                      |
|---|--------------------------------------|--------------------------------------|--------------------------------------|--------------------------------------|
|   | <b><u>September<br/>26, 2003</u></b> | <b><u>September<br/>27, 2002</u></b> | <b><u>September<br/>26, 2003</u></b> | <b><u>September<br/>27, 2002</u></b> |
| Numerator:  |                                      |                                      |                                      |                                      |
| Income (loss) before accounting change                                    | \$ 400                               | \$ (6,887 )                          | \$ 1,990                             | \$ (6,189 )                          |
| Cumulative effect of change in accounting principle, relating to goodwill | -                                    | -                                    | -                                    | (9,592 )                             |
| Net income (loss)   | <u>\$ 400</u>                        | <u>\$ (6,887 )</u>                   | <u>\$ 1,990</u>                      | <u>\$ (15,781 )</u>                  |
| Denominator:  |                                      |                                      |                                      |                                      |
| Basic weighted average shares of common stock outstanding                 | 23,066                               | 22,376                               | 22,939                               | 22,336                               |
| Diluted effect of options issued to employees                             | <u>1,276</u>                         | <u>-</u>                             | <u>1,197</u>                         | <u>-</u>                             |
| Diluted weighted average shares of common stock outstanding               | <u>24,342</u>                        | <u>22,376</u>                        | <u>24,136</u>                        | <u>22,336</u>                        |

Basic income (loss) per share has been computed based upon the weighted average number of common shares outstanding for the periods presented. For diluted income per share, shares used in the per share computation include weighted average common and potentially dilutive shares outstanding. Potentially dilutive shares consist of shares issuable upon the assumed exercise of dilutive stock options. These shares totaled 1,276,000 and 118,000 for the quarters ended September 26, 2003 and September 27, 2002, respectively, and 1,197,000 and 77,000 for the six months ended September 26, 2003 and September 27, 2002. The dilutive shares for the quarter and six months ended September 26, 2003 were included in the dilutive per share computation, however, the dilutive shares for the quarter and six months ended September 27, 2002 were excluded from the per share computation because they were anti-dilutive. Additionally, there were 784,000 shares of common stock issuable upon conversion of debentures. These shares, and the related effect of the accrued interest on the debentures, were not included in the calculation of diluted income per share for the quarter and six months ended September 26, 2003 and September 27, 2002, as their inclusion would have been anti-dilutive.

**Note 5. Restructure Costs**

In the first quarter of fiscal 2004, net.com recorded a restructuring charge of \$266,000. This charge included \$254,000 for lease write-off and \$12,000 for office closure costs. The remaining liability for restructuring charges is \$909,000 at September 26, 2003, as shown in the table below. Components of accrued restructuring charges, which are included in accrued liabilities in the accompanying balance sheets, and changes in accrued amounts related to this restructuring program during the first six months of fiscal 2004 and as of March 28, 2003 were as follows (in thousands):

|                               | <b><u>Employee<br/>Separation<br/>Costs</u></b> | <b><u>Lease<br/>Write-off</u></b> | <b><u>Office<br/>Closure<br/>Costs</u></b> | <b><u>Other<br/>Restructuring<br/>Costs</u></b> | <b><u>Total</u></b> |
|-------------------------------|---|-----------------------------------|--|---|---------------------|
| Balance at March 28, 2003     | \$ 160  | \$ 614                            | \$ 36                                      | \$ 94   | \$ 904              |
| Provision                     | -   | 254                               | 12   | -   | 266                 |
| Payments                      | <u>(25)</u>                                     | <u>(224)</u>                      | <u>(12)</u>                                | <u>-</u>  | <u>(261)</u>        |
| Balance at September 26, 2003 | <u>\$ 135</u>                                   | <u>\$ 644</u>                     | <u>\$ 36</u>                               | <u>\$ 94</u>                                    | <u>\$ 909</u>       |

net.com believes that all costs associated with these restructuring charges will be paid no later than the end of fiscal 2007.

**Note 6. Sale of N.E.T. Federal, Inc.'s Professional Service Business**

On December 1, 2000, net.com sold the assets of its federal services business to CACI International Inc. (CACI) for cash consideration of \$40.0 million. The assets sold were comprised mainly of federal government service contracts, accounts receivable, spares inventory and fixed assets. The cash received from CACI to date is \$38.5 million. The remaining \$1.5 million is payable during the first quarter of fiscal 2005. During the quarter ended June 27, 2003, net.com received payment and recorded a gain of \$1.5 million related to the sale. The total net gain on the sale to date is \$26.4 million. In addition, under an ongoing agreement with CACI, net.com will continue to receive royalties on maintenance revenue.

**Note 7. Goodwill and other intangible assets**

In July 2001, the FASB issued SFAS No. 142, Goodwill and Other Intangible Assets, which establishes financial accounting and reporting for acquired goodwill and other intangible assets and supercedes APB Opinion No.17, Intangible Assets. The Company adopted SFAS 142 on March 30, 2002. SFAS 142 requires that goodwill and intangible assets that have indefinite useful lives not be amortized but, instead, tested at least annually for impairment. Accordingly, net.com ceased amortization of all goodwill on March 30, 2002. Intangible assets that have finite useful lives, consisting primarily of patents, continue to be amortized over their estimated useful lives. Any impairment loss was measured as of the date of adoption and recognized as a cumulative effect of a change in accounting principle.

The standard also requires that goodwill be tested for impairment annually. In the year of adoption, the standard required a transitional goodwill impairment evaluation, which was a two-step process. The first step of the goodwill impairment test, used to identify potential impairment, compares the fair value of a reporting unit with its carrying amount, including goodwill. If the fair value of a reporting unit exceeds its carrying amount, goodwill of the reporting unit is considered not impaired, thus the second step of the impairment test is unnecessary. If the carrying amount of a reporting unit exceeds its fair value, the second step of the goodwill impairment test shall be performed to measure the amount of impairment loss. During the quarter ended June 28, 2002, net.com completed this first step, which indicated that the goodwill could be impaired.

The second step of the goodwill impairment test used to measure the amount of impairment loss compares the implied fair value of goodwill with the carrying amount of the goodwill. If the carrying amount of the goodwill exceeds the implied fair value of the goodwill, an impairment loss shall be recognized in an amount equal to that excess. As of June 28, 2002, net.com completed this second step and measured and recognized a transitional impairment loss of \$9.6 million (which represented the write off of the entire goodwill balance) as a cumulative effect of change in accounting principle in its statement of operations.

**Note 8. Warranty accruals**

Components of the warranty accrual, which are included in accrued liabilities in the accompanying condensed consolidated balance sheets, during the first six months of fiscal 2004 were as follows (in thousands):

|                               | <b>Warranty<br/>Accrual</b> |
|-------------------------------|-----------------------------|
| Balance at March 28, 2003     | \$ 204                      |
| Charges to cost of goods sold | 153                         |
| Charges to warranty accrual   | (137)                       |
| Other adjustments (1)         | (92)                        |
|                               | <hr/>                       |
| Balance at September 26, 2003 | \$ 128                      |
|                               | <hr/>                       |

(1) Adjustment resulted from a change in warranty cost estimates primarily from lower hourly costs of labor to repair products and frequency of warranty claims.

## ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF RESULTS OF OPERATIONS AND FINANCIAL CONDITION

This discussion and analysis should be read in conjunction with Part II of our Form 10-K for the fiscal year ended March 28, 2003. Statements contained in this Form 10-Q, which are not historical facts are forward-looking statements, including statements that relate to products, customers, operations and contingent payments. A forward-looking statement may contain words such as "plans," "hopes," "believes," "estimates," "will continue to be," "will be," "continue to," "expect to," "anticipate that," "to be," or "can impact." Forward-looking statements are based upon management expectations and involve risks and uncertainties that may cause actual results to differ materially from those anticipated in the forward-looking statements. Many factors may cause actual results to vary including, but not limited to, the factors discussed in this Form 10-Q. net.com expressly disclaims any obligation or undertaking to revise or publicly release any updates or revisions to any forward-looking statement contained in this Form 10-Q. Investors should carefully review the risk factors described in this Form 10-Q along with other documents net.com files from time to time with the Securities and Exchange Commission.

### Results of Operations

The following table depicts selected data derived from our consolidated condensed statements of operations expressed as a percentage of revenue for the periods presented:

| <b>Percent of revenue</b>  | <b><u>Quarter Ended</u></b>          |                                      | <b><u>Six Months Ended</u></b>       |                                      |
|--|--------------------------------------|--------------------------------------|--------------------------------------|--------------------------------------|
|  | <b><u>September<br/>26, 2003</u></b> | <b><u>September<br/>27, 2002</u></b> | <b><u>September<br/>26, 2003</u></b> | <b><u>September<br/>27, 2002</u></b> |
| Product revenue  | 87.0%                                | 82.3%                                | 86.4%                                | 81.6%                                |
| Service and other revenue  | 13.0                                 | 17.7                                 | 13.6                                 | 18.4                                 |
| Total revenue  | 100.0                                | 100.0                                | 100.0                                | 100.0                                |
| Product revenue gross margin   | 60.4                                 | 39.1                                 | 59.1                                 | 44.3                                 |
| Service and other revenue gross margin                                   | 13.4                                 | 3.4                                  | 15.6                                 | 4.6                                  |
| Total gross margin   | 54.2                                 | 32.7                                 | 53.2                                 | 37.0                                 |
| Sales and marketing  | 22.7                                 | 28.1                                 | 22.9                                 | 29.7                                 |
| Research and development   | 21.8                                 | 23.8                                 | 20.9                                 | 23.8                                 |
| General and administrative   | 7.6                                  | 10.3                                 | 7.9                                  | 10.4                                 |
| Restructure costs  | -                                    | 3.6                                  | 0.4                                  | 2.1                                  |
| Total operating costs  | 52.1                                 | 65.8                                 | 52.0                                 | 66.0                                 |
| Income (loss) from operations  | 2.1                                  | (33.1)                               | 1.1                                  | (29.0)                               |
| Other income (expense), net  | (0.2)                                | -                                    | 2.3                                  | 13.0                                 |
| Interest income (expense), net   | (0.6)                                | 0.4                                  | (0.4)                                | 0.6                                  |
| Income (loss) before taxes   | 1.3                                  | (32.7)                               | 3.0                                  | (15.4)                               |
| Tax benefit  | -                                    | (8.2)                                | -                                    | (4.2)                                |
| Income (loss) before accounting change                                   | 1.3                                  | (24.5)                               | 3.0                                  | (11.2)                               |
| Cumulative effect of change in accounting principle relating to goodwill | -                                    | -                                    | -                                    | (17.3)                               |
| Net income (loss)  | 1.3%                                 | (24.5)%                              | 3.0%                                 | (28.5)%                              |

## Revenue

|                           | <u>Quarter Ended</u> |                  |               | <u>Six Months Ended</u> |                  |               |
|---------------------------|----------------------|------------------|---------------|-------------------------|------------------|---------------|
|                           | <u>September</u>     | <u>September</u> |               | <u>September</u>        | <u>September</u> |               |
|                           | <u>26, 2003</u>      | <u>27, 2002</u>  | <u>Change</u> | <u>26, 2003</u>         | <u>27, 2002</u>  | <u>Change</u> |
| Product revenue           | \$ 27,776            | \$ 23,095        | 20.3%         | \$ 57,073               | \$ 45,096        | 26.6%         |
| Service and other revenue | 4,164                | 4,971            | (16.2)        | 8,968                   | 10,198           | (12.1)        |
| Total revenue             | <u>\$ 31,940</u>     | <u>\$ 28,066</u> | <u>13.8%</u>  | <u>\$ 66,041</u>        | <u>\$ 55,294</u> | <u>19.4%</u>  |

The increase in total revenue in the three and six months ended September 26, 2003 compared to the three and six months ended September 27, 2002 is due primarily to the increase in product revenue.

The increases in product revenue in the three and six months ended September 26, 2003 compared to the prior-year periods are due to strong sales in the Federal government sales channel, which increased \$5.5 million for the second quarter of fiscal 2004 from the prior year's comparative period and increased \$13.6 million on a fiscal year to date basis, due largely to government defense initiatives and adoption of our new products by the government for certain applications. This increase was offset by declines in the international commercial sales channel of \$1.6 million in the three and six months ended September 26, 2003 compared to the three and six months ended September 27, 2002, partly as a result of a general decline in the commercial market for circuit-switched products. Product revenue is generated primarily from our circuit switched product line, Promina, which accounts for the substantial majority of our product sales worldwide. While the level of revenue we experienced in the first six months of fiscal 2004 may be sustainable in the near term, we caution that factors such as new constraints on government spending, the uncertainty of future U.S. action internationally, or continued slowdown in our international business could cause our revenue to decrease in the near term. We have developed new service creation products for the broadband equipment and Internet protocol (IP) telephony markets. The product revenue from these products in the second quarter of fiscal 2004 was \$4.4 million, or 15.7% of product revenue, whereas year to date product revenue from these products was less than 10%. We expect the level of revenue from these new products, which are in the early stage of customer adoption, to fluctuate in the near term.

The decrease in service and other revenue is primarily the result of a decline in the installed base of equipment held by non-Federal customers requiring ongoing service support, the effect of our customers reducing their operating costs by lowering their levels of service support and the reliability of our Promina products resulting in lower levels of service support being purchased by our customers. As part of our product strategy, we have developed new broadband products and related service offerings, which we expect will offset part of the decline in service and other revenue from our narrowband service offerings if and when we achieve a sufficiently sized deployed base of broadband products. In addition, in the third quarter of fiscal 2003, we announced the end of life for service on our IDNX product line, which has stimulated new network upgrades together with related service revenue partially offsetting the declines in service revenue. Over the remainder of fiscal 2004, we expect our service revenue to remain flat or increase slightly compared to the levels experienced in the first six months of the fiscal year.

## Gross Margin

|  | <u>Quarter Ended</u> |                  | <u>Six Months Ended</u> |                  |
|--|----------------------|------------------|-------------------------|------------------|
|  | <u>September</u>     | <u>September</u> | <u>September</u>        | <u>September</u> |
|  | <u>26, 2003</u>      | <u>27, 2002</u>  | <u>26, 2003</u>         | <u>27, 2002</u>  |
| Product revenue gross margin           | 60.4%                | 39.1%            | 59.1%                   | 44.3%            |
| Service and other revenue gross margin | 13.4                 | 3.4              | 15.6                    | 4.6              |
| Total gross margin                     | <u>54.2%</u>         | <u>32.7%</u>     | <u>53.2%</u>            | <u>37.0%</u>     |

Total gross margins improved in the three and six months ended September 26, 2003 compared to the prior-year periods primarily due to higher product revenue and our ongoing cost reduction initiatives.

The increase in product revenue gross margins in the three months ended September 26, 2003 compared to the three months ended September 27, 2002 is due primarily to supply chain initiatives targeting material cost reductions, a \$4.7 million increase in product revenue allowing fixed costs to be spread over a greater revenue base, and a decrease in OEM product sales, which have lower gross margins. The increase in product revenue gross margins in

the six months ended September 26, 2003 compared to the six months ended September 27, 2002 is due primarily to supply chain initiatives targeting material cost reductions, higher product revenue of \$12.0 million allowing fixed costs to be spread over a greater revenue base, a decrease in OEM product sales, which have lower gross margins and a one-time refund in the amount of \$600,000 for third party royalty fees paid in prior years that was received in the first quarter of fiscal 2004. Additionally, in the second quarter of fiscal 2003, we recorded inventory reserve charges of \$1.9 million, which negatively affected our product revenue gross margins for the second quarter and first six months of fiscal 2003.

The increase in service and other revenue gross margin in the three months ended September 26, 2003 compared to the three months ended September 27, 2002 is due to a \$371,000 decrease in third party service costs and a \$727,000 reduction in compensation and related costs. The increase in service and other revenue gross margin in the six months ended September 26, 2003 compared to the six months ended September 27, 2002 is due to an \$846,000 decrease in third party service costs and a \$1.6 million reduction in compensation and related costs. We expect service and other revenue gross margins to remain flat or decrease slightly through the remainder of fiscal 2004.

Gross margins may be adversely affected in the future due to increases in material and labor costs, increases in subcontractor charges, changes in the mix of products and services we sell, increased sales through resellers or pressure on pricing and margins due to competition. Our newer product lines, SCREAM and SHOUT IP, have lower gross margins than our Promina product line, as a result of customary discounting for early customers and higher per-unit costs associated with low purchase volumes of components. We expect these margins to increase as additional quantities of our new products lines are shipped. Gross margins may also be adversely affected if product or related warranty costs associated with new products are greater than we have experienced historically. Also, to the extent we expand our sales through product resellers and strategic partnerships, we would expect to realize lower gross margins.

#### *Operating Expenses*

|                            | <u>Quarter Ended</u>          |                               |               | <u>Six Months Ended</u>       |                               |               |
|----------------------------|-------------------------------|-------------------------------|---------------|-------------------------------|-------------------------------|---------------|
|                            | <u>September<br/>26, 2003</u> | <u>September<br/>27, 2002</u> | <u>Change</u> | <u>September<br/>26, 2003</u> | <u>September<br/>27, 2002</u> | <u>Change</u> |
| Sales and marketing        | \$ 7,264                      | \$ 7,883                      | (7.9)%        | \$ 15,118                     | \$ 16,399                     | (7.8)%        |
| Research and development   | 6,949                         | 6,684                         | 4.0           | 13,789                        | 13,167                        | 4.7           |
| General and administrative | 2,442                         | 2,907                         | (16.0)        | 5,190                         | 5,772                         | (10.1)        |
| Restructure costs          | -                             | 1,002                         | (100.0)       | 266                           | 1,172                         | (77.3)        |
| Total operating costs      | <u>\$ 16,655</u>              | <u>\$ 18,476</u>              | <u>(9.9)%</u> | <u>\$ 34,363</u>              | <u>\$ 36,510</u>              | <u>(5.9)%</u> |

Operating expenses as a percentage of total revenue decreased to 52.1% in the second quarter of fiscal 2004, compared to 65.8% in the second quarter of fiscal 2003 and decreased to 52.0% from 66.0% on a fiscal year to date basis. The reductions in operating expenses are primarily a result of tightly managed expenses across all functions of the Company.

Sales and marketing expenses as a percentage of total revenue decreased to 22.7% in the second quarter of fiscal 2004, compared to 28.1% in the second quarter of fiscal 2003 and decreased to 22.9% from 29.7% on a fiscal year to date basis. The decrease in spending in the three months ended September 26, 2003 compared to the three months ended September 27, 2002 is primarily the result of a \$306,000 decrease in facility and information technology related costs, a \$188,000 decrease in commissions and a \$127,000 decrease in rental costs. The decrease in spending in the six months ended September 26, 2003 compared to the six months ended September 27, 2002 is primarily the result of a \$465,000 decrease in facility and information technology related costs, a \$329,000 decrease in marketing communications including advertising, promotions, tradeshow and other sales meeting events, a \$283,000 decrease in commissions, a \$247,000 decrease in the use of consultants and a \$233,000 decrease in rental costs, offset in part by a \$275,000 increase in compensation and related costs. We expect sales and marketing expenses to increase slightly in the third quarter of fiscal year 2004 due to our participation in the ITU Telecom World tradeshow that took place in Geneva, Switzerland during that quarter.

Research and development expense as a percentage of total revenue decreased to 21.8% in the second quarter of fiscal 2004 from 23.8% in the second quarter of fiscal 2003 and decreased to 20.9% from 23.8% on a fiscal year to date basis. The increase in spending in the three months ended September 26, 2003 compared to the three months ended September 27, 2002 is primarily the result of a \$161,000 increase in engineering related expenses, a \$151,000

increase for the use of outside consultants, and a \$136,000 increase in facilities, information technology and corporate services related costs, offset in part by a \$207,000 decrease in compensation and benefits. The increase in spending in the six months ended September 26, 2003 compared to the six months ended September 27, 2002 is primarily the result of a \$300,000 increase in facilities, information technology and corporate services related costs, a \$285,000 increase for the use of outside consultants, a \$184,000 increase in engineering related expenses and a \$137,000 increase in depreciation and amortization, offset in part by a \$134,000 decrease in compensation and benefits costs, an \$87,000 decrease in facility rental costs, a \$78,000 decrease in expenses for software and supplies and a \$77,000 decrease in recruiting and relocation expenses. We expect research and development spending in future periods to remain relatively constant compared to the first and second quarters of fiscal 2004 as we balance the priority of cost control and the importance of development for the new broadband products.

General and administrative expense as a percentage of total revenue decreased to 7.6% in the second quarter of fiscal 2004 from 10.4% in the second quarter of fiscal 2003 and decreased to 7.9% from 10.4% on a fiscal year to date basis. The decrease in spending in the three months ended September 26, 2003 compared to the three months ended September 27, 2002 is primarily the result of a \$269,000 decrease in outside legal fees, a \$225,000 decrease in facility and information technology related costs, and decreased salary related expenses, offset in part by a \$127,000 increase in the use of outside services. The decrease in spending in the six months ended September 26, 2003 compared to the six months ended September 27, 2002 is primarily the result of a \$384,000 decrease in outside legal fees, a \$330,000 decrease in facility and information technology related costs, and decreased salary related expenses, offset in part by a \$268,000 increase in the use of outside services. We expect general and administrative expenses in future periods to remain relatively constant as compared to the second quarter of fiscal 2004.

Restructuring charges in the second quarter and first six months of fiscal 2004 were zero and \$266,000, respectively. The charges consisted of \$254,000 for lease write-off and \$12,000 for office closure costs. Restructuring charges in the second quarter and first six months of fiscal 2003 were \$1.0 million and \$1.2 million, respectively, and related to employee separation costs. At September 26, 2003, the remaining liability for restructuring charges is \$909,000, as shown in the table below. Components of accrued restructuring charges, which are included in accrued liabilities in the accompanying balance sheet, and changes in accrued amounts related to this restructuring program during the first six months of fiscal 2004 and as of March 28, 2003 were as follows (in thousands):

|                                  | <b><u>Employee<br/>Separation<br/>Costs</u></b> | <b><u>Lease<br/>Write-off</u></b> | <b><u>Office<br/>Closure<br/>Costs</u></b> | <b><u>Other<br/>Restructuring<br/>Costs</u></b> | <b><u>Total</u></b> |
|----------------------------------|---|-----------------------------------|--|---|---------------------|
| Balance at<br>March 28, 2003     | \$ 160  | \$ 614                            | \$ 36                                      | \$ 94   | \$ 904              |
| Provision                        | -   | 254                               | 12   | -   | 266                 |
| Payments                         | (25)  | (224)                             | (12)                                       | -   | (261)               |
| Balance at<br>September 26, 2003 | <u>\$ 135</u>                                   | <u>\$ 644</u>                     | <u>\$ 36</u>                               | <u>\$ 94</u>                                    | <u>\$ 909</u>       |

We believe that all costs associated with these restructuring charges will be paid no later than the end of fiscal 2007.

#### *Non-Operating Items*

Interest income, primarily relating to short term investments, decreased \$289,000 to \$327,000 in the second quarter of fiscal 2004 compared to \$616,000 in the second quarter of fiscal 2003. Interest income decreased \$620,000 to \$744,000 in the first six months of fiscal 2004 compared to \$1.4 million in the first six months of fiscal 2003. The decrease in interest income is the result of a declining yield from our investment portfolio.

Interest expense increased \$20,000 to \$524,000 in the second quarter of fiscal 2004 compared to \$504,000 in the second quarter of fiscal 2003. Interest expense was \$1.0 million in the first six months of both fiscal 2004 and 2003. The most significant component of our interest expense is the interest on our 7 1/4% convertible subordinated debentures, which was \$456,000 for the second quarters of both fiscal 2004 and 2003 and \$913,000 for the first six months of both fiscal 2004 and 2003. Also included in interest expense in the first six months of fiscal 2004 and 2003 is interest expense related to our \$2.0 million note payable to our landlord for building repairs related to our former headquarters. The note bears interest at 10% and is payable in monthly installments over 10 years.

In the first quarters of fiscal 2004 and 2003, we recorded gains on the sale of our Federal Services Business of \$1.5 million and \$5.0 million, respectively. These gains resulted from certain milestones being met as part of the sale of the Federal Services Business to CACI International Inc. (CACI).

Other expense was \$68,000 and \$18,000 in the second quarters of fiscal 2004 and 2003, respectively. Other income was \$19,000 and \$2.2 million in the first six months of fiscal 2004 and 2003, respectively. Other income in the first quarter of fiscal 2003 resulted primarily from non-recurring gains of \$2.2 million from insurance proceeds received for construction costs associated with our new corporate headquarters in Fremont, California.

Income tax benefit was none and \$2.3 million in the second quarters of fiscal 2004 and 2003, respectively, and \$15,000 and \$2.3 million in the first six months of fiscal 2004 and 2003, respectively. In the second quarter of fiscal 2003, we received a non-recurring tax benefit of \$2.3 million comprised primarily of the release \$1.4 million of state deferred income taxes and \$1.0 million of refunds of domestic and international taxes paid in prior years. Current year income tax benefit represents the benefit for income taxes related to our international entities.

#### *Cumulative Effect of Change in Accounting Principle Relating to Goodwill*

In the first quarter of fiscal 2003, we recorded a charge of \$9.6 million for the impairment of goodwill as a result of the implementation of Statement of Financial Accounting Standard ("SFAS") No. 142, Goodwill and Other Intangible Assets. This charge was recorded as a cumulative change in accounting principle in our condensed consolidated financial statements.

#### **Significant Accounting Policy Judgments and Estimates**

The preparation of financial statements in accordance with accounting principles generally accepted in the United States requires that we make estimates and judgments, which affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosures of contingent assets and liabilities. On an on-going basis, we evaluate our estimates, including those related to sales returns, bad debts, inventories, investments, intangible assets, income taxes, warranty obligations, restructuring charges, contingencies, such as litigation, and contract terms that have multiple elements and other complexities typical in the telecommunications equipment industry. We base our estimates on historical experience and other assumptions that we believe are reasonable under the circumstances. Actual results may differ from these estimates under different assumptions or conditions.

We believe the following critical accounting policies affect the more significant judgments and estimates used in the preparation of our financial statements.

*Revenue Recognition:* We recognize revenue generally upon shipment, when all four of the following criteria are met:

- 1) we have a contract with our customer;
- 2) when delivery has occurred and risk of loss passes to the customer;
- 3) when our price is fixed or determinable; and
- 4) when collection of the receivable is reasonably assured.

For transactions where we have not yet obtained customer acceptance, revenue is generally deferred until the terms of acceptance are satisfied. Revenue for installation or other services is recognized upon completion of the service. Maintenance contracts are sold separately from the products and revenue is recognized ratably over the period of the contracts. A reserve for sales returns is established based on historical trends in product returns. If the actual future returns differ from historical levels, our revenue could be adversely affected.

*Allowance for Doubtful Accounts:* The allowance for doubtful accounts receivable is based on our assessment of the collectibility of specific customer accounts and the aging of accounts receivable. If there is a deterioration of a major customer's credit worthiness or actual defaults are higher than our historical experience, our estimates of the recoverability of amounts due us could be adversely affected.

*Inventory Provisions:* Inventory purchases and commitments are based upon future demand forecasts. If there is a significant decrease in demand for our products or there is a higher risk of inventory obsolescence because of rapidly changing technology and customer requirements, we may be required to make adjustments to write down our inventory to the lower of cost or market, and our gross margin could be adversely affected.

*Warranty Accruals:* We generally provide a warranty for hardware product sales for twelve months and a warranty for software sales for three months. We accrue warranty expense based on historical expense trends calculated as a percentage of new product sales. Actual expenses are charged against the accrual in the period they are incurred. On a quarterly basis, the warranty accrual is analyzed for adequacy based on actual trends and subsequent adjustments are made to the liability balance.

*Stock-Based Compensation:* We account for stock-based awards to employees using the intrinsic value method in accordance with Accounting Principles Board (APB) Opinion No. 25, Accounting for Stock Issued to Employees

and its related interpretations. Accordingly, no charges were taken in the first six months of fiscal 2004 and 2003 as all stock options were granted at market price.

*Deferred Taxes:* We have incurred tax losses in the last four fiscal years and, at September 26, 2003, we have an estimated \$88.3 million of federal net operating loss carryforwards and \$19.3 million of state operating loss carryforwards available expiring in the years 2020 through 2024. We have provided a full valuation allowance against our tax assets, given the uncertainty as to their realization. In future years, these benefits are available to reduce or eliminate taxes on future taxable income. Current federal and state tax laws include provisions that could limit the annual use of our net operating loss carryforwards in the event of certain defined changes in stock ownership. Our issuances of common and preferred stock could result in such a change. Accordingly, the annual use of our net operating loss carryforwards may be reduced by these provisions. Management has not yet determined the extent of the limitation, and this limitation may result in the loss of carryforward benefits due to their expiration.

### **Liquidity and Capital Resources**

As of September 26, 2003, we had cash and cash equivalents of \$8.9 million, restricted cash of \$1.4 million and short-term investments of \$84.1 million for a total of \$94.4 million as compared to \$94.6 million at the end of fiscal 2003. The Company benefited in the second quarter of fiscal 2004 from a refund of county property taxes of \$227,000 and benefited in the first quarter of fiscal 2004 from a \$1.5 million payment received from CACI as part of the sale of our Federal Services Business and \$600,000 of refunded royalties previously paid.

Net cash used in operating activities in the first six months of fiscal 2004 was \$1.7 million compared to net cash used in operating activities of \$9.1 million in the first six months of fiscal 2003. Net cash used in operating activities in the first six months of fiscal 2004 resulted primarily from an increase in accounts receivable of \$10.7 million due to the timing of our orders from customers, which was weighted toward the end of the quarter, an increase in accrued liabilities of \$1.9 million and a gain on the sale of the Federal Services Business of \$1.5 million, offset by net income of \$2.0 million, depreciation and amortization of \$4.4 million, a decrease in inventories of \$2.7 million and an increase in accounts payable of \$3.7 million. Net cash used in operating activities in the first six months of fiscal 2003 resulted primarily from a net loss of \$15.8 million, an increase in inventory of \$834,000, an increase in accrued liabilities of \$3.5 million and an increase in accounts payable of \$1.4 million, offset by a decrease in accounts receivable of \$1.3 million, a decrease in prepaid expenses of \$767,000 and the receipt of \$3.3 million in cash in relation to our insurance settlement. Other components of operating activities in the first six months of fiscal 2003 included a gain on the sale of the Federal Services Business of \$5.0 million, a gain on building insurance proceeds of \$2.2 million, depreciation and amortization of \$4.7 million and the cumulative effect of change in accounting principle relating to goodwill of \$9.6 million.

Net cash used in investing activities was \$13.2 million in the first six months of fiscal 2004, compared to net cash provided by investing activities of \$5.0 million in the first six months of fiscal 2003. Net cash used in investing activities in the first six months of fiscal 2004 consisted primarily of purchases of short term investments of \$134.3 million and purchases of property and equipment of \$3.3 million, offset by proceeds from maturities of short term investments of \$122.7 million and an increase in proceeds received from the sale of the Federal Services Business of \$1.5 million. Net cash provided by investing activities in the first six months of fiscal 2003 resulted primarily from proceeds from maturities of short-term investments of \$37.6 million, a decrease in restricted cash of \$1.8 million and an increase in proceeds from the sale of the Federal Services Business of \$5.0 million, partially offset by purchases of short term investments of \$35.9 million and purchases of property and equipment of \$3.6 million.

Net cash provided by financing activities in the first six months of fiscal 2004 was \$3.0 million compared to net cash provided by financing activities of \$883,000 in the first six months of fiscal 2003. Net cash provided by financing activities resulted from the sale of common stock to employees under stock plans.

We believe that our existing current cash and cash equivalents, short-term investments and cash flows from operations will be sufficient to fund operations, purchases of capital equipment and research and development programs currently planned at least through the next 12 months.

### **Recently Issued Accounting Standards**

In May 2003, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standard (SFAS) No. 150, Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity. SFAS 150 requires that certain financial instruments, which under previous guidance were accounted for as equity, must now be accounted for as liabilities. The financial instruments affected include mandatory redeemable stock, certain financial instruments that require or may require the issuer to buy back some of its shares in exchange for cash or other assets and certain obligations that can be settled with shares of stock. SFAS 150 is effective for



interim periods beginning after June 15, 2003. We do not expect the adoption of SFAS 150 to have a material effect on our results of operations or financial condition.

In April 2003, the FASB issued SFAS No. 149, Amendment of SFAS No. 133 on Derivative Instruments and Hedging Activities. SFAS 149 amends and clarifies the accounting for derivative instruments, including certain derivative instruments embedded in other contracts, and for hedging activities under SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities. SFAS 149 is generally effective for contracts entered into or modified after June 30, 2003 and for hedging relationships designated after June 30, 2003. We adopted SFAS 149, and the adoption did not have a material impact on our results of operations and financial condition.

In December 2002, FASB issued SFAS No. 148, Accounting for Stock-Based Compensation-Transition and Disclosure, which amends SFAS 123, Accounting for Stock-Based Compensation. SFAS 148 provides alternative methods of transition for a voluntary change to the fair value based method of accounting for stock-based employee compensation. In addition, SFAS 148 amends the disclosure requirements of SFAS 123 to require more prominent and more frequent disclosures in financial statements about the effects of stock-based compensation. SFAS 148 is effective for fiscal years ending after December 15, 2002. We adopted the disclosure provisions of SFAS 148 at March 28, 2003.

In November 2002, the FASB issued FIN 45, Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others, which elaborates on the disclosures to be made by a guarantor in its interim and annual financial statements about its obligations under certain guarantees that it has issued. We adopted the provisions of FIN 45 for guarantees issued or modified after December 31, 2002 and the adoption of FIN 45 did not have a material effect on the Company's results of operations or financial position.

## **BUSINESS ENVIRONMENT AND RISK FACTORS**

Our business is subject to the risks and uncertainties described below. Although we have tried to identify the material risks to our business, this is not an all-inclusive list. There may be additional risks that have not yet been identified and risks that are not material now but could become material. Any one of these risks could hurt our business, results of operations or financial condition.

***We have incurred net losses in the recent past and may incur losses again in the future.***

For each of the past five fiscal years, we have incurred net losses. Although the Company has reduced operating expenses over the past few years, and was profitable in the first quarter and six months of fiscal 2004, we will need revenue to continue to grow in order to achieve ongoing profitability. Our narrowband product line, Promina, currently provides the bulk of our revenue, but we expect revenue from that product line to decline over the next few years. Our newer broadband and IP-telephony product lines, SCREAM and SHOUTIP, have not yet achieved market acceptance or broad commercial sales, and we are incurring substantial product development and marketing expenses for those product lines. Accordingly, we will not likely be profitable on an ongoing basis unless our newer product lines achieve commercial success that outpaces the anticipated decline of our Promina product line. In addition, we must contain our operating expenses, many of which are fixed in the short term making it difficult to reduce expenses rapidly in response to shortfalls in revenue.

***Our operating results may continue to fluctuate.***

Our operating results vary significantly from quarter to quarter. These fluctuations may result from a number of factors, including:

- the volume and timing of orders from and shipments to our customers;
- the length and variability of the sales cycle of our products;
- the timing of and our ability to obtain new customer contracts;
- the timing of new products and services;
- variations in the mix of products and services we sell;
- the timing and level of prototype expenses;
- the availability of products and services;
- the overall capital expenditures of our customers;
- the market acceptance of new and enhanced versions of our products and services;

- the availability and cost of key components;
- the timing of revenue recognition/deferrals;
- the adoption of new accounting standards, such as the potential requirement to record expenses for employee stock option grants;
- changes to revenue recognition rules or changing interpretations of such rules as they apply to our sales;
- the obsolescence of inventories;
- the timing and size of Federal Government budget approvals; and
- general economic conditions as well as those specific to the telecommunications, Internet and related industries.

Due to the foregoing factors, we believe that quarter-to-quarter comparisons of our operating results are not a good indication of our future performance. Any shortfall in revenue may adversely affect our business, results of operations and financial condition. Investors should not rely on our results or growth for one quarter as any indication of our future performance.

***Our stock price may be volatile and could decline substantially.***

The market price of our common stock has fluctuated significantly in the past, will likely continue to fluctuate in the future and may decline. Fluctuations or a decline in our stock price may occur regardless of our performance. Among the factors that could affect our stock price, in addition to our performance, are:

- variations between our operating results and the published expectations of securities analysts;
- changes in financial estimates or investment recommendations by securities analysts following our business;
- announcements by us or our competitors of significant contracts, new products or services, acquisitions, or other significant transactions;
- sale of our common stock or other securities in the future;
- the inclusion or exclusion of our stock in various indices or investment categories, especially as compared to the investment profiles of our stockholders at a given time;
- changes in economic and capital market conditions;
- changes in business regulatory conditions; and
- the trading volume of our common stock.

***We are dependent on revenue from the Promina product line.***

Currently, we derive the majority of our product revenue from our Promina product line, a circuit-based narrowband technology. The market for our Promina product is expected to decline as networks are expected to increasingly employ packet-based broadband technology. This technology migration has already resulted in a significant drop in sales of our Promina products in the commercial markets over the last three years. If this decline extends into our government markets in a similar fashion before we gain traction on our newer packet-based broadband product lines, our revenue will decrease, and our business and results of operations will suffer.

***A significant portion of our revenue is generated from sales to governmental agencies.***

A significant portion of our total revenue from product sales comes from contracts with governmental agencies, most of which do not include long-term purchase commitments. Historically, the government has been slower to adopt new technology, such as packet-based technology, which has had the effect of extending the product life of our Promina product. While the government has purchased and is evaluating some of our new products for broader deployment, this new business may not be sufficient to offset expected declines in sales of our Promina product. Furthermore, if the government accelerated adoption of new technology, and replaced the Promina product line in their networks with products other than ours, our product revenue would decline sharply. We anticipate that our past experience will result in future contracts with the Federal Government; however, we face significant competition in this endeavor. If we fail in renewing a significant number of Federal Government contracts or if sales to the Federal Government decline sharply, our revenue may not increase to profitable levels.

***Continued declines in purchases by our commercial customers and the overall decline of product sales in the service provider market could negatively affect our operations and financial results.***

Over the last three years, the financial health of many of our commercial customers, particularly telecommunications service providers, has deteriorated, resulting in a decreased demand for telecommunications products. In addition, the timing and volume of purchases by service providers can be unpredictable due to their need to generate new revenue with sharply reduced capital budgets while reducing operating expenses. Further, our ability to recognize revenue on sales to these customers will depend on our meeting various acceptance criteria imposed on the company in connection with these products by our early adopter customers, and on the relative financial condition of these customers and whether receivables balances from them are deemed to be collectible. Also, the selling cycle of our SCREAM and SHOUTIP product lines could be extended if our service provider customers continue to reduce their capital budgets. Declines in revenue as a result of any of these factors could cause a material adverse effect on our business, operating results and financial condition.

***Our success depends on our ability to develop new products and product enhancements that will achieve market acceptance.***

Our operating results will depend on the successful design, development, testing, introduction, marketing, and broad commercial distribution of our newer packet-based products, the SCREAM and SHOUTIP product lines. The success of these and other new products is dependent on several factors, including proper product definition, competitive pricing, timely completion and introduction to the market, differentiation from competitors' products, and broad market acceptance. The markets for our products are characterized by rapidly changing technology, evolving industry standards, frequent new product introductions and evolving methods of building and operating networks. Our SCREAM product line is targeted at long-established incumbent carriers, such as BellSouth, SBC Communications, Sprint, Verizon, British Telecom and France Telecom, who typically have stringent product requirements and who are reluctant to purchase products from vendors lacking substantial revenues and assets. Our SHOUTIP product line is largely targeted at start-up telecommunications companies who demand highly competitive pricing and, more recently, to government agencies that require secure voice communications over limited bandwidth. We may not successfully identify new product opportunities, develop and bring new products to market in a timely manner, or achieve market acceptance of our products. Products and technologies developed by others may render our products or technologies obsolete or non-competitive, which in turn could adversely affect our ability to achieve profitability.

***The success of our SCREAM product line depends largely on it being chosen by service providers as a platform for the delivery of new services.***

Since the second quarter of our fiscal year 2000, we have spent the majority of our research and development and marketing resources to position ourselves, and our SCREAM family of products, as the next generation of telecommunications equipment that will enable carriers to optimize the delivery of differentiated services. The future success of the SCREAM product line will depend in large measure on service providers choosing to invest in products, such as SCREAM, that can be used to deliver new services such as quality-of-service guarantees, class-of-service subscriptions, or bandwidth-on-demand, to increase their revenue and lower their operating expenses. If service providers do not meaningfully invest in such new technologies, or do not choose the SCREAM product line for such investment, our revenues from SCREAM will be negatively affected, which will in turn have a negative effect on our business and operating results.

***We need partnerships to accelerate the acceptance of our new products by service providers.***

Building relationships with partners, such as software application partners, system integrators, OEMs or resellers can accelerate the sales of new products. The importance of the software application partners is that they provide functions, such as billing, mediation, provisioning and configuration that are needed to create a total solution for our customers. We need product OEM or resale partners to supplement and enhance our sales force both in the United States and overseas. Service providers rely on systems integrators to incorporate new equipment or services into their network. These integrators are important in the large incumbent carrier networks and could facilitate our entry into those networks. While we have begun the process of identifying and signing software application, system integrator and OEM or resale partners, more partners may be necessary in all these areas for us to be successful. We may need to pursue strategic partnerships with vendors who have broader technology or product offerings in order to compete with the end-to-end solution providers, as well as to bolster our co-marketing efforts. Failure to sign up these new strategic partners could affect our ability to grow overall revenue.

***Gross margins could decline over future periods.***

Due to increases in competition, material and labor costs, subcontractor costs, change in absorption rate and changes in the mix of products we sell, our gross margins could decline in future quarters. Our newer product lines, SCREAM and SHOUTIP, currently have lower gross margins than our Promina product line. These lower gross margins are a result of higher discounts awarded to early adopter customers and higher component costs due to low purchase volumes of these components. A decline in our gross margins could have a material adverse effect on our business, results of operations and financial condition.

***Factors beyond our control could affect our ability to sell into international markets.***

We conduct significant sales and customer support operations in countries outside of the United States and depend on non-US operations of our subsidiaries and distribution partners. In addition, we also maintain a satellite research and development facility in Ottawa, Province of Ontario, Canada and, on a case-by-case basis, we outsource research and development activities to third parties here in the US and abroad. As a general rule, international sales tend to have risks that are difficult to foresee and plan for, including political and economic stability, regulatory changes, currency exchange rates, changes in tax rates and structures, and collection of accounts receivable. Further, our international markets are served primarily by non-exclusive resellers who themselves may be severely affected by economic or market changes within a particular country or region. Our future results could be materially adversely affected by a variety of uncontrollable and changing factors that could affect these activities. Unforeseen or unpredictable changes in international markets could have a material adverse effect on our business, results of operations and financial condition.

***The divestiture of our federal services business has reduced our ability to control the quality of service provided to our Federal Government customers.***

On December 1, 2000, we closed the sale of our federal service business to CACI, which subsequently provides maintenance and other services to our Federal Government customers. We continue to sell net.com products directly to the Federal Government and we rely on CACI to perform staging and integration services for them. Additionally, we have a strategic alliance with CACI to jointly market each other's products and services. As a result of these arrangements, we are dependent on CACI to provide the level of service to which our customers have become accustomed. If CACI experiences difficulties in providing those services, or for any other reason leaves our mutual customers unsatisfied, it could adversely affect purchasing decisions for our products and cause our Federal Government customers to seek products from other vendors.

***The market for our products is highly competitive and many of our competitors have greater resources than us.***

The market for telecommunication equipment is highly competitive, dynamic and characterized by rapid changes to and the convergence of technologies, and a worldwide migration from existing circuit technology to the new packet-based technologies. We compete directly, internationally and domestically with many different companies, some of which are large, established suppliers of end-to-end solutions, such as Alcatel, Cisco, Lucent, Nortel, Juniper and Siemens. In addition, there are a number of other smaller companies that are targeting the same market, including CoSine, Nuera, Copper Mountain, Advanced Fiber Communications, Redback and others. Some of our larger competitors have significantly greater financial, marketing and technical resources than we have and offer a wider range of networking products than we offer. They are often able to devote greater resources to the development, marketing and sale of their products and to use their equity or significant cash reserves to acquire other companies with technology and/or products that compete directly with ours. They often can compete favorably on price because their large product selection allows them to bundle multiple solutions together without significantly affecting their overall product margins. The smaller companies have more ability than net.com to focus their resources on a particular product development unencumbered by the requirements to support an existing product line. As a result of the flexibility of their market strategies, our competitors may be able to obtain strategic advantages that may adversely affect our business, financial condition or results of operations.

In addition, the networking equipment market has seen the constant introduction of new technologies that has reduced the value of older technology solutions. This has created pricing pressure on older products while increasing the performance expectations of newer networking equipment. Moreover, broadband technology standards are constantly evolving and alternative technologies or technologies with greater capability are constantly introduced and sought by our customers. It is possible that the introduction of other technologies will either supplant our current technologies and technologies we have in development or will require us to significantly lower our prices in order to remain competitive. To remain competitive, we must continue to evolve our SCREAM and SHOUTIP product lines to meet the ever-changing technology needs of the networking market while ensuring that they can be sold at a competitive price. We also must enhance our Promina product line to provide needed features that increase their overall value for the customer while keeping the price competitive. Due to the competitive nature

of the market and the relative age of our Promina product offerings as well as the competitive pressure being exerted on our SCREAM and SHOUTIP technologies, we may not be able to maintain prices for them at levels that will sustain profitability.

***If we are unable to sign competitive resale partners, our future product and service revenue will be adversely affected.***

Our international sales are made almost entirely through indirect channels that include distributors and resellers worldwide, and our business strategy includes leveraging resale partners in the United States as well. Our reseller agreements do not have minimum purchase requirements that they must meet. Our distributors and resellers often also resell product lines from other companies, including our competitors, some of whom have strong market position relative to net.com. Because of existing relationships that many of our competitors have with distributors and resellers, it is often difficult for us to find a distributor or reseller who is willing and contractually able to resell our products. If we cannot develop relationships with distributors and resellers that can effectively market and sell our products and services, we may not be able to meet our forecasted revenue in future quarters.

***Our products have long sales cycles, making it difficult to predict when a customer will place an order and when to forecast revenue from the related sale.***

Our products are very complex and represent a significant capital expenditure to our customers. The purchase of our products can have a significant impact on how a customer designs its network and provides services either within its own organization or to an external customer. Consequently, our customers often engage in extensive testing and evaluation of products before purchase. There are also numerous financial and budget considerations and approvals that the customer often must obtain before it will issue a purchase order. As a result, the length of our sales cycle can be quite long, extending beyond twelve months in some cases. In addition, our customers, including resellers, often have the contractual right to delay scheduled order delivery dates with minimal penalties and to cancel orders within specified time frames without penalty, which makes it difficult to predict whether or not an order may actually ship. We often must incur substantial sales and marketing expense to ensure a purchase order is placed. If the order is not placed in the quarter forecasted, our sales may not meet forecast and revenue may be insufficient to meet expenses.

***Because it is difficult for us to accurately forecast sales, particularly within a given time frame, we face a risk of carrying too much or too little inventory.***

Typically, the majority of our revenue in each quarter has resulted from orders received and shipped in that quarter. While we do not believe that backlog is necessarily indicative of future revenue levels, our customers' ordering patterns and the possible absence of backlogged orders create a significant risk that we could carry too much or too little inventory if orders do not match forecasts. Rather than base forecasts on orders received, we have been forced to schedule production and commit to certain expenses based more upon forecasts of future sales, which are difficult to predict in the telecommunications industry. Furthermore, if large orders do not close when forecasted or if near-term demand weakens for the products we have available to ship, our operating results for that quarter or subsequent quarters would be materially adversely affected.

***If we are unable to retain existing employees and attract, recruit and retain key personnel, then we may not be able to successfully manage our business.***

Our success continues to be dependent on our being able to attract and retain highly skilled engineers, managers and other key employees. Despite the economic slowdown, we must continue to compete for the most qualified personnel for new positions and to replace departing employees. Any restrictions on our ability to use stock options as a key component of employee compensation, such as changes in accounting treatment, stockholder actions, or changes in corporate regulations, could severely impair our ability to recruit and retain personnel. If we are not able to continue to attract, recruit and retain key personnel, particularly in engineering, sales and marketing positions, we may be unable to meet important company objectives such as product delivery deadlines and sales targets.

***We rely on a number of sole source suppliers for our component parts and third party products which could affect our ability to ship our products in a timely manner.***

We purchase key components from single source suppliers, in particular, our back planes, integrated circuits, and power supplies. If we or our sole source suppliers fail to obtain components in sufficient quantities when required, delivery of our products could be delayed resulting in decreased revenues. In addition, if one of these suppliers were no longer able to supply a required component, we may have to significantly reengineer the affected product. Further, variability in demand and cyclical shortages of capacity in the semiconductor industry have caused lead times for ordering parts to increase from time to time. If we encounter shortages or delays in receiving ordered

components or if we are not able to accurately forecast our ordering requirements, we may be unable to ship ordered products in a timely manner.

***We single source our manufacturing processes; a failure or delay by a contract-manufacturing vendor could affect our ability to ship our products timely.***

We currently subcontract some product testing and all product manufacturing to third parties, with generally only a single source for manufacturing of each product line. Final test and assembly is generally performed at our Fremont, California facility, although we intend to have third parties also perform more of those functions. While subcontracting creates substantial cost efficiencies in the manufacturing process, it also exposes us to delays in product shipments should the contract manufacturer be unable to perform. We have agreed to compensate our contract manufacturers in the event of termination or cancellation of orders, discontinuance of product, or excess material created by an engineering change. Also, should a contract manufacturer in some future period decide not to renew our contract with them, it would be difficult for us to quickly transfer our manufacturing requirements to another vendor, likely causing substantial delays in customer product shipments and affecting our revenue and results of operations. We have recently transitioned some of our product manufacturing to a new vendor, but the transition is limited to specific products and has not materially diversified the outsourcing risk. Also, the transition itself and the lack of experience with the new vendor could cause delays in customer product shipments or otherwise negatively affect our results of operations.

***Our intellectual property rights may not be adequate to protect our business.***

Our future success depends in part upon our proprietary technology. Although we attempt to establish and maintain rights in proprietary technology and products through patents, copyrights, and trade secrets laws, we cannot predict whether such protection will be adequate, or whether our competitors can develop similar technology independently without violating our proprietary rights. As competition in the communications equipment industry increases and the functionality of the products in this industry further overlap, we believe that companies in the communications equipment industry may become increasingly subject to infringement claims. We have received and may continue to receive notice from third parties, including some of our competitors, claiming that we are infringing their patents or their other proprietary rights. We cannot predict whether we will prevail in any litigation over third-party claims, or that we will be able to license any valid and infringed patents on commercially reasonable terms. Any of these claims, whether with or without merit, could result in costly litigation, divert our management's time, attention and resources, delay our product shipments or require us to enter into royalty or licensing agreements. In addition, a third-party may not be willing to enter into a royalty or licensing agreement on acceptable terms, if at all. If a claim of product infringement against us is successful and we fail to obtain a license or develop or license non-infringing technology, we may be unable to market the affected product.

***We rely on technologies licensed from third parties.***

For our Promina, SCREAM and SHOUTIP products, we license some of our technology from third parties. These licenses are generally limited in duration or by the volume of shipments of the licensed technology. In addition, some of these licenses contain limitations on distribution of the licensed technology or provide for expiration upon certain events, such as a change in control of the company. If the relevant licensing agreement expires or is terminated without our being able to renew that license on commercially reasonable terms, or if we cannot obtain a license for our products or enhancements on our existing products we may be unable to market the affected products.

For many of these technologies, we rely on the third-party provider to update and maintain the technology, fixing errors and adding new features. If the third-party provider does not adequately update and maintain these technologies, whether due to changes in their product direction, their own financial difficulties, or other reasons, we would need to seek alternative means to fulfill the ongoing requirements for our products that incorporate the third-party technology. If we are unable to find alternative means of fulfilling the ongoing requirements, we may be unable to market the affected products.

***We face risks associated with changes in telecommunications regulations and tariffs, including regulation of the Internet.***

Changes in domestic and international telecommunications requirements could affect the sales of our products. In the United States, our products must comply with various Federal Communication Commission (FCC) requirements and regulations. In countries outside of the United States, our products must meet various requirements of local telecommunications authorities. Changes in tariffs or failure by us to obtain timely approval of products could impact our ability to market the affected product.

The demand for our broadband products could also be affected by rulings of the FCC regarding services offered by service providers to their customers, such as differentiated broadband services. If rulings or regulations of the FCC diminish the attractiveness of offering such services, then service providers would likely have less need for our products.

In addition, there are currently few laws or regulations that govern access or commerce on the Internet. If individual countries, or groups of countries, acting in concert, began to impose regulations or standards on Internet access or commerce including IP telephony, our ability to sell our new SCREAM and SHOUTIP products or other new products would be adversely impacted if the regulations or standards resulted in decreased demand or increased costs for our products.

New restrictions on trade, such as in response to transfers of jobs from the United States to lower-cost foreign locations, could limit our ability to purchase components from, or outsource functions to, foreign entities, which would likely make it more difficult to maintain competitiveness in the global market. As a result of our current concentration of business to the Federal government, we are more sensitive to these trade restrictions, whether tariffs, incentives, or government purchasing requirements such as the "Buy American Act," than it would be with a more diversified customer base.

In North America, the former Regional Bell Operating Companies (RBOCs) recommend that Telcordia Technologies, Inc. certify telecommunications equipment under its Operations Systems Modifications for the Integration of Network Elements (OSMINE) program in order to ensure interoperability with other network elements and operational support systems. We have initiated the process for our product lines to become OSMINE certified, but this is a very expensive and lengthy process. Any delays or problems with attaining this certification could have a material adverse impact on our business, operating results, and financial condition.

***We are exposed to fluctuations in the exchange rates of foreign currency.***

As a global concern, we face exposure to adverse movements in foreign currency exchange rates. These exposures may change over time as business practices evolve and could have a material adverse impact on our financial results. In fiscal 2003, we commenced using foreign exchange contracts to hedge significant accounts receivable and intercompany account balances denominated in foreign currencies. Although we have established foreign exchange contracts for non-dollar denominated sales and operating expenses in the United Kingdom, France, Germany and Japan, exposures remain for non-dollar denominated operating expenses in Latin America, Canada, and Asia. We will continue to monitor our exposure and may hedge against these or any other emerging market currencies as necessary. Market value gains and losses on hedge contracts are substantially offset by fluctuations in the underlying balances being hedged.

***The location of our facilities subjects us to the risk of earthquake and floods.***

Our corporate headquarters, including most of our research and development operations and our manufacturing facilities, are located in the Silicon Valley area of Northern California, a region known for seismic activity. These facilities are located near the San Francisco Bay where the water table is quite close to the surface and where tenants have experienced water intrusion problems in the facilities nearby. In particular, unknown defects in the construction of our new facilities combined with the proximity to water may result in future water infiltration problems for net.com. A significant natural disaster, such as an earthquake or flood, could have a material adverse impact on our business, operating results, and financial condition.

### **ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

In the first quarter of fiscal 2003 we began using foreign exchange contracts to hedge significant accounts receivable and intercompany account balances denominated in foreign currencies. Market value gains and losses on these hedged contracts are substantially offset by fluctuations in the underlying balances being hedged. The net financial impact of foreign exchange gains and losses has not been material. A 10% increase or decrease in the foreign currency rates would not have a significant effect on our business, operating results and financial condition. Our policy is to not use hedges or other derivative financial instruments for speculative purposes.

A portion of our investment portfolio is composed of income securities. These securities are subject to interest rate risk and will fall in value if market interest rates increase. A sensitivity analysis assuming a hypothetical increase or decrease of 10% from levels at September 26, 2003 and March 28, 2003 indicated the fair value of the portfolio would change by an immaterial amount. At September 26, 2003, the fair value of the short-term investments was \$84.1 million compared to \$72.6 million at March 28, 2003.

#### ITEM 4. DISCLOSURE CONTROLS AND PROCEDURES

In accordance with Section 302 of the Sarbanes-Oxley Act of 2002 and the Securities Exchange Act of 1934, we implemented disclosure controls and procedures pursuant to which management under the supervision and with the participation of the chief executive officer ("CEO") and chief financial officer ("CFO") carried out a review and evaluation of the effectiveness of these controls and procedures as of September 26, 2003. Based on this review, our CEO and CFO have concluded that our disclosure controls and procedures are effective in timely alerting them to material changes in information required to be included in our periodic Securities and Exchange Commission filings.

We intend to review and evaluate the design and effectiveness of our disclosure controls and procedures on an ongoing basis and to improve our controls and procedures over time and to correct any deficiencies that we may discover in the future. Our goal is to ensure that our senior management has timely access to all material financial and non-financial information concerning our business. While we believe the present design of our disclosure controls and procedures is effective to achieve our goal, future events affecting our business may cause us to significantly modify our disclosure controls and procedures.

### PART II -- OTHER INFORMATION

#### ITEM 1. LEGAL PROCEEDINGS

None

#### ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

On August 12, 2003, the Company held its Annual Meeting of Stockholders at the Company's headquarters in Fremont, California. Approximately 94% of the 22,936,095 outstanding shares entitled to vote were properly represented by proxy at the meeting.

The stockholders voted as follows to elect the following persons as Class I Directors for a three-year term:

|                    | <u>For</u> | <u>Withheld</u> |
|--------------------|------------|-----------------|
| David R. Laube     | 19,104,591 | 2,452,874       |
| Hubert A. J. Whyte | 17,243,603 | 4,313,862       |

The stockholders also approved the following proposals at the meeting:

|  | <u>For</u> | <u>Against</u> | <u>Abstain</u> |
|--|------------|----------------|----------------|
| Ratify the appointment of Deloitte & Touche LLP to serve as the Company's independent accountants for the fiscal year ending March 26, 2004      | 21,434,483 | 101,568        | 33,194         |
| Approve an amendment to the 1993 Stock Option Plan making various changes, including extending the term of the plan five years                   | 9,340,345  | 5,611,604      | 33,194         |
| Approve an amendment to the 1998 Employee Stock Purchase Plan to clarify the administrator's ability to designate subsidiaries for participation | 21,202,167 | 339,928        | 15,370         |



## **ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K**

### **(a) Exhibits**

31. Rule 13a-14(a) Certifications

32. Section 1350 Certification

### **(b) Report on Form 8-K**

The Company filed one Current Report on Form 8-K in the fiscal quarter ended September 26, 2003. The report, dated July 16, 2003, furnished the Company's press release announcing its financial results for the fiscal quarter ended June 27, 2003.

## **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.

### **NETWORK EQUIPMENT TECHNOLOGIES, INC.**

Dated: November 5, 2003

/s/ Hubert A.J. Whyte

Hubert A.J. Whyte

President and Chief Executive Officer

/s/ John F. McGrath, Jr.

John F. McGrath, Jr.

Vice President and Chief Financial Officer

(Principal Financial and Accounting Officer)