CISCO SYSTEMS INC
Form 10-Q
May 27, 2004
Table of Contents

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

(Mark one)

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

For the quarterly period ended May 1, 2004

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 0-18225

CISCO SYSTEMS, INC.

(Exact name of Registrant as specified in its charter)

California	**77-0059951**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification Number)**

170 West Tasman Drive

San Jose, California 95134

(Address of principal executive office and zip code)

(408) 526-4000

(Registrant s telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. YES x NO ¨

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act). YES x NO ¨

As of May 21, 2004, 6,761,489,462 shares of the registrant s common stock were outstanding.

Table of Contents

Cisco Systems, Inc.

FORM 10-Q for the Quarter ended May 1, 2004

INDEX

Table of Contents

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements (Unaudited)

Cisco Systems, Inc.

CONSOLIDATED STATEMENTS OF OPERATIONS

(In millions, except per-share amounts)

(Unaudited)

	Three Months Ended		Nine Months Ended	
	May 1, 2004	April 26, 2003	May 1, 2004	April 26, 2003
NET SALES:				
Product	$ 4,730	$ 3,799	$ 13,543	$ 11,703
Service	890	819	2,576	2,473
Total net sales	5,620	4,618	16,119	14,176
COST OF SALES:				
Product	1,452	1,086	4,193	3,467
Service	301	263	855	765
Total cost of sales	1,753	1,349	5,048	4,232
GROSS MARGIN	3,867	3,269	11,071	9,944
OPERATING EXPENSES:				
Research and development	867	725	2,392	2,375
Sales and marketing	1,153	1,019	3,350	3,092
General and administrative	231	184	653	512
Amortization of purchased intangible assets	60	92	182	284
In-process research and development	2	3	3	3
Total operating expenses	2,313	2,023	6,580	6,266
OPERATING INCOME	1,554	1,246	4,491	3,678
Interest income	127	161	388	514
Other income (loss), net	40	(26)	177	(552)
Interest and other income (loss), net	167	135	565	(38)
INCOME BEFORE PROVISION FOR INCOME TAXES AND CUMULATIVE EFFECT OF ACCOUNTING CHANGE	1,721	1,381	5,056	3,640
Provision for income taxes	510	394	1,468	1,044

INCOME BEFORE CUMULATIVE EFFECT OF ACCOUNTING CHANGE	1,211	987	3,588	2,596
Cumulative effect of accounting change, net of tax			(567)	
NET INCOME	$ 1,211	$ 987	$ 3,021	$ 2,596
Income per share before cumulative effect of accounting change:				
Basic	$ 0.18	$ 0.14	$ 0.52	$ 0.36
Diluted	$ 0.17	$ 0.14	$ 0.51	$ 0.36
Net income per share:				
Basic	$ 0.18	$ 0.14	$ 0.44	$ 0.36
Diluted	$ 0.17	$ 0.14	$ 0.43	$ 0.36
Shares used in per-share calculation:				
Basic	6,816	7,062	6,872	7,165
Diluted	7,074	7,158	7,095	7,257

See Notes to Consolidated Financial Statements.

Table of Contents

Cisco Systems, Inc.

CONSOLIDATED BALANCE SHEETS

(In millions, except par value)

(Unaudited)

	May 1, 2004	July 26, 2003
ASSETS		
Current assets:		
Cash and cash equivalents	$ 3,949	$ 3,925
Short-term investments	4,912	4,560
Accounts receivable, net of allowance for doubtful accounts of $188 at May 1, 2004 and $183 at July 26, 2003	1,540	1,351
Inventories	1,121	873
Deferred tax assets	1,905	1,975
Lease receivables, net	65	49
Prepaid expenses and other current assets	581	624
Total current assets	14,073	13,357
Investments	10,085	12,167
Property and equipment, net	3,351	3,643
Goodwill	4,198	4,043
Purchased intangible assets, net	387	556
Lease receivables, net	293	238
Other assets	2,810	3,103
TOTAL ASSETS	$ 35,197	$ 37,107
LIABILITIES AND SHAREHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 604	$ 594
Income taxes payable	848	739
Accrued compensation	1,432	1,470
Deferred revenue	3,420	3,034
Other accrued liabilities	1,899	2,162
Restructuring liabilities	71	295
Total current liabilities	8,274	8,294
Deferred revenue	937	774
Total liabilities	9,211	9,068
Commitments and contingencies (Note 6)		
Minority interest	5	10
Shareholders equity:		
Preferred stock, no par value: 5 shares authorized; none issued and outstanding		
Common stock and additional paid-in capital, $0.001 par value: 20,000 shares authorized; 6,790 and 6,998 shares issued and outstanding at May 1, 2004 and July 26, 2003, respectively	22,277	21,116
Retained earnings	3,489	6,559

Accumulated other comprehensive income	215	354
Total shareholders equity	25,981	28,029
TOTAL LIABILITIES AND SHAREHOLDERS EQUITY	$ 35,197	$ 37,107

See Notes to Consolidated Financial Statements.

Table of Contents

Cisco Systems, Inc.

CONSOLIDATED STATEMENTS OF CASH FLOWS

(In millions)

(Unaudited)

	Nine Months Ended	
	May 1, 2004	**April 26, 2003**
Cash flows from operating activities:		
Net income	$ 3,021	$ 2,596
Adjustments to reconcile net income to net cash provided by operating activities:		
Cumulative effect of accounting change, net of tax	567	
Depreciation and amortization	1,133	1,166
Provision for doubtful accounts	19	
Provision for inventory	124	26
Deferred income taxes	305	131
Tax benefits from employee stock option plans	454	19
In-process research and development	3	3
Net (gains) losses and impairment charges on investments	(149)	523
Change in operating assets and liabilities:		
Accounts receivable	(203)	(48)
Inventories	(371)	89
Prepaid expenses and other current assets	(13)	(79)
Accounts payable	1	10
Income taxes payable	144	(319)
Accrued compensation	(41)	(72)
Deferred revenue	543	(133)
Other accrued liabilities	(274)	(203)
Restructuring liabilities	(224)	(18)
Net cash provided by operating activities	5,039	3,691
Cash flows from investing activities:		
Purchases of short-term investments	(10,008)	(6,759)
Proceeds from sales and maturities of short-term investments	10,911	7,346
Purchases of investments	(16,054)	(13,024)
Proceeds from sales and maturities of investments	16,820	7,975
Acquisition of property and equipment	(487)	(504)
Acquisition of businesses, net of cash and cash equivalents	(104)	3
Change in lease receivables, net	(71)	49
Change in investments in privately held companies	20	(141)
Purchase of minority interest of Cisco Systems, K.K. (Japan)	(71)	(59)
Other	146	126
Net cash provided by (used in) investing activities	1,102	(4,988)
Cash flows from financing activities:		
Issuance of common stock	930	279

Repurchase of common stock	(7,082)	(4,549)
Other	35	23
Net cash used in financing activities	(6,117)	(4,247)
Net increase (decrease) in cash and cash equivalents	24	(5,544)
Cash and cash equivalents, beginning of period	3,925	9,484
Cash and cash equivalents, end of period	$ 3,949	$ 3,940

See Notes to Consolidated Financial Statements.

Table of Contents

Cisco Systems, Inc.

CONSOLIDATED STATEMENTS OF SHAREHOLDERS EQUITY

(In millions)

(Unaudited)

Nine Months Ended April 26, 2003	**Shares of Common Stock**	**Common Stock and Additional Paid-In Capital**	**Retained Earnings**	**Accumulated Other Comprehensive Income (Loss)**	**Total Shareholders Equity**
BALANCE AT JULY 27, 2002	7,303	$ 20,950	$ 7,733	$ (27)	$ 28,656
Net income			2,596		2,596
Change in unrealized gains and losses on investments, net of tax				294	294
Other				19	19
Comprehensive income					2,909
Issuance of common stock	35	279			279
Repurchase of common stock	(341)	(987)	(3,562)		(4,549)
Tax benefits from employee stock option plans		19			19
Purchase acquisitions	21	227			227
Amortization of deferred stock-based compensation		104			104
BALANCE AT APRIL 26, 2003	7,018	$ 20,592	$ 6,767	$ 286	$ 27,645

Nine Months Ended May 1, 2004	**Shares of Common Stock**	**Common Stock and Additional Paid-In Capital**	**Retained Earnings**	**Accumulated Other Comprehensive Income (Loss)**	**Total Shareholders Equity**
BALANCE AT JULY 26, 2003	6,998	$ 21,116	$ 6,559	$ 354	$ 28,029
Net income			3,021		3,021
Change in unrealized gains and losses on investments, net of tax				(170)	(170)
Other				31	31
Comprehensive income					2,882
Issuance of common stock	87	930			930
Repurchase of common stock	(318)	(991)	(6,091)		(7,082)
Tax benefits from employee stock option plans		454			454
Purchase acquisitions		6			6
Amortization of deferred stock-based compensation		130			130

Variable stock-based compensation		58			58
Cumulative effect of accounting change, net of tax		567			567
Acquisition of Andiamo Systems, Inc.	23	7			7
BALANCE AT MAY 1, 2004	6,790	$ 22,277	$ 3,489	$ 215	$ 25,981

See Notes to Consolidated Financial Statements.

Table of Contents

Cisco Systems, Inc.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

1. DESCRIPTION OF BUSINESS

Cisco Systems, Inc. (the Company or Cisco) manufactures and sells networking and communications products and provides services associated with that equipment and its use. The Company s products are installed at corporations, public institutions, telecommunication companies, and commercial businesses, and are also found in personal residences. Cisco provides a broad line of products for transporting data, voice, and video within buildings, across campuses, and around the world.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Fiscal Year

The Company s fiscal year is the 52 or 53 weeks ending on the last Saturday in July. Fiscal 2004 is a 53-week fiscal year and fiscal 2003 was a 52-week fiscal year. The third quarter of fiscal 2004 consisted of 14 weeks, one week more than a typical quarter.

Basis of Presentation

The accompanying financial data as of May 1, 2004 and for the three and nine months ended May 1, 2004 and April 26, 2003 has been prepared by the Company, without audit, pursuant to the rules and regulations of the Securities and Exchange Commission. Certain information and footnote disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles have been condensed or omitted pursuant to such rules and regulations. The July 26, 2003 Consolidated Balance Sheet was derived from audited financial statements, but does not include all disclosures required by generally accepted accounting principles. However, the Company believes that the disclosures are adequate to make the information presented not misleading. These Consolidated Financial Statements should be read in conjunction with the Consolidated Financial Statements and the notes thereto included in the Company s Annual Report on Form 10-K for the fiscal year ended July 26, 2003.

In the opinion of management, all adjustments (which include normal recurring adjustments, except as disclosed herein) necessary to present a fair statement of financial position as of May 1, 2004, results of operations for the three and nine months ended May 1, 2004 and April 26, 2003, and cash flows and shareholders equity for the nine months ended May 1, 2004 and April 26, 2003, as applicable, have been made. The results of operations for the three and nine months ended May 1, 2004 are not necessarily indicative of the operating results for the full fiscal year or any future periods.

Employee Stock Option Plans

The Company accounts for stock-based awards to employees and directors using the intrinsic value method of accounting in accordance with Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees (APB 25). Under the intrinsic value method, because the exercise price of the Company s employee stock options equals the market price of the underlying stock on the date of grant, no compensation expense is recognized in the Company s Consolidated Statements of Operations.

Table of Contents

Cisco Systems, Inc.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

Pro forma information regarding option grants made to the Company s employees based on specified valuation techniques that produce estimated compensation charges is as follows (in millions, except per-share amounts):

	Three Months Ended		Nine Months Ended	
	May 1, 2004	April 26, 2003	May 1, 2004	April 26, 2003
Net income as reported	$ 1,211	$ 987	$ 3,021	$ 2,596
Compensation expense, net of tax	(311)	(291)	(950)	(972)
Net income pro forma	$ 900	$ 696	$ 2,071	$ 1,624
Basic net income per share as reported	$ 0.18	$ 0.14	$ 0.44	$ 0.36
Diluted net income per share as reported	$ 0.17	$ 0.14	$ 0.43	$ 0.36
Basic net income per share pro forma	$ 0.13	$ 0.10	$ 0.30	$ 0.23
Diluted net income per share pro forma	$ 0.13	$ 0.10	$ 0.29	$ 0.22

The value of each option grant is estimated on the date of grant using the Black-Scholes option pricing model, which was developed for use in estimating the value of traded options that have no vesting restrictions and are fully transferable. Because the Company s employee stock options have characteristics significantly different from those of traded options, and because changes in the subjective input assumptions can materially affect the estimate, in management s opinion, the existing valuation models do not provide a reliable measure of the fair value of the Company s employee stock options. For additional information regarding this pro forma information, see Note 8 to the Consolidated Financial Statements.

Computation of Net Income per Share

Basic net income per share is computed using the weighted-average number of common shares outstanding during the period. Diluted net income per share is computed using the weighted-average number of common shares and dilutive potential common shares outstanding during the period. Dilutive potential common shares consist of employee stock options and restricted common stock.

Consolidation of Variable Interest Entities

Financial Accounting Standards Board (FASB) Interpretation No. 46, Consolidation of Variable Interest Entities (FIN 46), was issued in January 2003. FIN 46 requires that if an entity is the primary beneficiary of a variable interest entity, the assets, liabilities, and results of operations of the variable interest entity should be included in the consolidated financial statements of the entity. FIN 46(R) was issued in December 2003. The Company adopted FIN 46(R) effective January 24, 2004 and recorded a non-cash cumulative stock compensation charge of $567 million, net of tax, relating to the consolidation of Andiamo Systems, Inc. (Andiamo). For additional information regarding Andiamo, see Note 3 to the Consolidated Financial Statements. For additional information regarding variable interest entities and the impact of the adoption of FIN 46(R), see Note 6 to the Consolidated Financial Statements.

Reclassifications

Certain reclassifications have been made to prior period balances in order to conform to the current period s presentation.

Table of Contents

Cisco Systems, Inc.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

3. BUSINESS COMBINATIONS

During the second quarter of fiscal 2004, the Company completed the acquisition of Latitude Communications, Inc. (Latitude), to add rich-media conferencing which combines voice, video and web conferencing to its IP communications. During the third quarter of fiscal 2004, the Company completed the acquisition of Riverhead Networks, Inc. to add to its portfolio of security solutions that help customers defend against Distributed Denial of Service (DDoS) attacks and other security threats. In addition, during the third quarter of fiscal 2004, the Company completed the acquisition of Twingo Systems, Inc. to add desktop security features for Secure Socket Layer (SSL) virtual private networks (VPNs) to its networking products. A summary of the acquisitions is as follows (in millions):

Acquisition	Shares Issued	Purchase Consideration	Assumed Liabilities	In-Process R&D Expense	Goodwill	Purchased Intangible Assets
Latitude Communications, Inc.		$ 86	$ 29	$ 1	$ 60	$ 16
Riverhead Networks, Inc.		36	6	2	25	7
Twingo Systems, Inc.		5	1		5	1
Total		$ 127	$ 36	$ 3	$ 90	$ 24

The purchase consideration for the Company s acquisitions is also allocated to tangible assets and deferred stock-based compensation. Deferred stock-based compensation represents the intrinsic value of the unvested portion of any restricted shares exchanged, options assumed or options canceled and replaced with the Company s options, and is amortized as compensation cost over the remaining future vesting period of any restricted shares exchanged, stock options assumed or stock options canceled and replaced with the Company s options in connection with an acquisition. The balance for deferred stock-based compensation is reflected as a reduction of additional paid-in capital in the Consolidated Statements of Shareholders Equity.

The following table presents the activity of deferred stock-based compensation for the three and nine months ended May 1, 2004 and April 26, 2003, including the deferred stock-based compensation relating to the acquisition of Andiamo of $90 million (in millions):

	Three Months Ended		Nine Months Ended	
	May 1, 2004	April 26, 2003	May 1, 2004	April 26, 2003
Balance at beginning of period	$ 162	$ 129	$ 262	$ 182
Acquisitions	93	22	94	63

Amortization	(43)	(26)	(130)	(104)
Canceled unvested options			(14)	(16)
Balance at end of period	$ 212	$ 125	$ 212	$ 125

The following table presents details of the purchased intangible assets acquired during the nine months ended May 1, 2004 (in millions, except years):

	TECHNOLOGY		TRADE NAMES		CUSTOMER RELATIONSHIPS		
Acquisition	**Estimated Useful Life (in years)**	**Amount**	**Estimated Useful Life (in years)**	**Amount**	**Estimated Useful Life (in years)**	**Amount**	**Total**
Latitude Communications, Inc.	4.5	$ 4	7.0	$ 1	4.0	$ 11	$ 16
Riverhead Networks, Inc.	4.5	5			3.5	2	7
Twingo Systems, Inc.	3.5	1					1
Total		$ 10		$ 1		$ 13	$ 24

Table of Contents

Cisco Systems, Inc.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

The Consolidated Financial Statements include the operating results of each business from the date of acquisition. Pro forma results of operations have not been presented since the effects of these acquisitions were not material to the Company s results.

The following tables present details of the Company s total purchased intangible assets (in millions):

May 1, 2004	Gross	Accumulated Amortization	Net
Technology	$ 627	$ (423)	$ 204
Technology licenses	348	(321)	27
Customer relationships	88	(15)	73
Trade names	90	(39)	51
Other	131	(99)	32
Total	$ 1,284	$ (897)	$ 387

July 26, 2003	Gross	Accumulated Amortization	Net
Technology	$ 639	$ (349)	$ 290
Technology licenses	523	(447)	76
Customer relationships	75	(1)	74
Trade names	89	(24)	65
Other	160	(109)	51
Total	$ 1,486	$ (930)	$ 556

The estimated future amortization expense of purchased intangible assets as of May 1, 2004 is as follows (in millions):

Fiscal Year	Amount
2004 (remaining three months)	$ 61
2005	185
2006	82
2007	40
2008	19

Total	$ 387

The following table presents the changes in goodwill allocated to the Company s reportable segments during the nine months ended May 1, 2004 (in millions):

	Balance at July 26, 2003	Acquired	Balance at May 1, 2004
Americas	$ 2,642	$ 74	$ 2,716
EMEA	668	10	678
Asia Pacific	167	4	171
Japan	566	67	633
Total	$ 4,043	$ 155	$ 4,198

10

Table of Contents

Cisco Systems, Inc.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

During the three months ended May 1, 2004, the Company purchased a portion of the minority interest of Cisco Systems, K.K. (Japan). As a result, the Company increased its ownership from 94.8% to 97.6% of the voting rights of Cisco Systems, K.K. (Japan) and recorded goodwill of $65 million.

Acquisition of Andiamo Systems, Inc.

In April 2001, the Company entered into a commitment to provide convertible debt funding of approximately $84 million to Andiamo, a privately held storage switch developer. This debt was convertible into approximately 44% of the equity of Andiamo. In connection with this investment, the Company obtained a call option that provided the Company the right to purchase Andiamo. The purchase price under the call option was based on a valuation of Andiamo using a negotiated formula. On August 19, 2002, the Company entered into a definitive agreement to acquire Andiamo, which represented the exercise of its rights under the call option. The Company also entered into a commitment to provide non-convertible debt funding to Andiamo of approximately $100 million through the close of the acquisition. Substantially all of the convertible debt funding of $84 million and non-convertible debt funding of $100 million has been expensed as research and development costs.

The Company adopted FIN 46(R) effective January 24, 2004. The Company evaluated its debt investment in Andiamo and determined that Andiamo was a variable interest entity under FIN 46(R). The Company concluded that the Company was the primary beneficiary as defined by FIN 46(R) and, therefore, accounted for Andiamo as if the Company had consolidated Andiamo since the Company s initial investment in April 2001. The consolidation of Andiamo from the date of the Company s initial investment required accounting for the call option as a repurchase right. Under FASB Interpretation No. 44, Accounting for Certain Transactions Involving Stock Compensation, and related interpretations, variable accounting was required for substantially all Andiamo employee stock and options because the ending purchase price was primarily derived from a revenue-based formula.

Effective January 24, 2004, the last day of the second quarter of fiscal 2004, the Company recorded a non-cash cumulative stock compensation charge of $567 million (representing the amount of variable compensation from April 2001 through January 2004). This charge was reported as a separate line item in the Consolidated Statements of Operations as a cumulative effect of accounting change, net of tax. The charge was based on the value of the Andiamo employee stock and options and their vesting from the adoption of FIN 46(R) pursuant to the formula-based valuation.

On February 19, 2004, the Company completed the acquisition of Andiamo, exchanging approximately 23 million shares of the Company s common stock for Andiamo shares not owned by the Company and assuming approximately 6 million stock options, for a total estimated value of $750 million, primarily derived from the revenue-based formula, which after stock price related adjustments resulted in a total amount recorded of $722 million as summarized in the table below.

Subsequent to the adoption of FIN 46(R), changes to the value of Andiamo and the continued vesting of the employee stock and options resulted in an adjustment to the non-cash stock compensation charge. The Company recorded a non-cash variable stock compensation adjustment of $58 million in the third quarter of fiscal 2004 to the cumulative stock compensation charge recorded in the second quarter of fiscal 2004 to account for the additional vesting of the Andiamo employee stock and options and changes in the formula-based valuation from January 24, 2004 until February 19, 2004. This non-cash adjustment was reported as operating expense in the Consolidated Statements of Operations, as amortization of deferred stock-based compensation in the Consolidated Statements of Cash Flows, and as an increase to additional paid-in capital in the Consolidated Statements of Shareholders Equity. In addition, upon completion of the acquisition, deferred stock-based compensation of $90 million was recorded on the Consolidated Balance Sheets to reflect the unvested portion of

Cisco Systems, Inc.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

the formula-based valuation of the Andiamo employee stock and options. The amount of deferred stock-based compensation was fixed at the date of acquisition and will be amortized over the remaining vesting period of Andiamo employee stock and options of approximately two years.

A summary of the accounting of the consolidation under FIN 46(R) and the subsequent purchase of Andiamo, after stock price related adjustments, is as follows (in millions):

	Amount
Cumulative effect of accounting change, net of tax benefit of $5	$ 567
Variable stock-based compensation	58
Deferred stock-based compensation	90
Net assets	7
Total	$ 722

4. RESTRUCTURING COSTS AND OTHER SPECIAL CHARGES

On April 16, 2001, the Company announced a restructuring program, which included a worldwide workforce reduction, consolidation of excess facilities, and restructuring of certain business functions. The following table summarizes the activity related to the liability for restructuring costs and other special charges as of May 1, 2004 (in millions):

	Workforce Reduction	Consolidation of Excess Facilities and Other Charges	Impairment of Goodwill and Purchased Intangible Assets	Total
Initial charge in the third quarter of fiscal 2001	$ 397	$ 484	$ 289	$ 1,170
Non-cash charges	(71)	(141)	(289)	(501)
Cash payments	(265)	(18)		(283)
Balance at July 28, 2001	61	325		386
Adjustments (1)	(35)	128		93
Cash payments	(26)	(131)		(157)
Balance at July 27, 2002		322		322
Adjustments (2)		45		45

Cash payments		(72)		(72)
Balance at July 26, 2003		295		295
Cash payments (3)		(224)		(224)
Balance at May 1, 2004	$	$ 71	$	$ 71

Note 1: Due to changes in previous estimates, in fiscal 2002, the Company reclassified $35 million of restructuring liabilities related to the workforce reduction charges to consolidation of excess facilities and other charges. The initial estimated workforce reduction was approximately 6,000 regular employees. Approximately 5,400 regular employees were terminated and the liability was paid. In addition, during fiscal 2002, the Company increased the restructuring liabilities related to the consolidation of excess facilities and other charges by $93 million, which was recorded during the third quarter of fiscal 2002, due to changes in real estate market conditions. The increase in restructuring liabilities was recorded as expenses related to research and development ($39 million), sales and marketing ($42 million), general and administrative ($8 million), and cost of sales ($4 million) in the Consolidated Statements of Operations.

Table of Contents

Cisco Systems, Inc.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

Note 2: During fiscal 2003, the Company increased the restructuring liabilities related to the consolidation of excess facilities and other charges by a total of $45 million, which was recorded during the first quarter and fourth quarter of fiscal 2003, due to changes in real estate market conditions. The increase in restructuring liabilities was recorded as expenses related to research and development ($18 million), sales and marketing ($18 million), general and administrative ($4 million), and cost of sales ($5 million) in the Consolidated Statements of Operations.

Note 3: Includes payments of approximately $204 million on lease obligations that were terminated.

5. BALANCE SHEET DETAILS

The following tables provide details of selected balance sheet items (in millions):

	May 1, 2004	July 26, 2003
Inventories:		
Raw materials	$ 56	$ 38
Work in process	422	291
Finished goods	611	515
Demonstration systems	32	29
Total	$ 1,121	$ 873
Property and equipment, net:		
Land, buildings, and leasehold improvements	$ 3,424	$ 3,411
Computer equipment and related software	1,224	1,147
Production, engineering, and other equipment	2,676	2,410
Operating lease assets	98	356
Furniture and fixtures	356	350
	7,778	7,674
Less, accumulated depreciation and amortization	(4,427)	(4,031)
Total	$ 3,351	$ 3,643
Other assets:		
Deferred tax assets	$ 1,316	$ 1,476
Investments in privately held companies	360	516
Income tax receivable	690	727
Structured loans, net	19	42

Other	425	342
Total	$ 2,810	$ 3,103
Deferred revenue:		
Service	$ 2,864	$ 2,451
Product	1,493	1,357
Total	4,357	3,808
Less, current portion	(3,420)	(3,034)
Non-current deferred revenue	$ 937	$ 774

Table of Contents

Cisco Systems, Inc.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

6. COMMITMENTS AND CONTINGENCIES

Leases

The Company leases office space in several U.S. locations, as well as locations elsewhere in the Americas International; Europe, the Middle East, and Africa (EMEA); Asia Pacific; and Japan. Future annual minimum lease payments under all non-cancelable operating leases with an initial term in excess of one year as of May 1, 2004 were as follows (in millions):

Fiscal Year	Amount
2004 (remaining three months)	$ 64
2005	231
2006	170
2007	124
2008	106
Thereafter	667
Total	$ 1,362

Purchase Commitments with Contract Manufacturers and Suppliers

The Company purchases components from a variety of suppliers and uses several contract manufacturers to provide manufacturing services for its products. During the normal course of business, in order to reduce manufacturing lead times and to help assure adequate component supply, the Company enters into agreements with contract manufacturers and suppliers that either allow them to procure inventory based upon criteria as defined by the Company or that establish the parameters defining the Company s requirements. In certain instances, these agreements allow the Company the option to cancel, reschedule and adjust the Company s requirements based on its business needs prior to firm orders being placed. Consequently, only a portion of the Company s reported purchase commitments arising from these agreements are firm, non-cancelable and unconditional commitments. As of May 1, 2004, the Company had total purchase commitments for inventory of approximately $932 million, compared with $718 million as of July 26, 2003. These purchase commitments are expected to be fulfilled within one year.

In addition to the above, the Company records a liability for firm, non-cancelable and unconditional purchase commitments for quantities in excess of its future demand forecasts consistent with the Company s allowance for inventory. As of May 1, 2004, the liability for these firm, non-cancelable and unconditional purchase commitments was $124 million, compared with $99 million as of July 26, 2003, and was included in other accrued liabilities.

Other Commitments

The Company has agreed to invest up to $800 million in venture funds managed by SOFTBANK Corp. and its affiliates (SOFTBANK), which are required to be funded on demand. Up to $550 million is to be invested in venture funds on terms specified in the agreement and $250 million invested as senior debt with entities as directed by SOFTBANK. The Company s commitment to fund the senior debt is contingent upon the achievement of certain agreed-upon milestones. As of May 1, 2004, the Company had invested $290 million in the venture funds, compared with $247 million as of July 26, 2003. As of May 1, 2004 and July 26, 2003, the Company has invested $49 million in the senior debt.

Table of Contents

Cisco Systems, Inc.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

The Company provides structured financing to certain qualified customers for the purchase of equipment and other needs through its wholly owned subsidiary, Cisco Systems Capital Corporation. These loan commitments may be funded over a two- to three-year period, provided that these customers achieve specific business milestones and satisfy certain financial covenants. As of May 1, 2004, the outstanding loan commitments were approximately $64 million, of which approximately $26 million was eligible for draw-down. As of July 26, 2003, the outstanding loan commitments were approximately $97 million, of which approximately $38 million was eligible for draw-down.

As of May 1, 2004 and July 26, 2003, the Company had a commitment of approximately $59 million and $130 million, respectively, to purchase the remaining portion of the minority interest of Cisco Systems, K.K. (Japan).

The Company also has certain other funding commitments related to its privately held investments that are based on the achievement of certain agreed-upon milestones. The funding commitments were approximately $74 million as of May 1, 2004, compared with approximately $95 million as of July 26, 2003.

Variable Interest Entities

In the ordinary course of business, the Company has investments in privately held companies and provides structured financing to certain customers through its wholly owned subsidiary, Cisco Systems Capital Corporation, which may be considered variable interest entities. The Company has evaluated its investments in privately held companies and structured financings and has determined that the adoption of FIN 46(R) did not have a material impact on its operating results or financial condition, except for the impact of Andiamo. See Note 3 to the Consolidated Financial Statements.

Guarantees and Product Warranties

FASB Interpretation No. 45, Guarantor s Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others (FIN 45), requires that upon issuance of a guarantee, the guarantor must disclose and recognize a liability for the fair value of the obligation it assumes under that guarantee.

The requirements of FIN 45 are applicable to the Company s product warranty liability and certain guarantees. The Company s guarantees subject to the recognition and disclosure requirements of FIN 45 as of May 1, 2004 and July 26, 2003 were not material. As of May 1, 2004 and July 26, 2003, the Company s product warranty liability recorded in other accrued liabilities was $240 million and $246 million, respectively. The following table summarizes the activity related to the product warranty liability for the nine months ended May 1, 2004 and April 26, 2003 (in millions):

	Nine Months Ended	
	May 1, 2004	April 26, 2003
Balance at beginning of period	$ 246	$ 242
Provision for warranties issued	243	270
Payments	(249)	(266)
Balance at end of period	$ 240	$ 246

The Company accrues for warranty costs as part of its cost of sales based on associated material product costs and technical support labor costs. The products sold are generally covered by a warranty for periods of 90 days, one year, or five years, and for some products, the Company provides a limited lifetime warranty.

Table of Contents

Cisco Systems, Inc.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

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

It is not possible to determine the maximum potential amount under these indemnification agreements due to the limited history of prior indemnification claims and the unique facts and circumstances involved in each particular agreement. Historically, payments made by the Company under these agreements have not had a material impact on the Company s operating results or financial position.

Derivative Instruments

The Company conducts business on a global basis in several currencies. As such, it is exposed to adverse movements in foreign currency exchange rates. The Company enters into foreign exchange forward contracts to minimize the short-term impact of foreign currency fluctuations on certain foreign currency receivables, investments, and payables. The gains and losses on the foreign exchange forward contracts offset the transaction gains and losses on certain foreign currency receivables, investments, and payables recognized in earnings.

The Company does not enter into foreign exchange forward contracts for trading purposes. Gains and losses on the contracts are included in other income (loss), net, in the Consolidated Statements of Operations and offset foreign exchange gains or losses from the revaluation of intercompany balances or other current assets, investments, and liabilities denominated in currencies other than the functional currency of the reporting entity. The Company s foreign exchange forward contracts related to current assets and liabilities generally range from one to three months in original maturity. Additionally, the Company has entered into foreign exchange forward contracts related to long-term customer financings with maturities of up to two years. The foreign exchange contracts related to investments generally have maturities of less than one year.

The Company periodically hedges certain foreign currency forecasted transactions related to certain operating expenses with currency options. These transactions are designated as cash flow hedges. The effective portion of the derivative s gain or loss is initially reported as a component of accumulated other comprehensive income (loss) and subsequently reclassified into earnings when the hedged exposure affects earnings. The ineffective portion of the gain or loss is reported in earnings immediately. These currency option contracts generally have maturities of less than 18 months. The Company does not purchase currency options for trading purposes. Foreign exchange forward and option contracts as of May 1, 2004 are summarized as follows (in millions):

	Notional Amount	Fair Value

Forward contracts:		
Purchased	$ 921	$ 2
Sold	$ 414	$ (8)
Option contracts:		
Purchased	$ 554	$ 17
Sold	$ 477	$ (4)

Cisco Systems, Inc.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

The Company s foreign exchange forward and option contracts expose the Company to credit risk to the extent that the counterparties may be unable to meet the terms of the agreement. The Company minimizes such risk by limiting its counterparties to major financial institutions. In addition, the potential risk of loss with any one counterparty resulting from this type of credit risk is monitored. Management does not expect any material losses as a result of default by counterparties.

Legal Proceedings

Beginning on April 20, 2001, a number of purported shareholder class action lawsuits were filed in the United States District Court for the Northern District of California against Cisco and certain of its officers and directors. The lawsuits have been consolidated, and the consolidated action is purportedly brought on behalf of those who purchased the Company s publicly traded securities between August 10, 1999 and February 6, 2001. Plaintiffs allege that defendants have made false and misleading statements, purport to assert claims for violations of the federal securities laws, and seek unspecified compensatory damages and other relief. Cisco believes the claims are without merit and intends to defend the actions vigorously.

In addition, beginning on April 23, 2001, a number of purported shareholder derivative lawsuits were filed in the Superior Court of California, County of Santa Clara, and in the Superior Court of California, County of San Mateo. There is a procedure in place for the coordination of such actions (one of which has been dismissed and is currently on appeal). Two purported derivative suits were filed in the United States District Court for the Northern District of California, and those federal court actions have been consolidated. The consolidated federal court derivative action was dismissed by the court, and plaintiffs have appealed from that decision. The complaints in the various derivative actions include claims for breach of fiduciary duty, waste of corporate assets, mismanagement, unjust enrichment, and violations of the California Corporations Code; seek compensatory and other damages, disgorgement, and other relief; and are based on essentially the same allegations as the class actions.

With respect to the above-described shareholder litigation, Cisco believes there is no legal basis for liability. However, due to the uncertainty surrounding the litigation process, Cisco is unable to reasonably estimate a range of loss, if any, at this time. In addition, the Company is subject to legal proceedings, claims, and litigation arising in the ordinary course of business. While the outcome of these matters is currently not determinable, the Company does not expect that the ultimate costs to resolve these matters will have a material adverse effect on the Company s consolidated financial position, results of operations, or cash flows.

7. SHAREHOLDERS EQUITY

Stock Repurchase Program

Between September 2001 and September 2003, the Company s Board of Directors authorized the repurchase of up to $20 billion of Cisco s outstanding common stock. During the first nine months of fiscal 2004, the Company repurchased and retired 318 million shares of Cisco common stock at an average price of $22.29 per share for an aggregate purchase price of $7.1 billion. As of May 1, 2004, the Company had repurchased and retired 866 million shares of Cisco common stock at an average price of $17.22 per share for an aggregate purchase price of $14.9 billion since inception of the stock repurchase program, and the remaining authorized amount for stock repurchases under this program was $5.1 billion with no termination date.

In addition, on May 13, 2004, the Company s Board of Directors authorized the repurchase of up to an additional $5 billion of Cisco s outstanding common stock with no termination date.

Table of Contents

Cisco Systems, Inc.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

Comprehensive Income

The components of comprehensive income are as follows (in millions):

	Three Months Ended		Nine Months Ended	
	May 1, 2004	April 26, 2003	May 1, 2004	April 26, 2003
Net income	$ 1,211	$ 987	$ 3,021	$ 2,596
Other comprehensive income:				
Change in unrealized gains and losses on investments, net of tax	(160)	(6)	(170)	294
Other	(57)	(3)	31	19
Total	$ 994	$ 978	$ 2,882	$ 2,909

The change in unrealized gains and losses on investments, net of tax, for the nine months ended April 26, 2003 included the effect of the recognition of a charge in the Consolidated Statements of Operations of $412 million, pre-tax, attributable to the impairment of certain publicly traded equity securities during the first quarter of fiscal 2003. The impairment charge was related to the decline in the fair value of certain publicly traded equity investments below their cost basis that were judged to be other-than-temporary.

8. EMPLOYEE STOCK OPTION PLANS

Stock Option Program Description

The Company has two plans under which it grants stock options: the 1996 Stock Incentive Plan (the 1996 Plan) and the 1997 Supplemental Stock Incentive Plan (the Supplemental Plan).

Stock option grants are designed to reward employees for their long-term contributions to the Company and provide incentives for them to remain with the Company. The number and frequency of stock option grants are based on competitive practices, operating results of the Company, and government regulations. Since the inception of the 1996 Plan, the Company has granted options to all of its employees, and the majority has been granted to employees below the vice president level. No options have been granted to directors or executive officers under the

Supplemental Plan.

Distribution and Dilutive Effect of Options

The following table illustrates the grant dilution and exercise dilution (in millions, except percentages):

	Nine Months Ended	
	May 1, 2004	April 26, 2003
Shares of common stock outstanding	6,790	7,018
Granted and assumed	178	176
Canceled	(41)	(44)
Net options granted	137	132
Grant dilution (1)	2.0%	1.9%
Options exercised	75	25
Exercise dilution (2)	1.1%	0.4%

Table of Contents

Cisco Systems, Inc.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

Note 1: The percentage for grant dilution is computed based on net options granted as a percentage of shares of common stock outstanding.

Note 2: The percentage for exercise dilution is computed based on options exercised as a percentage of shares of common stock outstanding.

Basic and diluted shares outstanding for the nine months ended May 1, 2004 were 6.9 billion shares and 7.1 billion shares, respectively. Diluted shares outstanding include the dilutive impact of in-the-money options, which is calculated based on the average share price for each fiscal period using the treasury stock method. Under the treasury stock method, the tax-effected proceeds that would be hypothetically received from the exercise of all in-the-money options are assumed to be used to repurchase shares. During the nine months ended May 1, 2004, the dilutive impact of in-the-money employee stock options was approximately 214 million shares or 3.1% of the basic shares outstanding based on Cisco s average share price of $22.42 during that period.

The following table summarizes the options granted to the Named Executive Officers during the periods indicated. The Named Executive Officers represent the Company s Chief Executive Officer and the four other most highly paid executive officers whose salary and bonus for the fiscal years ended July 26, 2003 or July 27, 2002, respectively, were in excess of $100,000.

	Nine Months Ended	
	May 1, 2004	**April 26, 2003**
Options granted to the Named Executive Officers	2 million	4 million
Options granted to the Named Executive Officers as a % of net options granted	1.5%	3.0%
Options granted to the Named Executive Officers as a % of outstanding shares	0.03%	0.06%
Cumulative options held by Named Executive Officers as a % of total options outstanding	4.2%	4.5%

Table of Contents

Cisco Systems, Inc.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

General Option Information

A summary of option activity follows (in millions, except per-share amounts). The Company has, in connection with the acquisitions of various companies, assumed the stock option plans of each acquired company or issued replacement options.

		Options Outstanding	
	Options Available for Grant	Number Outstanding	Weighted-Average Exercise Price per Share
BALANCE AT JULY 27, 2002	664	1,206	$ 27.17
Granted and assumed	(199)	199	12.01
Exercised		(45)	7.14
Canceled	57	(57)	33.03
Additional shares reserved	4		
BALANCE AT JULY 26, 2003	526	1,303	25.29
Granted and assumed	(178)	178	19.45
Exercised		(75)	10.44
Canceled	41	(41)	31.77
Additional shares reserved	7		
BALANCE AT MAY 1, 2004	396	1,365	$ 25.15

The following table summarizes significant ranges of outstanding and exercisable options as of May 1, 2004 (shares and aggregate intrinsic value in millions, except years and per-share amounts):

	Options Outstanding				Options Exercisable		
Range of Exercise Prices	Number Outstanding	Weighted-Average Remaining Contractual Life (in Years)	Weighted-Average Exercise Price per Share	Aggregate Intrinsic Value	Number Exercisable	Weighted-Average Exercise Price per Share	Aggregate Intrinsic Value

$ 0.01 9.75	223	3.69	$ 6.78	$ 3,151	168	$ 6.05	$ 2,496
9.76 13.04	160	5.44	12.52	1,342	96	12.26	830
13.05 16.15	184	6.50	15.61	975	83	15.68	434
16.16 18.57	98	6.36	18.18	268	46	18.21	124
18.58 19.59	146	8.16	19.56	197	5	19.21	9
19.60 26.42	171	5.75	23.32	31	107	24.49	13
26.43 50.38	186	5.18	43.32		140	42.23	
50.39 64.38	162	4.82	55.01		134	55.10	
64.39 72.56	35	5.10	67.28		28	69.17	
Total	1,365	5.58	$ 25.15	$ 5,964	807	$ 27.61	$ 3,906

The aggregate intrinsic value in the table above represents the total pre-tax intrinsic value based on Cisco s closing stock price of $20.91 as of April 30, 2004, that would have been received by the option holders had all option holders exercised their options as of that date. The total number of in-the-money options exercisable as of May 1, 2004 was 427 million options. As of July 26, 2003, 748 million outstanding options were exercisable and the weighted average exercise price was $26.12 per share.

Table of Contents

Cisco Systems, Inc.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

The following table presents the option exercises for the nine months ended May 1, 2004 and option values as of that date for the Named Executive Officers (in millions):

	Number of Shares Acquired On Exercise	Value Realized	Number of Securities Underlying Unexercised Options at May 1, 2004		Intrinsic Value of Unexercised In-the-Money Options at May 1, 2004	
			Exercisable	Unexercisable	Exercisable	Unexercisable
Named Executive Officers	4.1	$ 70	43	15	$ 279	$ 49

Pro forma Information

Pro forma information regarding option grants made to the Company s employees based on specified valuation techniques that produce estimated compensation charges is as follows (in millions, except per-share amounts):

	Three Months Ended		Nine Months Ended	
	May 1, 2004	April 26, 2003	May 1, 2004	April 26, 2003
Net income as reported	$ 1,211	$ 987	$ 3,021	$ 2,596
Compensation expense, net of tax	(311)	(291)	(950)	(972)
Net income pro forma	$ 900	$ 696	$ 2,071	$ 1,624
Basic net income per share as reported	$ 0.18	$ 0.14	$ 0.44	$ 0.36
Diluted net income per share as reported	$ 0.17	$ 0.14	$ 0.43	$ 0.36
Basic net income per share pro forma	$ 0.13	$ 0.10	$ 0.30	$ 0.23
Diluted net income per share pro forma	$ 0.13	$ 0.10	$ 0.29	$ 0.22

The value of each option grant is estimated on the date of grant using the Black-Scholes option pricing model with the following weighted-average assumptions:

	Three Months Ended		Nine Months Ended	
	May 1, 2004	**April 26, 2003**	**May 1, 2004**	**April 26, 2003**
Expected dividend	0.0%	0.0%	0.0%	0.0%
Risk-free interest rate	3.3%	3.2%	3.8%	3.2%
Expected volatility	40.5%	45.4%	40.1%	45.8%
Expected life (in years)	5.5	5.7	5.6	5.8

The Black-Scholes option pricing model was developed for use in estimating the value of traded options that have no vesting restrictions and are fully transferable. In addition, option pricing models require the input of highly subjective assumptions, including the expected stock price volatility and expected life. The Company uses projected data for expected volatility and expected life of its stock options based upon historical and other economic data trended into future years. Because the Company s employee stock options have characteristics significantly different from those of traded options, and because changes in the subjective input assumptions can materially affect the estimate, in management s opinion, the existing valuation models do not provide a reliable measure of the fair value of the Company s employee stock options. Under the Black-Scholes option pricing

Table of Contents

Cisco Systems, Inc.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

model, the weighted-average estimated values of employee stock options granted for the three and nine months ended May 1, 2004 were $10.12 and $8.70, respectively, and for the three and nine months ended April 26, 2003 were $6.09 and $5.48, respectively. The value of shares of common stock relating to the Employee Stock Purchase Plan included in the estimated compensation expense in the pro forma information above was not material.

9. INCOME TAXES

The Company paid net income taxes of $535 million and $1.2 billion for the nine months ended May 1, 2004 and April 26, 2003, respectively. The Company s income taxes currently payable for federal and state purposes have been reduced by the tax benefits from employee stock option transactions. These benefits totaled $454 million and $19 million for the nine months ended May 1, 2004 and April 26, 2003, respectively, and were reflected as an increase to additional paid-in capital in the Consolidated Statements of Shareholders Equity.

The Company s federal income tax returns for fiscal years ended July 25, 1998 through July 28, 2001 are under examination and the Internal Revenue Service has proposed certain adjustments. The Company believes that adequate amounts have been reserved for any adjustments that may ultimately result from these examinations.

10. SEGMENT INFORMATION AND MAJOR CUSTOMERS

The Company s operations involve the design, development, manufacturing, marketing and technical support of networking and communications products and services. Cisco products include routers, switches, advanced technologies, and other networking equipment. These products, primarily integrated by Cisco IOS Software, link geographically dispersed LANs and WANs.

The Company conducts business globally and is managed geographically. The Company s management makes financial decisions and allocates resources based on the information it receives from its internal management system. Prior to fiscal 2004, the Company s management relied on the internal management system to provide sales and standard cost information by geographic theater. Beginning in fiscal 2004, production overhead and manufacturing variances and other related costs in the cost of sales information are attributed to each geographic theater in the internal management system. As a result, effective in fiscal 2004, the Company s management uses gross margin by geographic theater and prior period information has been reclassified to conform to the current period s presentation.

Sales are attributed to a geographic theater based on the ordering location of the customer. The Company does not allocate research and development, sales and marketing, or general and administrative expenses to its geographic theaters in this internal management system, as management does not currently use the information to measure the performance of the operating segments. Based on established criteria, the Company has four reportable segments: the Americas, EMEA, Asia Pacific, and Japan.

22

Table of Contents

Cisco Systems, Inc.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

Summarized financial information by theater for the three and nine months ended May 1, 2004 and April 26, 2003, as taken from the internal management system previously discussed, is as follows (in millions):

	Three Months Ended		Nine Months Ended	
	May 1, 2004	April 26, 2003	May 1, 2004	April 26, 2003
Net sales:				
Americas	$ 3,058	$ 2,526	$ 8,885	$ 7,853
EMEA	1,617	1,294	4,518	3,900
Asia Pacific	572	459	1,629	1,437
Japan	373	339	1,087	986
Total	$ 5,620	$ 4,618	$ 16,119	$ 14,176
Gross margin:				
Americas	$ 2,074	$ 1,789	$ 6,011	$ 5,483
EMEA	1,116	903	3,131	2,736
Asia Pacific	401	329	1,128	1,014
Japan	276	248	801	711
Total	$ 3,867	$ 3,269	$ 11,071	$ 9,944

The Americas theater included non-U.S. net sales of $280 million and $244 million for the three months ended May 1, 2004 and April 26, 2003, respectively. The Americas theater included non-U.S. net sales of $773 million and $680 million for the nine months ended May 1, 2004 and April 26, 2003, respectively.

The following table presents net sales for groups of similar products and services (in millions):

	Three Months Ended		Nine Months Ended	
	May 1, 2004	April 26, 2003	May 1, 2004	April 26, 2003

Net sales:				
Routers	$ 1,279	$ 1,187	$ 3,979	$ 3,628
Switches	2,339	1,899	6,470	5,856
Advanced Technologies	906	486	2,473	1,430
Other	206	227	621	789
Product	4,730	3,799	13,543	11,703
Service	890	819	2,576	2,473
Total	$ 5,620	$ 4,618	$ 16,119	$ 14,176

The Company reclassified net sales for groups of similar products in fiscal 2003 to conform to the current period s presentation. The reclassification was related to the separate classification of net sales of Advanced Technology products, which were previously included in the Access and Other product categories, and the elimination of the separate classification of net sales of Access products.

The Company refers to some of its products and technologies as Advanced Technologies. The Company has currently identified six Advanced Technologies for particular focus: home networking, IP telephony, optical

Table of Contents

Cisco Systems, Inc.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

networking, security, storage networking, and wireless. Over time, additional Advanced Technologies may be identified for focus and investment and investments may be curtailed or eliminated in some presently identified Advanced Technologies depending on market developments, acquisitions, and resource allocation decisions.

The majority of the Company s assets as of May 1, 2004 and July 26, 2003 were attributable to its U.S. operations. For the three and nine months ended May 1, 2004 and April 26, 2003, no single customer accounted for 10% or more of the Company s net sales.

11. NET INCOME PER SHARE

The following table presents the calculation of basic and diluted net income per share (in millions, except per-share amounts):

	Three Months Ended		Nine Months Ended	
	May 1, 2004	April 26, 2003	May 1, 2004	April 26, 2003
Income before cumulative effect of accounting change	$ 1,211	$ 987	$ 3,588	$ 2,596
Cumulative effect of accounting change			(567)	
Net income	$ 1,211	$ 987	$ 3,021	$ 2,596
Weighted-average shares basic	6,816	7,062	6,872	7,165
Effect of dilutive potential common shares	258	96	223	92
Weighted-average shares diluted	7,074	7,158	7,095	7,257
Income per share before cumulative effect of accounting change:				
Basic	$ 0.18	$ 0.14	$ 0.52	$ 0.36
Diluted	$ 0.17	$ 0.14	$ 0.51	$ 0.36
Per share amount of cumulative effect of accounting change:				
Basic	$	$	$ 0.08	$
Diluted	$	$	$ 0.08	$

Net income per share:				
Basic	$ 0.18	$ 0.14	$ 0.44	$ 0.36
Diluted	$ 0.17	$ 0.14	$ 0.43	$ 0.36

Dilutive potential common shares consist of employee stock options and restricted common stock. Employee stock options to purchase approximately 467 million and 857 million shares for the three months ended May 1, 2004 and April 26, 2003, respectively, and 496 million shares and 898 million shares in the first nine months of fiscal 2004 and 2003, respectively, were outstanding, but were not included in the computation of diluted earnings per share because the exercise price of the stock options was greater than the average share price of the common shares and, therefore, the effect would have been antidilutive.

Table of Contents

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

Forward-Looking Statements

This Quarterly Report on Form 10-Q, including this Management s Discussion and Analysis of Financial Condition and Results of Operations, contains forward-looking statements regarding future events and our future results that are subject to the safe harbors created under the Securities Act of 1933 and the Securities Exchange Act of 1934. These statements are based on current expectations, estimates, forecasts, and projections about the industries in which we operate and the beliefs and assumptions of our management. Words such as expects, anticipates, targets, goals, projects, intends, plans, believes, seeks, estimates, continues, may, variations of such words, and similar expres to identify such forward-looking statements. In addition, any statements that refer to projections of our future financial performance, our anticipated growth and trends in our businesses (including the potential growth of Advanced Technologies), and other characterizations of future events or circumstances, are forward-looking statements. Readers are cautioned that these forward-looking statements are only predictions and are subject to risks, uncertainties, and assumptions that are difficult to predict. Therefore, actual results may differ materially and adversely from those expressed in any forward-looking statements. Readers are referred to risks and uncertainties identified below, under Risk Factors and elsewhere herein. We undertake no obligation to revise or update any forward-looking statements for any reason.

Critical Accounting Policies

The preparation of financial statements and related disclosures in conformity with accounting principles generally accepted in the United States requires us to make judgments, assumptions, and estimates that affect the amounts reported in the Consolidated Financial Statements and accompanying notes. Note 2 to the Consolidated Financial Statements in the Annual Report on Form 10-K for the fiscal year ended July 26, 2003 describes the significant accounting policies and methods used in the preparation of the Consolidated Financial Statements. We consider the accounting policies described below to be our critical accounting policies. These critical accounting policies are affected significantly by judgments, assumptions, and estimates used in the preparation of the Consolidated Financial Statements and actual results could differ materially from the amounts reported based on these policies.

Revenue Recognition

We account for revenue in accordance with Statement of Position 97-2 Software Revenue Recognition and its related interpretations. Revenue is recognized when persuasive evidence of an arrangement exists, delivery has occurred, the fee is fixed or determinable, and collectibility is reasonably assured. In instances where final acceptance of the product, system, or solution is specified by the customer, revenue is deferred until all acceptance criteria have been met. Our total deferred revenue for products was $1.5 billion and $1.4 billion as of May 1, 2004 and July 26, 2003, respectively. Service revenue is generally deferred and, in most cases, recognized ratably over the period during which the services are to be performed, which is typically from one to three years. Our total deferred revenue for services was $2.9 billion and $2.5 billion as of May 1, 2004 and July 26, 2003, respectively.

Contracts and customer purchase orders are generally used to determine the existence of an arrangement. Shipping documents and customer acceptance, when applicable, are used to verify delivery. We assess whether the fee is fixed or determinable based on the payment terms associated with the transaction and whether the sales price is subject to refund or adjustment. We assess collectibility based primarily on the creditworthiness of the customer as determined by credit checks and analysis, as well as the customer s payment history.

When a sale involves multiple elements, such as sales of products that include services, the entire fee from the arrangement is allocated to each respective element based on its relative fair value and recognized when revenue

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

recognition criteria for each element are met. The amount of product revenue recognized is affected by our judgments as to whether an arrangement includes multiple elements and if so, whether vendor-specific objective evidence of fair value exists for those elements. Changes to the elements in an arrangement and the ability to establish vendor-specific objective evidence for those elements could affect the timing of the revenue recognition.

We make sales to two-tier distribution channels and recognize revenue based on a sell-through method utilizing information provided by our distributors. These distributors are given business terms that allow them to return a portion of inventory, receive credits for changes in selling prices, and participate in various cooperative marketing programs. We maintain estimated accruals and allowances for such exposures. If actual credits received by distributors for inventory returns, changes in selling prices, and cooperative marketing programs were to deviate significantly from our estimates, which are based on historical experience, our revenue could be adversely affected.

Allowance for Doubtful Accounts and Sales Returns

Our accounts receivable balance, net of allowance for doubtful accounts, was $1.5 billion and $1.4 billion as of May 1, 2004 and July 26, 2003, respectively. The allowance for doubtful accounts as of May 1, 2004 was $188 million, compared with $183 million as of July 26, 2003. The allowance is based on our assessment of the collectibility of customer accounts. We regularly review the allowance by considering factors such as historical experience, credit quality, age of the accounts receivable balances, and current economic conditions that may affect a customer s ability to pay.

Our provision for doubtful accounts was $19 million for the first nine months of fiscal 2004. There was no provision for doubtful accounts recorded for the first nine months of fiscal 2003. If a major customer s creditworthiness deteriorates, or if actual defaults are higher than our historical experience, or if other circumstances arise, our estimates of the recoverability of amounts due to us could be overstated, and additional allowances could be required, which could have an adverse impact on our revenue.

A reserve for sales returns is established based on historical trends in product return rates. The reserve for sales returns as of May 1, 2004 and July 26, 2003 included $74 million and $73 million, respectively, for estimated future returns that were recorded as a reduction of our accounts receivable. If the actual future returns were to deviate from the historical data on which the reserve had been established, our revenue could be adversely affected.

Allowance for Inventory

Our inventory balance was $1.1 billion as of May 1, 2004, compared with $873 million as of July 26, 2003. Our inventory allowances as of May 1, 2004 were $124 million, compared with $122 million as of July 26, 2003. We provide inventory allowances based on excess and obsolete inventories determined primarily by future demand forecasts. The allowance is measured as the difference between the cost of the inventory and market based upon assumptions about future demand and charged to the provision for inventory, which is a component of our cost of sales. At the point of the loss recognition, a new, lower-cost basis for that inventory is established, and subsequent changes in facts and circumstances do not result in the restoration or increase in that newly established cost basis.

Our provision for inventory was $124 million and $26 million for the first nine months of fiscal 2004 and 2003, respectively. If there were to be a sudden and significant decrease in demand for our products, or if there were a higher incidence of inventory obsolescence because of rapidly changing technology and customer requirements, we could be required to increase our inventory allowances and our gross margin could be adversely affected.

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

Inventory management remains an area of focus as we balance the need to maintain strategic inventory levels to ensure competitive lead times compared with the risk of inventory obsolescence because of rapidly changing technology and customer requirements.

Warranty Costs

The liability for product warranties, included as other accrued liabilities, was $240 million as of May 1, 2004, compared with $246 million as of July 26, 2003. See Note 6 to the Consolidated Financial Statements. Our products are generally covered by a warranty for periods of 90 days, one year, or five years, and for some products we provide a limited lifetime warranty. We accrue for warranty costs as part of our cost of sales based on associated material costs and technical support labor costs. Material cost is primarily estimated based upon historical trends in the volume of product returns within the warranty period and the cost to repair or replace the equipment. Technical support labor cost is primarily estimated based upon historical trends in the rate of customer calls and the cost to support the customer calls within the warranty period.

The provision for warranties issued during for the first nine months of fiscal 2004 and 2003 was $243 million and $270 million, respectively. If we experience an increase in warranty claims compared with our historical experience, or if costs of servicing warranty claims are greater than the expectations on which the accrual has been based, our gross margin could be adversely affected.

Investment Impairments

Our publicly traded equity investments are reflected on the Consolidated Balance Sheets at a fair value of $954 million as of May 1, 2004, compared with $745 million as of July 26, 2003. We recognize an impairment charge when the decline in the fair value of our publicly traded equity investments below their cost basis is judged to be other-than-temporary. The ultimate value realized on these equity investments is subject to market price volatility until they are sold. We consider various factors in determining whether we should recognize an impairment charge, including, but not limited to, the length of time and extent to which the fair value has been less than our cost basis, the financial condition and near-term prospects of the company, and our intent and ability to hold the investment for a period of time sufficient to allow for any anticipated recovery in market value. Our ongoing consideration of these factors could result in additional impairment charges in the future, which could adversely affect our net income. There was no charge attributable to the impairment of publicly traded equity securities during the first nine months of fiscal 2004. During the first quarter of fiscal 2003, we recognized a charge of $412 million attributable to the impairment of certain publicly traded equity securities.

We also have investments in privately held companies, many of which can still be considered to be in the startup or development stages. As of May 1, 2004, our investments in privately held companies were $360 million, compared with $516 million as of July 26, 2003, and were included in other assets. See Note 5 to the Consolidated Financial Statements. We monitor these investments for impairment and make appropriate reductions in carrying values if we determine an impairment charge is required based primarily on the financial condition and near-term prospects of these companies. These investments are inherently risky, as the markets for the technologies or products these companies are developing are typically in the early stages and may never materialize. Our impairment charges on investments in privately held companies were $27 million and $35 million during the third quarter of fiscal 2004 and 2003, respectively, and were $112 million and $194 million for the first nine months of fiscal 2004 and 2003, respectively.

Goodwill Impairments

Our methodology for allocating the purchase price relating to purchase acquisitions is determined through established valuation techniques in the high-technology communications equipment industry. Goodwill is

27

Table of Contents

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

measured as the excess of the cost of acquisition over the sum of the amounts assigned to tangible and identifiable intangible assets acquired less liabilities assumed. We perform goodwill impairment tests on an annual basis and between annual tests in certain circumstances for each reporting unit. The goodwill recorded on the Consolidated Balance Sheets as of May 1, 2004 and July 26, 2003 was $4.2 billion and $4.0 billion, respectively. In response to changes in industry and market conditions, we could be required to strategically realign our resources and consider restructuring, disposing of, or otherwise exiting businesses, which could result in an impairment of goodwill.

Income Taxes

Our effective tax rates differ from the statutory rate primarily due to acquisition-related costs, research and experimentation tax credits, state taxes, and the tax impact of non-U.S. operations. The effective tax rate was 29.6% in the third quarter of fiscal 2004 and 29.0% for the first nine months of fiscal 2004. The effective tax rate was 28.5% in the third quarter of fiscal 2003 and 28.7% for the first nine months of fiscal 2003. Our future effective tax rates could be adversely affected by earnings being lower than anticipated in countries where we have lower statutory rates and higher than anticipated in countries where we have higher statutory rates, changes in the valuation of our deferred tax assets or liabilities, or changes in tax laws or interpretations thereof. In addition, we are subject to the continuous examination of our income tax returns by the Internal Revenue Service and other tax authorities. We regularly assess the likelihood of adverse outcomes resulting from these examinations to determine the adequacy of our provision for income taxes.

Loss Contingencies

We are subject to the possibility of various loss contingencies arising in the ordinary course of business. We consider the likelihood of loss or impairment of an asset or the incurrence of a liability, as well as our ability to reasonably estimate the amount of loss in determining loss contingencies. An estimated loss contingency is accrued when it is probable that an asset has been impaired or a liability has been incurred and the amount of loss can be reasonably estimated. We regularly evaluate current information available to us to determine whether such accruals should be adjusted and whether new accruals are required.

Net Sales

We manage our business based on four geographic theaters: the Americas; EMEA; Asia Pacific; and Japan. Net sales, which include product and service revenue, for each theater are summarized in the following table (in millions, except percentages):

	Three Months Ended				Nine Months Ended			
	May 1, 2004	**April 26, 2003**	**Variance in Dollars**	**Variance in Percent**	**May 1, 2004**	**April 26, 2003**	**Variance in Dollars**	**Variance in Percent**
Net sales:								
Americas	$ 3,058	$ 2,526	$ 532	21.1%	$ 8,885	$ 7,853	$ 1,032	13.1%

EMEA	1,617	1,294	323	25.0%	4,518	3,900	618	15.8%
Asia Pacific	572	459	113	24.6%	1,629	1,437	192	13.4%
Japan	373	339	34	10.0%	1,087	986	101	10.2%
Total	$ 5,620	$ 4,618	$ 1,002	21.7%	$ 16,119	$ 14,176	$ 1,943	13.7%

28

Table of Contents

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

The following table is a breakdown of net sales between product and service revenue (in millions, except percentages):

	Three Months Ended				Nine Months Ended			
	May 1, 2004	April 26, 2003	Variance in Dollars	Variance in Percent	May 1, 2004	April 26, 2003	Variance in Dollars	Variance in Percent
Net sales:								
Product	$ 4,730	$ 3,799	$ 931	24.5%	$ 13,543	$ 11,703	$ 1,840	15.7%
Service	890	819	71	8.7%	2,576	2,473	103	4.2%
Total	$ 5,620	$ 4,618	$ 1,002	21.7%	$ 16,119	$ 14,176	$ 1,943	13.7%

Net Product Sales by Theater

The following table is a breakdown of net product sales by theater (in millions, except percentages):

	Three Months Ended				Nine Months Ended			
	May 1, 2004	April 26, 2003	Variance in Dollars	Variance in Percent	May 1, 2004	April 26, 2003	Variance in Dollars	Variance in Percent
Net product sales:								
Americas	$ 2,408	$ 1,919	$ 489	25.5%	$ 6,982	$ 6,032	$ 950	15.7%
EMEA	1,459	1,153	306	26.5%	4,067	3,467	600	17.3%
Asia Pacific	523	416	107	25.7%	1,491	1,305	186	14.3%
Japan	340	311	29	9.3%	1,003	899	104	11.6%
Total	$ 4,730	$ 3,799	$ 931	24.5%	$ 13,543	$ 11,703	$ 1,840	15.7%

Net product sales in the Americas theater consist of net product sales in the United States and Americas International, which includes Canada, Mexico, and Latin America. Net product sales in the Americas theater increased primarily due to an increase in net product sales in the United States. Net product sales in the United States increased by $461 million, or 27.0%, from $1.7 billion in the third quarter of fiscal 2003 to $2.2 billion in the third quarter of fiscal 2004, primarily due to higher sales to enterprise customers and higher sales of home networking products. The increase in sales to enterprise customers was primarily due to higher information technology-related capital spending. The increase in sales of home networking products was due to our acquisition of the business of The Linksys Group, Inc. (Linksys) during the fourth quarter of fiscal 2003. Sales of home networking products increased by $146 million for the third quarter of fiscal 2004 compared with the third quarter of fiscal 2003

Net product sales in the United States were $6.3 billion in the first nine months of fiscal 2004, compared with $5.4 billion in the first nine months of fiscal 2003, an increase of $877 million or 16.1%. Sales of home networking products increased by approximately $396 million for the nine months of fiscal 2004, compared with the first nine months of fiscal 2003. The remainder of the increase was primarily due to an increase in net product sales to enterprise customers and the United States federal government. Net product sales to the United States federal government increased by approximately 24% in the first nine months of fiscal 2004, compared with the first nine months of fiscal 2003, and were due to higher program capital spending in the defense sector, primarily during our first quarter of fiscal 2004.

The increase in net product sales in the EMEA theater in the third quarter of fiscal 2004 compared with the third quarter of fiscal 2003 was primarily a result of the growth in service provider markets. The increase in net product sales in the EMEA theater in the first nine months of fiscal 2004 compared with the first nine months of fiscal 2003 was due to higher sales to the service provider and enterprise markets.

Table of Contents

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

Net Product Sales by Groups of Similar Products

The following table presents net sales for groups of similar products (in millions, except percentages):

	Three Months Ended				Nine Months Ended			
	May 1, 2004	April 26, 2003	Variance in Dollars	Variance in Percent	May 1, 2004	April 26, 2003	Variance in Dollars	Variance in Percent
Net product sales:								
Routers	$ 1,279	$ 1,187	$ 92	7.8%	$ 3,979	$ 3,628	$ 351	9.7%
Switches	2,339	1,899	440	23.2%	6,470	5,856	614	10.5%
Advanced Technologies	906	486	420	86.4%	2,473	1,430	1,043	72.9%
Other	206	227	(21)	(9.3)%	621	789	(168)	(21.3)%
Total	$ 4,730	$ 3,799	$ 931	24.5%	$ 13,543	$ 11,703	$ 1,840	15.7%

Routers

The increase in net product sales related to routers in the third quarter of fiscal 2004 compared with the third quarter of fiscal 2003 was primarily due to increased sales of high-end routers, which increased by $78 million as a result of higher spending by service providers. The increase in net product sales related to routers in the first nine months of 2004 compared with the first nine months of fiscal 2003 was similarly attributable to higher sales of high-end routers, which increased by $418 million, partially offset by a decline in sales of midrange routers and low-end routers, which decreased by approximately $67 million. The increase in high-end router sales was due to increased spending by service providers. The decrease in midrange and low-end routers was due primarily to the increased size of the default memory in our basic configurations, which resulted in fewer customers requiring additional memory.

Switches

The increase in net product sales related to switches in the third quarter of fiscal 2004 compared with the third quarter of fiscal 2003 was primarily due to higher sales of LAN fixed switches, which increased by $237 million, and LAN modular switches, which increased by $231 million. The increase in sales of LAN fixed switches was due to higher sales of our Cisco Catalyst 3750 platform, which was introduced in the fourth quarter of fiscal 2003, and higher sales of our Catalyst 3550 platform. The increase in sales of LAN modular switches was a result of new technologies being implemented by customers and higher sales of our Catalyst 4500 platform, which was introduced in the first quarter of fiscal 2003. The increase in net product sales related to switches in the first nine months of 2004 compared with the first nine months of fiscal 2003 was primarily due to higher sales of LAN modular switches, which increased by $377 million, and LAN fixed switches, which increased by $346 million, partially offset by lower sales of WAN switches, which decreased by $109 million. The increase in sales of LAN modular switches was the result of new technologies being implemented by customers and higher sales of our Catalyst 4500 platform. The increase in sales of LAN fixed switches was primarily due to higher sales of our Catalyst 3750 and Catalyst 3550 platforms. The decline in sales of WAN switches was due to the continued technology migration away from Asynchronous Transfer Mode (ATM) to Internet Protocol (IP).

Advanced Technologies

The increase in net product sales related to Advanced Technologies in the third quarter of fiscal 2004 compared with the third quarter of fiscal 2003 was primarily due to sales of home networking products, which increased by $174 million, sales of security products, which increased by $80 million, and sales of IP telephony products,

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

which increased by $68 million. The increase in sales of home networking products was related to our acquisition of Linksys. The increase in sales of security products was primarily due to line card sales related to our routers and switches and sales of our PIX firewall appliances. The increase in sales of IP telephony products was due to higher sales of IP phones and associated software. The increase in net product sales related to Advanced Technologies in the first nine months of 2004 compared with the first nine months of fiscal 2003 was primarily due to the sales of home networking products, which increased $458 million, sales of security products, which increased $168 million, sales of IP telephony products, which increased $153 million, and sales of wireless LAN products, which increased $113 million. The increase in sales of home networking products was related to our acquisition of Linksys. The increase in sales of security products was primarily due to line card sales related to our routers and switches. The increase in sales of IP telephony products was due to higher sales of IP phones and associated software. The increase in sales of wireless LAN products was due to higher sales of our access points.

Factors That May Impact Net Product Sales

Net product sales may be adversely affected in the future by changes in the geopolitical environment and global economic conditions; sales cycles and implementation cycles of our products; changes in the mix of our customers between service provider and enterprise; changes in the mix of direct sales and indirect sales; variations in sales channels; and final acceptance criteria of the product, system, or solution as specified by the customer. Service provider customers typically have longer implementation cycles, require a broader range of services, including design services, and often have acceptance provisions, which can lead to a delay in revenue recognition. To improve customer satisfaction, we continue to attempt to reduce our manufacturing lead times, which may result in corresponding reductions in order backlog. A decline in backlog levels could result in more variability and less predictability in our quarter-to-quarter net sales and operating results. Net product sales may also be adversely affected by fluctuations in demand for our products, especially with respect to Internet businesses and telecommunications service providers, price and product competition in the communications and networking industries, introduction and market acceptance of new technologies and products, adoption of new networking standards, and financial difficulties experienced by our customers. We may, from time to time, experience manufacturing issues that create a delay in our suppliers ability to provide specific components resulting in delayed shipments. To the extent that manufacturing issues and any related component shortages result in delayed shipments in the future, and particularly in periods when we and our suppliers are operating at higher levels of capacity, it is possible that revenue for a quarter could be adversely affected if such matters are not remediated within the same quarter.

Two-tier distributors are given business terms that allow them to return a portion of inventory, receive credits for changes in selling prices, and participate in various cooperative marketing programs. In addition, increasing two-tier distribution channels generally results in greater difficulty in forecasting the mix of our products and, to a certain degree, the timing of orders from our customers. We recognize revenue to two-tier distributors based on a sell-through method utilizing information provided by our distributors, and we maintain accruals and allowances for all cooperative marketing and other programs.

The third quarter of fiscal 2004 had 14 weeks compared with 13 weeks in the third quarter of fiscal 2003, and we believe that this extra week may have had a positive impact on our sales in the third quarter of fiscal 2004. However, we are not able to quantify the effect of the slightly longer quarter on our revenue.

Net Service Revenue

Net service revenue is generally deferred and, in most cases, recognized ratably over the service period, which is typically one to three years. Net service revenue will typically experience some variability over time due to various factors such as the timing of technical support service contract initiations and renewals. In addition, our revenue from advanced services may increase to a higher proportion of total service revenue due to our continued focus on providing comprehensive support of our customers networking devices, applications, and infrastructures.

Table of Contents

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

Gross Margin

The following table shows the gross margin for products and services for each theater (in millions):

	Three Months Ended		Nine Months Ended	
	May 1, 2004	**April 26, 2003**	**May 1, 2004**	**April 26, 2003**
Gross margin:				
Americas	$ 2,074	$ 1,789	$ 6,011	$ 5,483
EMEA	1,116	903	3,131	2,736
Asia Pacific	401	329	1,128	1,014
Japan	276	248	801	711
Total	$ 3,867	$ 3,269	$ 11,071	$ 9,944

The following table shows the gross margin for products and services for each theater (percentages):

	Three Months Ended		Nine Months Ended	
	May 1, 2004	**April 26, 2003**	**May 1, 2004**	**April 26, 2003**
Gross margin:				
Americas	67.8%	70.8%	67.7%	69.8%
EMEA	69.0%	69.8%	69.3%	70.2%
Asia Pacific	70.1%	71.7%	69.2%	70.6%
Japan	74.0%	73.2%	73.7%	72.1%
Total	68.8%	70.8%	68.7%	70.1%

Gross margin for products and services in the third quarter and first nine months of fiscal 2004 and 2003 was as follows (in millions):

	Three Months Ended		Nine Months Ended	
	May 1, 2004	**April 26, 2003**	**May 1, 2004**	**April 26, 2003**

Gross margin:				
Product	$ 3,278	$ 2,713	$ 9,350	$ 8,236
Service	589	556	1,721	1,708
Total	$ 3,867	$ 3,269	$ 11,071	$ 9,944

Gross margin for products and services in the third quarter and first nine months of fiscal 2004 and 2003 was as follows (percentages):

	Three Months Ended		**Nine Months Ended**	
	May 1, 2004	**April 26, 2003**	**May 1, 2004**	**April 26, 2003**
Gross margin:				
Product	69.3%	71.4%	69.0%	70.4%
Service	66.2%	67.9%	66.8%	69.1%
Total	68.8%	70.8%	68.7%	70.1%

32

Table of Contents

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

Product Gross Margin

The decrease in product gross margin of 2.1% in the third quarter of fiscal 2004, compared with the third quarter of fiscal 2003, was primarily due to changes in the mix of products sold, which decreased product gross margin by approximately 3%. The decrease in product gross margin due to mix of products sold was related to increased sales of home networking products related to our Linksys acquisition and new product introductions within our switching business. In addition, product pricing reductions decreased product gross margin by approximately 1%. However, lower manufacturing costs related to lower component costs and value engineering increased product gross margin by approximately 2%. Value engineering is the process by which the production costs are reduced through component redesign, board configuration, test processes, and transformation processes. Higher provision for inventory and other manufacturing costs decreased product gross margin by approximately 1%. Higher shipment volume also increased product gross margin by approximately 1%.

The decrease in product gross margin of 1.4% in the first nine months of fiscal 2004 compared with the first nine months of fiscal 2003 was primarily due to similar changes in the mix of products sold as was experienced in the third quarter period, which decreased product gross margin by approximately 3%. In addition, product pricing reductions decreased product gross margin by approximately 1%. However, lower manufacturing costs increased product gross margin by approximately 2%. The decrease in manufacturing costs was primarily due to lower component costs and value engineering. Higher shipment volume also increased product gross margin by approximately 0.5%.

Product gross margin may be adversely affected in the future by changes in the mix of products sold, including further periods of increased growth of some of our lower-margin products, changes in channels of distribution, sales discounts, increases in material or labor costs, excess inventory and obsolescence charges, changes in shipment volume, loss of cost savings due to changes in component pricing, impact of value engineering, inventory holding charges, price competition and introduction of new products or entering new markets, and different pricing and cost structures of new markets. If warranty costs associated with our products are greater than we have experienced, product gross margin may also be adversely affected. Product gross margin may also be affected by geographic mix, as well as the mix of configurations within each product group.

Service Gross Margin

Service gross margin decreased by 1.7% and 2.3% during the third quarter and first nine months of fiscal 2004, compared with the third quarter and first nine months of fiscal 2003, respectively. Service gross margin increased in absolute dollars by $33 million during the third quarter of fiscal 2004, compared with the third quarter of fiscal 2003. Service gross margin increased in absolute dollars by $13 million during the first nine months of fiscal 2004, compared with the first nine months of fiscal 2003. Service gross margin will typically experience some variability over time due to various factors such as the change in mix between technical support services and advanced services, as well as the timing of technical support service contract initiations and renewals.

Table of Contents

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

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

Research and development (R&D), sales and marketing, and general and administrative (G&A) expenses are summarized in the following table (in millions, except percentages):

	Three Months Ended				Nine Months Ended			
	May 1, 2004	April 26, 2003	Variance in Dollars	Variance in Percent	May 1, 2004	April 26, 2003	Variance in Dollars	Variance in Percent
Research and development	$ 867	$ 725	$ 142	19.6%	$ 2,392	$ 2,375	$ 17	0.7%
Percentage of net sales	15.4%	15.7%			14.8%	16.8%		
Sales and marketing	$ 1,153	$ 1,019	$ 134	13.2%	$ 3,350	$ 3,092	$ 258	8.3%
Percentage of net sales	20.5%	22.1%			20.8%	21.8%		
General and administrative	$ 231	$ 184	$ 47	25.5%	$ 653	$ 512	$ 141	27.5%
Percentage of net sales	4.1%	4.0%			4.1%	3.6%		
Total	$ 2,251	$ 1,928	$ 323	16.8%	$ 6,395	$ 5,979	$ 416	7.0%
Percentage of net sales	40.1%	41.7%			39.7%	42.2%		

The increase in R&D expenses in the third quarter of fiscal 2004 compared with the third quarter of fiscal 2003 was primarily due to the non-cash variable stock compensation charge relating to Andiamo of $52 million, higher prototype expenses of $43 million, and an additional week of headcount-related expense of $28 million. The increase in R&D expenses in the first nine months of fiscal 2004 compared with the first nine months of fiscal 2003 was primarily due to higher discretionary spending of $42 million, which included higher prototype expenses, and an additional week of headcount-related expense of $28 million partially offset by lower depreciation expense of $53 million. We have continued to invest in R&D efforts in a wide variety of areas such as data, voice, and video over IP; access and aggregation technologies such as cable, wireless, mobility, and other broadband technologies; advanced enterprise switching; optical technology; storage area networking; content networking; security; network management; and advanced core and edge routing technologies. We have also continued to purchase or license technology in order to bring a broad range of products to market in a timely fashion. If we believe that we are unable to enter a particular market in a timely manner with internally developed products, we may license technology from other businesses or acquire businesses as an alternative to internal R&D. All of our R&D costs have been expensed as incurred. In May 2004, we announced plans to hire additional engineers, and we expect to incur additional R&D expense in connection with any such new hires.

The increase in sales and marketing expenses in the third quarter of fiscal 2004 compared with the third quarter of fiscal 2003 was primarily due to an increase in sales expenses of $98 million, primarily due to the effect of foreign currency fluctuations, net of hedging, of $44 million, amortization of deferred compensation of $16 million, and an additional week of headcount-related expense of $14 million. Marketing expenses increased by $36 million due to continued investments in advanced technology market opportunities, an additional week of headcount-related expense, and the effect of foreign currency fluctuations, net of hedging. Sales expenses increased by $150 million during the first nine months of fiscal 2004 compared to the first nine months of fiscal 2003 primarily due to the effect of foreign currency fluctuations, net of hedging, of $107 million and an increase in sales commissions of $62 million partially offset by a decrease in expenses related to our sales programs of $83 million. Marketing expenses increased by $108 million during the first nine months of fiscal 2004 compared to the first nine months of fiscal 2003 primarily related to an increase in our investments of approximately $63 million in an integrated marketing campaign. In May 2004, we announced plans to increase the size of our sales force, and we expect to incur additional sales expenses in connection with any such new hires.

Table of Contents

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

The increase in G&A expenses in the first nine months of fiscal 2004 compared with the first nine months of fiscal 2003 was primarily due to higher amortization of deferred stock-based compensation of $39 million, charges related to investments in internal information technology systems and related program spending of $35 million, and the effect of foreign currency fluctuations, net of hedging, of $26 million.

We hedge certain foreign currency forecasted transactions related to operating expenses with currency options. The effects of foreign currency fluctuations, net of hedging, increased total R&D, sales and marketing, and G&A expenses by approximately 3.5% in the third quarter of fiscal 2004, compared with the third quarter of fiscal 2003. The effects of foreign currency fluctuations, net of hedging, increased total R&D, sales and marketing, and G&A expenses by approximately 2.8% in the first nine months of fiscal 2004, compared with the first nine months of fiscal 2003. See Item 3. Quantitative and Qualitative Disclosures About Market Risk for additional information relating to our hedging program.

In the third quarter of fiscal 2001, we announced a restructuring program to prioritize our initiatives around a focus on profit contribution, high-growth areas of our business, reduction of expenses, and improved efficiency. This restructuring program included a worldwide workforce reduction, consolidation of excess facilities, and restructuring of certain business functions. For additional information regarding the restructuring program, see Note 4 to the Consolidated Financial Statements. During the first quarter of fiscal 2003, we increased the restructuring liabilities related to the consolidation of excess facilities and other charges by $40 million due to changes in real estate market conditions. The increase in restructuring liabilities was recorded as expenses related to R&D ($16 million), sales and marketing ($16 million), G&A ($4 million), and cost of sales ($4 million) in the Consolidated Statements of Operations. There can be no assurance that future changes in real estate market conditions will not result in additional real estate liabilities.

Amortization of Purchased Intangible Assets

Amortization of purchased intangible assets included in operating expenses was $60 million in the third quarter of fiscal 2004, compared with $92 million in the third quarter of fiscal 2003. Amortization of purchased intangible assets included in operating expenses was $182 million in the first nine months of fiscal 2004, compared with $284 million in the first nine months of fiscal 2003. The decrease in the amortization of purchased intangible assets in the three and nine months of fiscal 2004 compared with the three and nine months of fiscal 2003, was primarily due to the amortization for certain technology and patent intangibles in the prior year period that were fully amortized as of the end of fiscal 2003.

In-Process Research and Development

Our methodology for allocating purchase price to in-process R&D in purchase acquisitions is determined through established valuation techniques in the high-technology communications equipment industry. In-process R&D expense in the first nine months of fiscal 2004 was $3 million, compared with $3 million for the same period in fiscal 2003. In-process R&D was expensed upon acquisition because technological feasibility had not been established and no future alternative uses existed. See Note 3 to the Consolidated Financial Statements for additional information regarding the acquisitions completed and the in-process R&D recorded for each acquisition.

The fair value of the existing purchased technology and patents, as well as the technology under development, is determined using the income approach, which discounts expected future cash flows to present value. The discount rates used in the present value calculations are typically derived from a weighted-average cost of capital analysis and venture capital surveys, adjusted upward to reflect additional risks inherent in the development life cycle. We consider the pricing model for products related to these acquisitions to be standard within the high-technology communications equipment industry. However, we do not expect to achieve a material amount of expense reductions as a result of integrating the acquired in-process technology. Therefore, the valuation assumptions do not include significant anticipated cost savings.

Table of Contents

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

For purchase acquisitions completed to date, the development of these technologies remains a significant risk due to the remaining efforts to achieve technical viability, rapidly changing customer markets, uncertain standards for new products, and significant competitive threats from several companies. The nature of the efforts to develop these technologies into commercially viable products consists primarily of planning, designing, experimenting, and testing activities necessary to determine that the technologies can meet market expectations, including functionality and technical requirements. Failure to bring these products to market in a timely manner could result in a loss of market share or a lost opportunity to capitalize on emerging markets, and could have a material adverse impact on our business and operating results.

Interest Income

	Three Months Ended				Nine Months Ended			
(In millions)	May 1, 2004	April 26, 2003	Variance in dollars	Variance in percentage	May 1, 2004	April 26, 2003	Variance in dollars	Variance in percentage
Interest income	$ 127	$ 161	$ (34)	(21.1)%	$ 388	$ 514	$ (126)	(24.5)%

The decreases in interest income were primarily due to lower average interest rates on our portfolio of fixed income securities.

Other Income (Loss), Net

The components of other income (loss), net, are as follows (in millions):

	Three Months Ended		Nine Months Ended	
	May 1, 2004	April 26, 2003	May 1, 2004	April 26, 2003
Net gains on investments in fixed income and publicly traded equity securities	$ 13	$ 26	$ 204	$ 79
Impairment charges on publicly traded equity securities				(412)
Net gains (losses) on investments in privately held companies	42	(5)	57	4
Impairment charges on investments in privately held companies	(27)	(35)	(112)	(194)
Net gains (losses) and impairment charges on investments	28	(14)	149	(523)
Other	12	(12)	28	(29)
Total	$ 40	$ (26)	$ 177	$ (552)

The impairment charge on publicly traded equity securities of $412 million, pre-tax, during the first nine months of fiscal 2003 was due to the decline in the fair value of certain publicly traded equity securities below their cost basis that was judged to be other-than-temporary.

Provision for Income Taxes

The effective tax rate was 29.6% for the third quarter of fiscal 2004 and 29.0% for the first nine months of fiscal 2004. The effective tax rate was 28.5% in the third quarter of fiscal 2003 and 28.7% for the first nine months of fiscal 2003. The effective tax rate differs from the statutory rate primarily due to acquisition-related costs, research and experimentation tax credits, state taxes, and the tax impact of non-U.S. operations.

Our future effective tax rates could be adversely affected by earnings being lower than anticipated in countries where we have lower statutory rates and higher than anticipated in countries where we have higher statutory rates, changes in the valuation of our deferred tax assets or liabilities, or changes in tax laws or interpretations

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

thereof. In addition, we are subject to the continuous examination of our income tax returns by the Internal Revenue Service and other tax authorities. We regularly assess the likelihood of adverse outcomes resulting from these examinations to determine the adequacy of our provision for income taxes.

Cumulative Effect of Accounting Change, Net of Tax

In April 2001, we entered into a commitment to provide convertible debt funding of approximately $84 million to Andiamo, a privately held storage switch developer. This debt was convertible into approximately 44% of the equity of Andiamo. In connection with this investment, we obtained a call option that provided us the right to purchase Andiamo. The purchase price under the call option was based on a valuation of Andiamo using a negotiated formula. On August 19, 2002, we entered into a definitive agreement to acquire Andiamo, which represented the exercise of our rights under the call option. We also entered into a commitment to provide non-convertible debt funding to Andiamo of approximately $100 million through the close of the acquisition. Substantially all of the convertible debt funding of $84 million and non-convertible debt funding of $100 million has been expensed as research and development costs.

We adopted FIN 46(R) effective January 24, 2004. We evaluated our debt investment in Andiamo and determined that Andiamo was a variable interest entity under FIN 46(R). We concluded that we were the primary beneficiary as defined by FIN 46(R) and, therefore, accounted for Andiamo as if we had consolidated Andiamo since our initial investment in April 2001. The consolidation of Andiamo from the date of our initial investment required accounting for the call option as a repurchase right. Under FASB Interpretation No. 44, Accounting for Certain Transactions Involving Stock Compensation, and related interpretations, variable accounting was required for substantially all Andiamo employee stock and options because the ending purchase price was primarily derived from a revenue-based formula.

Effective January 24, 2004, the last day of the second quarter of fiscal 2004, we recorded a non-cash cumulative stock compensation charge of $567 million (representing the amount of variable compensation from April 2001 through January 2004). This charge was reported as a separate line item in the Consolidated Statements of Operations as a cumulative effect of accounting change, net of tax. The charge was based on the value of the Andiamo employee stock and options and their vesting from the adoption of FIN 46(R) pursuant to the formula-based valuation.

On February 19, 2004, we completed the acquisition of Andiamo, exchanging approximately 23 million shares of our common stock for Andiamo shares not owned by us and assuming approximately 6 million stock options, for a total estimated value of $750 million, primarily derived from the revenue-based formula, which after stock price related adjustments resulted in a total amount recorded of $722 million as summarized in the table below.

Subsequent to the adoption of FIN 46(R), changes to the value of Andiamo and the continued vesting of the employee stock and options resulted in an adjustment to the non-cash stock compensation charge. We recorded a non-cash variable stock compensation adjustment of $58 million in the third quarter of fiscal 2004 to the cumulative stock compensation charge recorded in the second quarter of fiscal 2004 to account for the additional vesting of the Andiamo employee stock and options and changes in the formula-based valuation from January 24, 2004 until February 19, 2004. This non-cash adjustment was reported as research and development expense of $52 million and sales and marketing expense of $6 million in the Consolidated Statements of Operations, as amortization of deferred stock-based compensation in the Consolidated Statements of Cash Flows, and as an increase to additional paid-in capital in the Consolidated Statements of Shareholders Equity. In addition, upon completion of the acquisition, deferred stock-based compensation of $90 million was recorded to reflect the unvested portion of the formula-based valuation of the Andiamo employee stock and options. See Note 3 to the Consolidated Financial Statements. The amount of deferred stock-based compensation was fixed at the date of acquisition and will be amortized over the remaining vesting period of Andiamo employee stock and options of approximately two years.

Table of Contents

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

A summary of the accounting of the consolidation under FIN 46(R) and the subsequent purchase of Andiamo, after stock price related adjustments, is as follows (in millions):

	Amount
Cumulative effect of accounting change, net of tax benefit of $5	$ 567
Variable stock-based compensation	58
Deferred stock-based compensation	90
Net assets	7
Total	$ 722

Liquidity and Capital Resources

The following sections discuss the effects of changes in our balance sheets, cash flows, and commitments on our liquidity and capital resources.

Balance Sheet and Cash Flows

Cash and Cash Equivalents and Total Investments

Cash and cash equivalents and total investments were $18.9 billion as of May 1, 2004, a decrease of $1.7 billion or 8.3% from $20.7 billion at July 26, 2003. The decrease was primarily a result of cash used for the repurchase of common stock of $7.1 billion and capital expenditures of $487 million, partially offset by cash provided by operating activities of $5.0 billion and cash provided by the issuance of common stock of $930 million related to employee stock option exercises and employee stock purchases.

We expect that cash provided by operating activities may fluctuate in future periods as a result of several factors, including fluctuations in our operating results, shipment linearity, accounts receivable collections, inventory management, and the timing of tax and other payments. For additional discussion, see the section entitled Risk Factors below.

Accounts Receivable, Net

Accounts receivable, net was $1.5 billion and $1.4 billion as of May 1, 2004 and July 26, 2003, respectively. Days sales outstanding (DSO) in receivables as of May 1, 2004 and July 26, 2003 were 27 days and 26 days, respectively. Our accounts receivable and DSO are primarily affected by shipment linearity and collections performance. Shipment linearity is a measure of the level of shipments throughout a particular quarter. A steady level of shipments and good collections performance will result in reduced DSO compared with a higher level of shipments toward the end of the quarter, which will result in a shorter amount of time to collect the related accounts receivable and will result in increased DSO.

Inventories

Inventories were $1.1 billion as of May 1, 2004, compared with $873 million at July 26, 2003, an increase of $248 million or 28%. Inventories consist of raw materials, work in process, finished goods, and demonstration systems. The primary increase in our inventories was in our work-in-process category due to increased assembly levels needed to meet targeted lead times on certain high-demand products. As of May 1, 2004, approximately 31% of our finished goods inventory was located at distributor sites, and represents the deferred cost of sales relating to unrecognized revenue on sales to those distributors. All inventories, including finished goods, are accounted for at the lower of cost or market.

Inventory turns were 6.3 in the third quarter of fiscal 2004, compared with 6.8 in the fourth quarter of fiscal 2003. Inventory levels and the associated inventory turns reflect our ongoing inventory management efforts.

Table of Contents

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

Inventory management remains an area of focus as we balance the need to maintain strategic inventory levels to ensure competitive lead times against the risk of inventory obsolescence because of rapidly changing technology and customer requirements.

Deferred Revenue

The breakdown of deferred revenue as of May 1, 2004 and July 26, 2003 was as follows (in millions):

	May 1, 2004	July 26, 2003
Service	$ 2,864	$ 2,451
Product	1,493	1,357
Total	4,357	3,808
Less, current portion	(3,420)	(3,034)
Non-current deferred revenue	$ 937	$ 774

The increase in deferred service revenue of $413 million during the first nine months of fiscal 2004 reflects technical support contract initiations and renewals.

Commitments

Leases

We lease office space in several U.S. locations, as well as locations elsewhere in the Americas International, EMEA, Asia Pacific, and Japan. For additional information, see Note 6 to the Consolidated Financial Statements.

Purchase Commitments with Contract Manufacturers and Suppliers

We purchase components from a variety of suppliers and use several contract manufacturers to provide manufacturing services for our products. During the normal course of business, in order to reduce manufacturing lead times and to help assure adequate component supply, we enter into agreements with contract manufacturers and suppliers that either allow them to procure inventory based upon criteria as defined by us or that establish the parameters defining our requirements. In certain instances, these agreements allow us the option to cancel, reschedule and adjust our requirements based on our business needs prior to firm orders being placed. Consequently, only a portion of our reported purchase commitments arising from these agreements are firm, non-cancelable and unconditional commitments. As of May 1, 2004, we had total purchase commitments for inventory of approximately $932 million, compared with $718 million as of July 26, 2003. These purchase commitments are expected to be fulfilled within one year.

In addition to the above, we record a liability for firm, non-cancelable, and unconditional purchase commitments for quantities in excess of our future demand forecasts consistent with our allowance for inventory. As of May 1, 2004, the liability for these firm, non-cancelable, and unconditional purchase commitments was $124 million, compared with $99 million as of July 26, 2003, and was included in other accrued liabilities.

Other Commitments

We have agreed to invest up to $800 million in venture funds, managed by SOFTBANK Corp. and its affiliates (SOFTBANK), which are required to be funded on demand. Up to $550 million is to be invested in venture funds on terms specified in the agreement and $250 million invested as senior debt with entities as directed by SOFTBANK. Our commitment to fund the senior debt is contingent upon the achievement of certain agreed upon milestones. As of May 1, 2004, we had invested $290 million in the venture funds, compared with $247 million as of July 26, 2003. As of May 1, 2004 and July 26, 2003, we have invested $49 million in the senior debt.

Table of Contents

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

We provide structured financing to certain qualified customers for the purchase of equipment and other needs through our wholly owned subsidiary, Cisco Systems Capital Corporation. These loan commitments may be funded over a two- to three-year period, provided that these customers achieve specific business milestones and satisfy certain financial covenants. As of May 1, 2004, the outstanding loan commitments were approximately $64 million, of which approximately $26 million was eligible for draw-down. As of July 26, 2003, the outstanding loan commitments were approximately $97 million, of which approximately $38 million was eligible for draw-down.

As of May 1, 2004 and July 26, 2003, we had a commitment of approximately $59 million and $130 million, respectively, to purchase the remaining portion of the minority interest of Cisco Systems, K.K. (Japan) and the payment under this commitment is based on a put option held by the minority shareholders.

We also have certain other funding commitments related to our privately held investments that are based on the achievement of certain agreed-upon milestones. The funding commitments were approximately $74 million as of May 1, 2004, compared with approximately $95 million as of July 26, 2003.

Variable Interest Entities

In the ordinary course of business, we have investments in privately held companies and provide structured financing to certain customers through our wholly owned subsidiary, Cisco Systems Capital Corporation, which may be considered variable interest entities. We have evaluated our investments in privately held companies and structured financings and have determined that the adoption of FIN 46(R) did not have a material impact on our operating results or financial condition, except for the impact of Andiamo. See Note 3 to the Consolidated Financial Statements.

Under FIN 46(R), certain events can require a reassessment of our investments in privately held companies or structured financings to determine if they are variable interest entities and which of the stakeholders will be the primary beneficiary. As a result of such events, we may be required to make additional disclosures or consolidate these entities. As we may not control these entities, we may not have the ability to influence these events.

Stock Repurchase Program

Between September 2001 and September 2003, the Board of Directors authorized the repurchase of up to $20 billion of our outstanding common stock. During the first nine months of fiscal 2004, we repurchased and retired 318 million shares of our common stock at an average price of $22.29 per share for an aggregate purchase price of $7.1 billion. As of May 1, 2004, we had repurchased and retired 866 million shares of our common stock at an average price of $17.22 per share for an aggregate purchase price of $14.9 billion since inception of the stock repurchase program, and the remaining authorized amount for stock repurchases under this program was $5.1 billion with no termination date.

In addition, on May 13, 2004, the Board of Directors authorized the repurchase of up to an additional $5 billion of our outstanding common stock with no termination date.

Liquidity and Capital Resource Requirements

Based on past performance and current expectations, we believe that our cash and cash equivalents, short-term investments, and cash generated from operations will satisfy our working capital needs, capital expenditures, investment requirements, stock repurchases, commitments (see Note 6 to the Consolidated Financial Statements), future customer financings, and other liquidity requirements associated with our existing operations through at least the next 12 months. We believe that the most strategic uses of our cash resources include repurchase of shares, strategic investments to gain access to new technologies, acquisitions, financing activities, and working capital. There are no transactions, arrangements, and other relationships with unconsolidated entities or other persons that are reasonably likely to materially affect liquidity or the availability of our requirements for capital.

Table of Contents

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

RISK FACTORS

Set forth below and elsewhere in this report and in other documents we file with the SEC are risks and uncertainties that could cause actual results to differ materially from the results contemplated by the forward-looking statements contained in this report.

OUR OPERATING RESULTS MAY FLUCTUATE IN FUTURE PERIODS, WHICH MAY ADVERSELY AFFECT OUR STOCK PRICE

Our operating results have been in the past, and will continue to be, subject to quarterly and annual fluctuations as a result of a number of factors. These factors include:

- Fluctuations in demand for our products and services, especially with respect to Internet businesses and telecommunications service providers;
- Changes in sales and implementation cycles for our products and reduced visibility into our customers spending plans and associated revenue;
- Our ability to maintain appropriate inventory levels and purchase commitments;
- Price and product competition in the communications and networking industries, which can change rapidly due to technological innovation;
- The overall trend toward industry consolidation both among our competitors and our customers;
- The introduction and market acceptance of new technologies and products and our success in new markets, as well as the adoption of new networking standards;
- Variations in sales channels, product costs, or mix of products sold;
- The timing and size of orders from customers;
- Manufacturing lead times;
- Fluctuations in our gross margins, and the factors that contribute to this as described below;

Our ability to achieve targeted cost reductions;

The ability of our customers, channel partners and suppliers to obtain financing or to fund capital expenditures;

The timing and amount of employer payroll tax to be paid on employees gains on stock options exercised;

Actual events, circumstances, outcomes, and amounts differing from judgments, assumptions, and estimates used in determining the values of certain assets (including the amounts of related valuation allowances), liabilities and other items reflected in our Consolidated Financial Statements;

How well we execute on our strategy and operating plans; and

Changes in accounting rules, such as recording expenses for employee stock option grants.

As a consequence, operating results for a particular future period are difficult to predict, and therefore, prior results are not necessarily indicative of results to be expected in future periods. Any of the foregoing factors, or any other factors discussed elsewhere herein, could have a material adverse effect on our business, results of operations, and financial condition that could adversely affect our stock price.

Table of Contents

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

RISK FACTORS

OUR OPERATING RESULTS MAY BE ADVERSELY AFFECTED BY THE UNCERTAIN GEOPOLITICAL ENVIRONMENT AND UNFAVORABLE ECONOMIC AND MARKET CONDITIONS

Economic conditions worldwide have contributed to recent slowdowns in the communications and networking industries and may continue to impact our business, resulting in:

- Reduced demand for our products as a result of continued constraints on information technology-related capital spending by our customers, particularly service providers;
- Increased price competition for our products, not only from our competitors but also as a consequence of customers disposing of unutilized products;
- Increased risk of excess and obsolete inventories;
- Excess facilities and manufacturing capacity; and
- Higher overhead costs as a percentage of revenues.

Recent turmoil in the geopolitical environment in many parts of the world, including terrorist activities and military actions, particularly the continuing tension in and surrounding Iraq, may continue to put pressure on global economic conditions. If the economic and market conditions in the United States and globally do not improve, or if they deteriorate, we may experience material impacts on our business, operating results, and financial condition.

OUR REVENUES FOR A PARTICULAR PERIOD ARE DIFFICULT TO PREDICT, AND A SHORTFALL IN REVENUES MAY HARM OUR OPERATING RESULTS

As a result of a variety of factors discussed in this report, our revenues for a particular quarter are difficult to predict. Our net sales may grow at a slower rate than in past periods and, in particular periods, may decline. Our ability to meet financial expectations could also be adversely affected if the nonlinear sales pattern seen in some of our past quarters recurs in future periods. We have experienced periods of time during which shipments exceeded net bookings or where manufacturing issues have delayed shipments leading to nonlinearity in shipping patterns. In addition to making it difficult to predict revenues for a particular period, nonlinearity in shipping can increase costs, as irregular shipment patterns result in periods of underutilized capacity and periods when overtime expenses may be incurred, as well as leading to additional costs arising out of inventory management. In addition, to the extent that manufacturing issues and any related component shortages result in delayed shipments in the future, and particularly in periods when we and our contract manufacturers are operating at higher levels of capacity, it is possible that revenues for a quarter could be adversely affected if such matters are not remediated within the same quarter.

In addition, to improve customer satisfaction, we continue to attempt to reduce our manufacturing lead times, which may result in corresponding reductions in order backlog. A decline in backlog levels could result in more variability and less predictability in our quarter-to-quarter net sales and operating results. Long manufacturing lead times have caused our customers in the past to place the same order multiple times within our various sales channels and cancel the duplicative orders upon receipt of the product, or to place orders with other vendors with shorter manufacturing lead times. Such multiple ordering (along with other factors) may cause difficulty in predicting our sales and, as a result, could impair our ability to manage parts inventory effectively.

We plan our operating expense levels based primarily on forecasted revenue levels. These expenses and the impact of long-term commitments are relatively fixed in the short-term. A shortfall in revenue could lead to operating results being below expectations as we may not be able to quickly reduce these fixed expenses in response to short-term business changes.

Any of the above factors could have a material adverse impact on our operations and financial results.

Table of Contents

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

RISK FACTORS

WE EXPECT THAT GROSS MARGIN VARIABILITY AND OUR RECENT LEVEL OF PRODUCT GROSS MARGIN MAY NOT BE SUSTAINABLE

Although we have generally experienced increasing product gross margins over the past few years, our recent level of product gross margins may not be sustainable and may be adversely affected in the future by numerous factors, including but not limited to:

- Changes in customer, geographic or product mix, including mix of configurations within each product group;
- Increases in material or labor costs;
- Excess inventory;
- Obsolescence charges;
- Changes in shipment volume;
- Loss of cost savings due to changes in component pricing or charges incurred due to inventory holding periods if parts ordering does not correctly anticipate product demand;
- Increased price competition;
- Changes in distribution channels;
- Increased warranty costs;
- How well we execute on our strategy and operating plans; and
- Introduction of new products or entering new markets, and different pricing and cost structures of new markets.

Changes in service gross margin may result from various factors such as changes in the mix between technical support services and advanced services, as well as the timing of technical support service contract initiations and renewals.

DISRUPTION OF OR CHANGES IN THE MIX OF OUR PRODUCTS AND SERVICES DISTRIBUTION MODEL OR CUSTOMER BASE COULD HARM OUR SALES AND MARGINS

If we fail to manage distribution of our products and services properly, or if our distributors financial condition or operations weaken, our revenues and gross margins could be adversely affected. Furthermore, a change in the mix of our customers between service provider and enterprise, or a change in the mix of direct and indirect sales, could adversely affect our revenues and gross margins.

We use a variety of channels to bring our products and services to our end-user customers, including system integrators, two-tier distributors, and direct sales. System integrators integrate our products and services into an overall network solution that they typically resell to an end user. Two-tier distributors stock inventory and sell to resellers who may themselves be system integrators. Direct sales occur to both enterprise accounts and service providers. A substantial portion of our products and services is distributed through our channel partners and the remainder is distributed through direct sales. If sales through indirect channels increase, this may lead to greater difficulty in forecasting the mix of our products, and to a certain degree, the timing of orders from our customers.

Historically, we have seen fluctuations in our gross margins based on changes in the balance of our distribution channels. Although variability to date has not been significant, because each distribution channel has a unique

Table of Contents

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

RISK FACTORS

profile, there can be no assurance that changes in the balance of our distribution model in future periods would not have an adverse effect on our gross margins and profitability.

For example:

We could compete with our channel partners through our direct sales, which may lead these channel partners to use other suppliers that do not directly sell their own products, which could adversely affect our distribution model.

Some of our system integrators may demand that we absorb a greater share of the risks that their customers may ask them to bear, which may affect our gross margin.

Some of our channel partners may have insufficient financial resources and may not be able to withstand changes in business conditions, including the recent economic downturn. Revenues from indirect sales could suffer if our distributors financial condition or operations weaken.

Service provider customers may demand rigorous acceptance testing or prime contracting. As we develop more solution oriented products, enterprise customers may demand similar terms and conditions. Such terms and conditions can lower gross margins and defer revenue recognition.

OUR INVENTORY MANAGEMENT RELATING TO OUR SALES TO DISTRIBUTORS IS COMPLEX, AND EXCESS FINISHED GOODS MAY HARM OUR GROSS MARGINS

We must manage our inventory relating to sales to our distributors effectively. With respect to finished goods, inventory held by our two-tier distributors could affect our results of operations. Distributors may increase orders during periods of product shortages, cancel orders if their inventory is too high, or delay orders in anticipation of new products. Distributors also may adjust their orders in response to the supply of our products and the products of our competitors that are available to the distributor and in response to seasonal fluctuations in end-user demand. If we have excess inventory, we may have to reduce our prices and write down inventory, which in turn could result in lower gross margins. Our two-tier distribution channels, in contrast to our one-tier distributors, are given business terms that allow them to return a portion of inventory and participate in various cooperative marketing programs. We recognize revenue to two-tier distributors based on a sell-through method utilizing information provided by our distributors, and we also maintain accruals and allowances for all cooperative marketing and other programs.

SALES TO THE SERVICE PROVIDER MARKET ARE ESPECIALLY VOLATILE, AND CONTINUED DECLINES OR DELAYS IN SALES ORDERS FROM THIS INDUSTRY MAY HARM OUR OPERATING RESULTS AND FINANCIAL CONDITION

Sales to the service provider market have been characterized by large and often sporadic purchases with longer sales cycles. Although we continue to invest in development of new products aimed at this market segment, we have experienced significant decreases in sales to service providers as market conditions have changed. Sales activity in this industry depends upon the stage of completion of expanding network infrastructures, the availability of funding, and the extent that service providers are affected by regulatory, economic and business conditions in the country of operations. Although there may be some early signs of increased levels of capital spending by service providers over the depressed levels that have prevailed over the last few years, continued declines or delays in orders from this industry could have a material adverse effect on our business, operating results and financial condition. The recent slowdown in the general economy, over-capacity, changes in the service provider market, and the constraints on capital availability have had a material adverse effect on many of our service provider customers, with many of such customers going out of business or substantially reducing their expansion plans. These conditions have materially harmed our business and operating results, and we expect

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

RISK FACTORS

that some or all of these conditions may continue for the foreseeable future. Finally, service provider customers typically have longer implementation cycles, require a broader range of service including design services, demand that vendors take on a larger share of risks, often require acceptance provisions which can lead to a delay in revenue recognition, and expect financing from vendors. All these factors can add further risk to business conducted with service providers.

A SHORTAGE OF ADEQUATE COMPONENT SUPPLY OR MANUFACTURING CAPACITY COULD INCREASE OUR COSTS OR CAUSE A DELAY IN OUR ABILITY TO FULFILL ORDERS, AND OUR FAILURE TO ESTIMATE CUSTOMER DEMAND PROPERLY MAY RESULT IN EXCESS OR OBSOLETE COMPONENT SUPPLY THAT COULD ADVERSELY AFFECT OUR GROSS MARGINS

Our growth and ability to meet customer demands depend in part on our ability to obtain timely deliveries of parts from our suppliers and contract manufacturers. We have experienced component shortages in the past, including shortages caused by manufacturing process issues, that have affected our operations. We may in the future experience a shortage of certain component parts as a result of our own manufacturing process issues, manufacturing process issues at our suppliers or contract manufacturers, capacity problems experienced by our suppliers or contract manufacturers, or strong demand in the industry for those parts, especially if the economy grows. Growth in the economy is likely to create greater pressures on us and our suppliers to accurately project overall component demand and component demands within specific product categories, and to establish optimal component levels. If shortages or delays persist, the price of these components may increase, or the components may not be available at all, and we may also encounter shortages if we do not accurately anticipate our needs. We may not be able to secure enough components at reasonable prices or of acceptable quality to build new products in a timely manner in the quantities or configurations needed. Accordingly, our revenues and gross margins could suffer until other sources can be developed. Our operating results would also be adversely affected if, anticipating greater demand than actually develops, we commit to the purchase of more components than we need. There can be no assurance that we will not encounter these problems in the future. Although in many cases we use standard parts and components for our products, certain components are presently available only from a single source or limited sources. We may not be able to diversify sources in a timely manner, which could harm our ability to deliver products to customers and seriously impact present and future sales.

We believe that we may be faced with the following challenges going forward:

- New markets in which we participate may grow quickly, and thus consume significant component capacity;
- As we acquire companies and new technologies, we are dependent, at least initially, on unfamiliar supply chains or relatively small supply partners; and
- We face competition for certain components, which are supply constrained, from existing competitors and companies in other markets.

Manufacturing capacity and component supply constraints could be significant issues for us. We purchase components from a variety of suppliers and use several contract manufacturers to provide manufacturing services for our products. During the normal course of business, in order to reduce manufacturing lead times and to help assure adequate component supply, we enter into agreements with contract manufacturers and suppliers that either allow them to procure inventory based upon criteria as defined by us or that establish the parameters defining our requirements. In certain instances, these agreements allow us the option to cancel, reschedule and adjust our requirements based on our business needs prior to firm orders being placed. If we fail to anticipate customer demand properly, an oversupply of parts could result in excess or obsolete components that could adversely affect our gross margins. For additional information regarding our purchase commitments, see Note 6

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

RISK FACTORS

to the Consolidated Financial Statements. A reduction or interruption in supply, a significant increase in the price of one or more components, a failure to adequately authorize procurement of inventory by our contract manufacturers, a failure to appropriately cancel, reschedule or adjust our requirements based on our business needs, or a decrease in demand for products could materially adversely affect our business, operating results and financial condition and could materially damage customer relationships. Furthermore, as a result of binding price or purchase commitments with suppliers, we may be obligated to purchase components at prices that are higher than those available in the current market. In the event that we become committed to purchase components at prices in excess of the current market price when the components are actually utilized, our gross margins could decrease.

The fact that we do not own the bulk of our manufacturing facilities could have an adverse impact on the supply of our products and on operating results. Financial problems of contract manufacturers on whom we rely, or reservation of manufacturing capacity by other companies, inside or outside of our industry, could either limit supply or increase costs.

THE MARKETS IN WHICH WE COMPETE ARE INTENSELY COMPETITIVE, WHICH COULD ADVERSELY AFFECT OUR REVENUE GROWTH

We compete in the networking and communications equipment markets, providing products and services for transporting data, voice and video traffic across intranets, extranets, and the Internet. These markets are characterized by rapid change, converging technologies, and a migration to networking solutions that offer superior advantages. These market factors represent both an opportunity and a competitive threat to us. We compete with numerous vendors in each product category. The overall number of our competitors providing niche product solutions may increase. Also, the identity and composition of competitors may change as we increase our activity in our advanced technology markets.

Our competitors include 3Com, Alcatel, Avaya, Avici Systems, Brocade Communications Systems, Inc., Check Point Software Technologies, Ciena, D-Link Systems, Inc., Dell, Enterasys Networks, Extreme Networks, Foundry Networks, Fujitsu, Huawei Technologies, Juniper Networks, Lucent, McDATA Corporation, NETGEAR, Inc., Nokia, Nortel Networks, Redback Networks, Siemens AG and Sycamore Networks, among others.

Some of these companies compete across many of our product lines, while others are primarily focused in a specific product area. Barriers to entry are relatively low, and new ventures to create products that do or could compete with our products are regularly formed. In addition, several of our competitors may have greater resources, including technical and engineering resources, than we do. As we expand into new markets, we will face competition not only from our existing competitors but from other competitors as well, including existing companies with strong technological, marketing and sales positions in those markets. We also sometimes face competition from resellers and distributors of our products.

The principal competitive factors in the markets in which we presently compete and may compete in the future include:

- The ability to provide a broad range of networking products and services;

Product performance;

Price;

The ability to provide new products;

Table of Contents

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

RISK FACTORS

The ability to provide value-added features such as security, reliability and investment protection;

Conformance to standards;

Market presence; and

The ability to provide financing.

We also face competition from customers to whom we license or supply technology and suppliers from whom we transfer technology. The inherent nature of networking requires interoperability. As such, we must cooperate and at the same time compete with many companies. Any inability to effectively manage these complicated relationships with customers and suppliers could have a material adverse effect on our business, operating results, and financial condition and accordingly affect our chances of success.

WE DEPEND UPON THE DEVELOPMENT OF NEW PRODUCTS AND ENHANCEMENTS TO EXISTING PRODUCTS, AND IF WE FAIL TO PREDICT AND RESPOND TO EMERGING TECHNOLOGICAL TRENDS AND CUSTOMERS CHANGING NEEDS, OUR OPERATING RESULTS AND MARKET SHARE MAY SUFFER

The markets for our products are characterized by rapidly changing technology, evolving industry standards, new product introductions, and evolving methods of building and operating networks. Our operating results depend on our ability to develop and introduce new products into existing and emerging markets and to reduce the production costs of existing products. We believe the Internet and other data, voice and video networks are evolving into a network of networks, which will require common technology platforms and broad end-to-end solutions for particular applications rather than products aimed at particular market segments. In that environment, customers will be more concerned with overall solutions rather than with whether the solution is built around a particular technology, such as routing or switching. The process of developing new technology is complex and uncertain, and if we fail to accurately predict customers changing needs and emerging technological trends, our business could be harmed. We must commit significant resources to develop new products before knowing whether our investments will result in products the market will accept. In particular, if the network of networks model does not emerge as we believe it will, many of our investments may prove to be without value. Furthermore, we may not execute successfully on that vision because of errors in product planning or timing, technical hurdles that we fail to overcome in a timely fashion, or a lack of appropriate resources. This could result in competitors providing those solutions before we do, and loss of market share, revenues and earnings. The success of new products is dependent on several factors, including proper new product definition, component costs, timely completion and introduction of these products, differentiation of new products from those of our competitors, and market acceptance of these products. There can be no assurance that we will successfully identify new product opportunities, develop and bring new products to market in a timely manner, or achieve market acceptance of our products, or that products and technologies developed by others will not render our products or technologies obsolete or noncompetitive. Specifically, the products and technologies that we have identified as Advanced Technologies may not prove to have the market success we anticipate, and we may not successfully identify and invest in other advanced technologies that will be important for our future success.

OUR BUSINESS SUBSTANTIALLY DEPENDS UPON THE CONTINUED GROWTH OF THE INTERNET AND INTERNET-BASED SYSTEMS

A substantial portion of our business and revenue depends on growth of the Internet and on the deployment of our products by customers that depend on the continued growth of the Internet. As a result of the recent economic slowdown and reduction in capital spending, which have particularly affected telecommunications

47

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

service providers, spending on Internet infrastructure has declined, which has materially harmed our business. To the extent that the recent economic slowdown and reduction in capital spending continue to adversely affect spending on Internet infrastructure, we could continue to experience material harm to our business, operating results, and financial condition.

Because of the rapid introduction of new products, and changing customer requirements related to matters such as cost-effectiveness and security, we believe that there could be certain performance problems with Internet communications in the future, which could receive a high degree of publicity and visibility. As we are a large supplier of networking products, our business, operating results, and financial condition may be materially adversely affected, regardless of whether or not these problems are due to the performance of our own products. Such an event could also result in a material adverse effect on the market price of our common stock independent of direct effects on our business.

CHANGES IN INDUSTRY STRUCTURE AND MARKET CONDITIONS COULD LEAD TO DISCONTINUANCES OF CERTAIN OF OUR PRODUCTS OR BUSINESSES

In response to changes in industry and market conditions, we may be required to strategically realign our resources and consider restructuring, disposing of, or otherwise exiting businesses. Any decision to limit investment in or dispose of or otherwise exit businesses may result in the recording of special charges, such as inventory and technology related write-offs, workforce reduction costs, charges relating to consolidation of excess facilities, or claims from third parties who were resellers or users of discontinued products. Our estimates with respect to the useful life or ultimate recoverability of our carrying basis of assets, including purchased intangible assets, could change as a result of such assessments and decisions. Further, our estimates relating to the liabilities for excess facilities are affected by changes in real estate market conditions. Additionally, we are required to perform goodwill impairment tests on an annual basis and between annual tests in certain circumstances. There can be no assurance that future goodwill impairment tests will not result in a charge to earnings.

WE HAVE MADE AND EXPECT TO CONTINUE TO MAKE ACQUISITIONS THAT COULD DISRUPT OUR OPERATIONS AND HARM OUR OPERATING RESULTS

Our growth is dependent upon market growth, our ability to enhance our existing products, and our ability to introduce new products on a timely basis. We intend to continue to address the need to develop new products and enhance existing products through acquisitions of other companies, product lines, technologies and personnel. Acquisitions involve numerous risks, including the following:

- Difficulties in integrating the operations, technologies, products and personnel of the acquired companies;
- Diversion of management s attention from normal daily operations of the business;
- Potential difficulties in completing projects associated with in-process research and development;

Difficulties in entering markets in which we have no or limited direct prior experience and where competitors in such markets have stronger market positions;

Initial dependence on unfamiliar supply chains or relatively small supply partners;

Insufficient revenues to offset increased expenses associated with acquisitions; and

The potential loss of key employees of the acquired companies.

Table of Contents

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

RISK FACTORS

Acquisitions may also cause us to:

- Issue common stock that would dilute our current shareholders percentage ownership;
- Assume liabilities;
- Record goodwill and non-amortizable intangible assets that will be subject to impairment testing on a regular basis and potential periodic impairment charges;
- Incur amortization expenses related to certain intangible assets;
- Incur large and immediate write-offs, and restructuring and other related expenses; or
- Become subject to litigation.

Mergers and acquisitions of high-technology companies are inherently risky, and no assurance can be given that our previous or future acquisitions will be successful and will not materially adversely affect our business, operating results or financial condition. Failure to manage and successfully integrate acquisitions we make could harm our business and operating results in a material way. Prior acquisitions have resulted in a wide range of outcomes, from successful introduction of new products and technologies to an inability to do so. Even when an acquired company has already developed and marketed products, there can be no assurance that product enhancements will be made in a timely fashion or that preacquisition due diligence will have identified all possible issues that might arise with respect to such products.

From time to time, we have made acquisitions that result in in-process research and development expenses being charged in an individual quarter. These charges may occur in any particular quarter, resulting in variability in our quarterly earnings.

Risks related to new product development also apply to acquisitions. Please see the risk factor above entitled We depend upon the development of new products and enhancements to existing products, and if we fail to predict and respond to emerging technological trends and customers changing needs, our operating results and market share may suffer for additional information.

ENTRANCE INTO NEW OR DEVELOPING MARKETS EXPOSES US TO ADDITIONAL COMPETITION AND WILL LIKELY INCREASE DEMANDS ON OUR SERVICE AND SUPPORT OPERATIONS

As we focus on new market opportunities, such as storage, wireless, security, and transporting data, voice, and video traffic across the same network, we will increasingly compete with large telecommunications equipment suppliers as well as startup companies. Several of our competitors may have greater resources, including technical and engineering resources, than we do. Additionally, as customers in these markets complete infrastructure deployments, they may require greater levels of service, support and financing than we have provided in the past. Demand for these types of service or financing contracts may increase in the future. There can be no assurance that we can provide products, service, support and financing to effectively compete for these market opportunities. Further, provision of greater levels of services by us may result in a delay in the timing of revenue recognition. In addition, entry into other markets, including our recent entry into the consumer market, has and will subject us to additional risks particular to those markets, including the effects of general market conditions and reduced consumer confidence.

Table of Contents

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

RISK FACTORS

PRODUCT QUALITY PROBLEMS COULD LEAD TO REDUCED REVENUES, GROSS MARGINS AND NET INCOME

We produce highly complex products that incorporate leading-edge technology, including both hardware and software. Software typically contains bugs that can unexpectedly interfere with expected operations. There can be no assurance that our pre-shipment testing programs will be adequate to detect all defects, either in individual products or which could affect numerous shipments, which might interfere with customer satisfaction, reduce sales opportunities, or affect gross margins. In the past, we have had to recall certain components and provide remediation in response to the discovery of bugs in products that we had shipped. While the cost of such recalls and remediation has not been material in the past, there can be no assurance that such a recall or remediation, depending on the product involved, would not have a material impact. An inability to cure a product defect could result in the failure of a product line, temporary or permanent withdrawal from a product or market segment, damage to our reputation, inventory costs, or product reengineering expenses, any of which could have a material impact on revenues, margins and net income.

INDUSTRY CONSOLIDATION MAY LEAD TO INCREASED COMPETITION AND MAY HARM OUR OPERATING RESULTS

There has been a trend toward industry consolidation in our markets for several years. We expect this trend to continue as companies attempt to strengthen or hold their market positions in an evolving industry and as companies are acquired or are unable to continue operations. We believe that industry consolidation may result in stronger competitors that are better able to compete as sole-source vendors for customers. This could lead to more variability in operating results and could have a material adverse effect on our business, operating results, and financial condition. Furthermore, particularly in the service provider market, rapid consolidation will lead to fewer customers, with the effect that loss of a major customer could have a material impact on results not anticipated in a customer marketplace composed of more numerous participants.

DUE TO THE GLOBAL NATURE OF OUR OPERATIONS, POLITICAL OR ECONOMIC CHANGES, OR OTHER FACTORS, IN A SPECIFIC COUNTRY OR REGION COULD HARM OUR COSTS, EXPENSES AND FINANCIAL CONDITION

We conduct significant sales and customer support operations in countries outside of the United States and also depend on non-U.S. operations of our contract manufacturers and our distribution partners. For fiscal 2003 and the first nine months of fiscal 2004, we derived 48.9% and 49.7% of our revenues, respectively, from sales outside the United States. Accordingly, our future results could be materially adversely affected by a variety of uncontrollable and changing factors including, among others, foreign currency exchange rates; political or social unrest or economic instability in a specific country or region; trade protection measures and other regulatory requirements which may affect our ability to import or export our products from various countries; political considerations that affect service provider and government spending patterns; health or similar issues such as the outbreak of Severe Acute Respiratory Syndrome (SARS) in Asia; difficulties in staffing and managing international operations; and adverse tax consequences, including imposition of withholding or other taxes on payments by subsidiaries. Any or all of these factors could have a material adverse impact on our costs, expenses and financial condition.

WE ARE EXPOSED TO FLUCTUATIONS IN CURRENCY EXCHANGE RATES THAT COULD NEGATIVELY IMPACT OUR FINANCIAL RESULTS AND CASH FLOWS

Because a significant portion of our business is conducted outside the United States, we face exposure to adverse movements in foreign currency exchange rates. These exposures may change over time as business practices

Table of Contents

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

RISK FACTORS

evolve and could have a material adverse impact on our financial results and cash flows. Historically, our primary exposures have related to non-dollar-denominated sales in Japan, Canada, and Australia, and certain non-dollar-denominated operating expenses in Europe, Latin America, and Asia, where we sell primarily in U.S. dollars. Additionally, we have exposures to emerging market currencies, which can have extreme currency volatility. An increase in the value of the dollar could increase the real cost to our customers of our products in those markets outside the United States where we sell in dollars, and a weakened dollar could increase the cost of local operating expenses and procurement of raw materials to the extent we must purchase components in foreign currencies.

Currently, we enter into foreign exchange forward contracts to minimize the short-term impact of foreign currency fluctuations on certain foreign currency receivables, investments and payables. In addition, we periodically will hedge anticipated foreign currency cash flows. Our attempts to hedge against these risks may not be successful, resulting in an adverse impact on our net income.

WE ARE EXPOSED TO THE CREDIT RISK OF SOME OF OUR CUSTOMERS AND TO CREDIT EXPOSURES IN WEAKENED MARKETS, WHICH COULD RESULT IN MATERIAL LOSSES

Most of our sales are on an open credit basis, with typical payment terms of 30 days in the United States, and, because of local customs or conditions, longer in some markets outside the United States. We monitor individual customer payment capability in granting such open credit arrangements, seek to limit such open credit to amounts we believe the customers can pay, and maintain reserves we believe are adequate to cover exposure for doubtful accounts. Beyond our open credit arrangements, we have also experienced demands for customer financing and facilitation of leasing arrangements. We expect demand for customer financing to continue. We believe customer financing is a competitive factor in obtaining business, particularly in supplying customers involved in significant infrastructure projects. Our loan financing arrangements may include not only financing the acquisition of our products and services but also providing additional funds for other costs associated with network installation and integration of our products and services and for working capital purposes. We do not recognize revenue on structured loan financing arrangements until cash payments are received.

Because of the recent slowdown in the global economy, our exposure to the credit risks relating to our financing activities described above may increase. Although we have programs in place that are designed to monitor and mitigate the associated risk, including monitoring of particular risks in certain geographic areas, there can be no assurance that such programs will be effective in reducing our credit risks. There have been significant bankruptcies among customers both on open credit and with loan or lease financing arrangements, particularly among Internet businesses and service providers, causing us to incur economic or financial losses. There can be no assurance that additional losses will not be incurred. Although these losses have not been material to date, future losses, if incurred, could harm our business and have a material adverse effect on our operating results and financial condition.

A portion of our sales is derived through our resellers in two-tier distribution channels. These resellers/customers are generally given business terms that allow them to return a portion of inventory, receive credits for changes in selling prices, and participate in various cooperative marketing programs. We maintain estimated accruals and allowances for such exposures. However, such resellers tend to have more limited financial resources than other resellers and end-user customers and therefore represent potential sources of increased credit risk because they may be more likely to lack the reserve resources to meet payment obligations.

OUR PROPRIETARY RIGHTS MAY PROVE DIFFICULT TO ENFORCE

We generally rely on patents, copyrights, trademarks, and trade secret laws to establish and maintain proprietary rights in our technology and products. While we have been issued a number of patents and other patent

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

RISK FACTORS

applications are currently pending, there can be no assurance that any of these patents will not be challenged, invalidated, or circumvented, or that any rights granted under these patents will in fact provide competitive advantages to us. Furthermore, many key aspects of networking technology are governed by industry-wide standards, which are usable by all market entrants. In addition, there can be no assurance that patents will be issued from pending applications, or that claims allowed on any patents will be sufficiently broad to protect our technology. In addition, the laws of some foreign countries may not protect our proprietary rights to the same extent as do the laws of the United States. The outcome of any actions taken in these foreign countries may be different than if such actions were determined under the laws of the United States. While we are not dependent on any individual patents or group of patents for particular segments of the business for which we compete, if we are unable to protect our proprietary rights to the totality of the features (including aspects of products protected other than by patent rights) in a market, we may find ourselves at a competitive disadvantage to others who need not incur the substantial expense, time and effort required to create the innovative products which have enabled us to be successful.

WE MAY BE FOUND TO INFRINGE ON INTELLECTUAL PROPERTY RIGHTS OF OTHERS

Third parties, including customers, have in the past and may in the future assert claims or initiate litigation related to exclusive patent, copyright, trademark and other intellectual property rights to technologies and related standards that are relevant to us. These assertions have increased over time as a result of our growth and the general increase in the pace of patent claims assertions, particularly in the United States. Because of the existence of a large number of patents in the networking field, the secrecy of some pending patents and the rapid rate of issuance of new patents, it is not economically practical nor even possible to determine in advance whether a product or any of its components infringe or will infringe the patent rights of others. The asserted claims and/or initiated litigation, can include claims against us or our manufacturers, suppliers, or customers, alleging infringement of their proprietary rights with respect to our existing or future products or components of those products. Regardless of the merit of these claims, they can be time-consuming, result in costly litigation and diversion of technical and management personnel, or require us to develop a non-infringing technology or enter into license agreements. Where claims are made by customers, resistance even to unmeritorious claims could damage customer relationships. There can be no assurance that licenses will be available on acceptable terms and conditions, if at all, in all such circumstances, or that our indemnification by their suppliers will be adequate to cover their costs if a claim were brought directly against us or our customers. Furthermore, because of the potential for high court awards that are not necessarily predictable, it is not unusual to find even arguably unmeritorious claims settled for significant funds. If any infringement or other intellectual property claim made against us by any third party is successful, or if we fail to develop non-infringing technology or license the proprietary rights on commercially reasonable terms and conditions, our business, operating results and financial condition could be materially and adversely affected.

Our exposure to risks associated with the use of intellectual property may be increased as a result of acquisitions, as we have a lower level of visibility into the development process with respect to such technology or the care taken to safeguard against infringement risks. Further, in the past third parties have made infringement and similar claims after we have acquired technology that had not been asserted prior to our acquisition.

WE RELY ON THE AVAILABILITY OF THIRD-PARTY LICENSES

Many of our products are designed to include software or other intellectual property licensed from third parties. It may be necessary in the future to seek or renew licenses relating to various aspects of these products. There can be no assurance that the necessary license would be available on acceptable terms, if at all. The inability to obtain certain licenses or other rights or to obtain such licenses or rights on favorable terms, or the need to engage in

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

litigation regarding these matters, could have a material adverse effect on our business, operating results, and financial condition. Moreover, the inclusion in our products of software or other intellectual property licensed from third parties on a non-exclusive basis could limit our ability to protect our proprietary rights in our products.

OUR OPERATING RESULTS AND FUTURE PROSPECTS COULD BE MATERIALLY HARMED BY UNCERTAINTIES OF REGULATION OF THE INTERNET

Currently, few laws or regulations apply directly to access or commerce on the Internet. We could be materially adversely affected by regulation of the Internet and Internet commerce in any country where we operate. Such regulations could include matters such as voice over the Internet or using Internet Protocol, encryption technology, and access charges for Internet service providers. The adoption of regulation of the Internet and Internet commerce could decrease demand for our products, and at the same time, increase the cost of selling our products, which could have a material adverse effect on our business, operating results, and financial condition.

CHANGES IN TELECOMMUNICATIONS REGULATION AND TARIFFS COULD HARM OUR PROSPECTS AND FUTURE SALES

Changes in telecommunications requirements in the United States or other countries could affect the sales of our products. In particular, we believe that there may be future changes in U.S. telecommunications regulations that could slow the expansion of the service providers network infrastructures and materially adversely affect our business, operating results, and financial condition. Future changes in tariffs by regulatory agencies or application of tariff requirements to currently untariffed services could affect the sales of our products for certain classes of customers. Additionally, in the United States, our products must comply with various Federal Communications Commission 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 have a material adverse effect on our business, operating results, and financial condition.

FAILURE TO RETAIN AND RECRUIT KEY PERSONNEL WOULD HARM OUR ABILITY TO MEET KEY OBJECTIVES

Our success has always depended in large part on our ability to attract and retain highly skilled technical, managerial, sales and marketing personnel. In spite of the recent economic slowdown, competition for these personnel is intense, especially in the Silicon Valley area of Northern California. Volatility or lack of positive performance in our stock price may also adversely affect our ability to retain key employees, all of whom have been granted stock options. The loss of services of any of our key personnel, the inability to retain and attract qualified personnel in the future, or delays in hiring required personnel, particularly engineering and sales personnel, could make it difficult to meet key objectives, such as timely and effective product introductions. In addition, companies in the networking industry whose employees accept positions with competitors frequently claim that competitors have engaged in improper hiring practices. We have received these claims in the past and may receive additional claims to this effect in the future.

ADVERSE RESOLUTION OF LITIGATION MAY HARM OUR OPERATING RESULTS OR FINANCIAL CONDITION

We are a party to lawsuits in the normal course of our business. Litigation can be expensive, lengthy and disruptive to normal business operations. Moreover, the results of complex legal proceedings are difficult to

Table of Contents

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

RISK FACTORS

predict. An unfavorable resolution of a particular lawsuit could have a material adverse effect on our business, operating results, or financial condition. For additional information regarding certain of the lawsuits in which we are involved, see Item 1, Legal Proceedings, contained in Part II of this report.

CHANGES IN EFFECTIVE TAX RATES OR ADVERSE OUTCOMES RESULTING FROM EXAMINATION OF OUR INCOME TAX RETURNS COULD ADVERSELY AFFECT OUR RESULTS

Our future effective tax rates could be adversely affected by earnings being lower than anticipated in countries where we have lower statutory rates and higher than anticipated in countries where we have higher statutory rates, by changes in the valuation of our deferred tax assets and liabilities, or by changes in tax laws or interpretations thereof. In addition, we are subject to the continuous examination of our income tax returns by the Internal Revenue Service and other tax authorities. We regularly assess the likelihood of adverse outcomes resulting from these examinations to determine the adequacy of our provision for income taxes. There can be no assurance that the outcomes from these continuous examinations will not have an adverse effect on our operating results and financial condition.

OUR BUSINESS AND OPERATIONS ARE ESPECIALLY SUBJECT TO THE RISKS OF EARTHQUAKES, FLOODS, AND OTHER NATURAL CATASTROPHIC EVENTS

Our corporate headquarters, including certain 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. Additionally, a certain number of our facilities, including one of our manufacturing facilities, are located near rivers that have experienced flooding in the past. A significant natural disaster, such as an earthquake or a flood, could have a material adverse impact on our business, operating results, and financial condition.

MANMADE PROBLEMS SUCH AS COMPUTER VIRUSES OR TERRORISM MAY DISRUPT OUR OPERATIONS AND HARM OUR OPERATING RESULTS

Despite our implementation of network security measures, our servers are vulnerable to computer viruses, break-ins, and similar disruptions from unauthorized tampering with our computer systems. Any such event could have a material adverse effect on our business, operating results and financial condition. In addition, the continued threat of terrorism and heightened security and military action in response to this threat, or any future acts of war or terrorism, may cause further disruptions to the economies of the U.S. and other countries and create further uncertainties, or otherwise materially harm our business, operating results and financial condition. Similarly, events such as last year s blackouts in the eastern United States, and recurrences of these blackouts, could have similar negative impacts. To the extent that such disruptions or uncertainties result in delays or cancellations of customer orders, or the manufacture or shipment of our products, our business, operating results and financial condition could be materially and adversely affected.

WE ARE EXPOSED TO FLUCTUATIONS IN THE MARKET VALUES OF OUR PORTFOLIO INVESTMENTS AND IN INTEREST RATES; IMPAIRMENT OF OUR INVESTMENTS COULD HARM OUR EARNINGS

We maintain an investment portfolio of various holdings, types and maturities. These securities are generally classified as available for sale and, consequently, are recorded on the Consolidated Balance Sheets at fair value with unrealized gains or losses reported as a separate component of accumulated other comprehensive income (loss), net of tax. Part of this portfolio includes equity investments in several publicly traded companies, the values of which are subject to market price volatility. The recent economic downturn and other factors have

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

RISK FACTORS

adversely affected the public equities market, and general economic conditions may continue to worsen. As a result, we may recognize in earnings the decline in fair value of our publicly traded equity investments below the cost basis when the decline is judged to be other-than-temporary. For information regarding the sensitivity of and risks associated with the market value of portfolio investments and interest rates, refer to the section titled Quantitative and Qualitative Disclosures About Market Risk included in this report and in our Annual Report on Form 10-K for the fiscal year ended July 26, 2003. Furthermore, our equity investments in both publicly traded companies and private companies are subject to risk of loss of investment capital. These investments are inherently risky as the market for the technologies or products they have under development are typically in the early stages and may never materialize. We could lose our entire investment in these companies.

IF WE DO NOT SUCCESSFULLY MANAGE OUR STRATEGIC ALLIANCES, WE MAY EXPERIENCE INCREASED COMPETITION OR DELAYS IN PRODUCT DEVELOPMENT

We have several strategic alliances with large and complex organizations and other companies with whom we work to offer complementary products and services. These arrangements are generally limited to specific projects, the goal of which is generally to facilitate product compatibility and adoption of industry standards. If successful, these relationships may be mutually beneficial and result in industry growth. However, these alliances carry an element of risk because, in most cases, we must compete in some business areas with a company with which we have a strategic alliance and, at the same time, cooperate with that company in other business areas. Also, if these companies fail to perform or if these relationships fail to materialize as expected, we could suffer delays in product development or other operational difficulties.

OUR STOCK PRICE MAY CONTINUE TO BE VOLATILE

Our common stock has experienced substantial price volatility, particularly as a result of variations between our actual financial results and the published expectations of analysts, and as a result of announcements by our competitors and us. Furthermore, speculation in the press or investment community about our strategic position, financial condition, results of operations, business or significant transactions can cause changes in our stock price. In addition, the stock market has experienced extreme price and volume fluctuations that have affected the market price of many technology companies, in particular, and that have often been unrelated to the operating performance of these companies. These factors, as well as general economic and political conditions, may materially adversely affect the market price of our common stock in the future. Additionally, volatility or a lack of positive performance in our stock price may adversely affect our ability to retain key employees, all of whom are compensated in part based on the performance of our stock price.

Table of Contents

Item 3. Quantitative and Qualitative Disclosures About Market Risk

Cash and Cash Equivalents and Total Investments

We consider investments purchased with an original or remaining maturity of less than three months at the date of purchase to be cash equivalents. We maintain an investment portfolio of various holdings, types, and maturities. These securities are generally classified as available for sale and consequently are recorded on the Consolidated Balance Sheets at fair value with unrealized gains or losses reported as a separate component of accumulated other comprehensive income (loss), net of tax. The following table summarizes our cash and cash equivalents and total investments (in millions):

	May 1, 2004	July 26, 2003
Cash and cash equivalents	$ 3,949	$ 3,925
Fixed income securities	14,043	15,982
Publicly traded equity securities	954	745
Total	$ 18,946	$ 20,652

Cash and cash equivalents and total investments decreased by $1.7 billion during the first nine months of fiscal 2004 due to a decrease in fixed income securities of $1.9 billion partially offset by an increase in cash and cash equivalents of $24 million and an increase in publicly traded equity securities of $209 million. The changes in cash and cash equivalents, fixed income securities and publicly traded equity securities were related to our portfolio management strategies and did not have a material adverse impact on our existing levels of interest rate risk.

The values of our equity investments in several publicly traded companies are subject to market price volatility. The following analysis presents the hypothetical changes in fair value of publicly traded equity securities that are sensitive to changes in the stock market (in millions):

	Valuation of Securities Given X% Decrease in Each Stock s Price			Fair Value as of May 1, 2004	Valuation of Securities Given X% Increase in Each Stock s Price		
	(75%)	(50%)	(25%)		25%	50%	75%
Publicly traded equity securities	$ 239	$ 477	$ 716	$ 954	$ 1,193	$ 1,431	$ 1,670

Our equity portfolio consists of securities with characteristics that most closely match the S&P Index or companies traded on the Nasdaq National Market. These equity securities are held for purposes other than trading. The modeling technique used measures the change in fair values arising from selected hypothetical changes in each stock s price. Stock price fluctuations of plus or minus 25%, 50%, and 75% were selected based on the probability of their occurrence. During the first quarter of fiscal 2003, we recognized a charge of $412 million attributable to the impairment of certain publicly traded equity securities. The impairment charge was related to the decline in the fair value of certain publicly traded equity investments below their cost basis that was judged to be other-than-temporary. See Note 7 to the Consolidated Financial Statements for additional information regarding the change in unrealized gains and losses on our investments portfolio.

Investments in Privately Held Companies

We have invested in privately held companies, many of which can still be considered in the startup or development stages. These investments are inherently risky as the markets for the technologies or products they have under development are typically in the early stages and may never materialize. We could lose our entire initial investment in these companies. As of May 1, 2004, these investments were $360 million, compared with $516 million at July 26, 2003.

Table of Contents

Item 3. Quantitative and Qualitative Disclosures About Market Risk

Our evaluation of equity investments in private and public companies is based on the fundamentals of the business, including among other factors, the nature of their technologies and potential for financial return to us.

Derivative Instruments

We enter into foreign exchange forward contracts to minimize the short-term impact of foreign currency fluctuations on foreign currency receivables, investments, and payables, primarily denominated in Australian, Canadian, Japanese, and several European currencies, including the euro and British pound. Our market risks associated with our foreign currency receivables, investments, and payables relate primarily to variances from our forecasted foreign currency transactions and balances.

Approximately 75% of our operating expenses are U.S. dollar denominated. In order to reduce variability in operating expenses caused by the remaining non-U.S. dollar denominated operating expenses, we periodically hedge certain foreign currency forecasted transactions with currency options with maturities up to 18 months. In designing a specific hedging approach, we consider several factors including offsetting exposures, significance of exposures, costs associated with entering into a particular hedge instrument and potential effectiveness of the hedge. The gains on foreign exchange contracts mitigate the variability in operating expenses associated with currency movements. Due primarily to our limited currency exposure to date, our foreign currency fluctuations have not been material to our Consolidated Financial Statements. The impact of foreign currency fluctuations on foreign currency sales has not been material because our sales are primarily denominated in U.S. dollars.

Foreign exchange forward and option contracts as of May 1, 2004 are summarized as follows (in millions):

	Notional Amount	Fair Value
Forward contracts:		
Purchased	$ 921	$ 2
Sold	$ 414	$ (8)
Option contracts:		
Purchased	$ 554	$ 17
Sold	$ 477	$ (4)

Our foreign exchange forward contracts related to current assets and liabilities generally range from one to three months in original maturity. Additionally, we have entered into foreign exchange forward contracts related to long-term financings with maturities of up to two years. The foreign exchange forward contracts related to investments generally have maturities of less than one year. Currency option contracts generally have maturities of less than 18 months. We do not enter into foreign exchange forward and option contracts for trading purposes. We do not expect gains or losses on these derivative instruments to have a material impact on our financial results. See Note 6 to the Consolidated Financial Statements.

Item 4. Controls and Procedures

Evaluation of disclosure controls and procedures. Based on our management s evaluation (with the participation of our principal executive officer and principal financial officer), as of the end of the period covered by this report, our principal executive officer and principal financial officer have concluded that our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended, (the Exchange Act)) are effective to ensure that information required to be disclosed by us in reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in Securities and Exchange Commission rules and forms.

Changes in internal control over financial reporting. There was no change in our internal control over financial reporting during our third quarter of fiscal 2004 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

Table of Contents

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

Beginning on April 20, 2001, a number of purported shareholder class action lawsuits were filed in the United States District Court for the Northern District of California against us and certain of our officers and directors. The lawsuits have been consolidated, and the consolidated action is purportedly brought on behalf of those who purchased our publicly traded securities between August 10, 1999 and February 6, 2001. Plaintiffs allege that defendants have made false and misleading statements, purport to assert claims for violations of the federal securities laws, and seek unspecified compensatory damages and other relief. We believe the claims are without merit and intend to defend the actions vigorously.

In addition, beginning on April 23, 2001, a number of purported shareholder derivative lawsuits were filed in the Superior Court of California, County of Santa Clara and in the Superior Court of California, County of San Mateo. There is a procedure in place for the coordination of such actions (one of which has been dismissed and is currently on appeal). Two purported derivative suits were filed in the United States District Court for the Northern District of California, and those federal court actions have been consolidated. The consolidated federal court derivative action was dismissed by the court, and plaintiffs have appealed from that decision. The complaints in the various derivative actions include claims for breach of fiduciary duty, waste of corporate assets, mismanagement, unjust enrichment, and violations of the California Corporations Code; seek compensatory and other damages, disgorgement, and other relief; and are based on essentially the same allegations as the class actions.

In addition, we are subject to legal proceedings, claims, and litigation arising in the ordinary course of business. While the outcome of these matters is currently not determinable, we do not expect that the ultimate costs to resolve these matters will have a material adverse effect on our consolidated financial position, results of operations, or cash flows.

Item 2. Changes in Securities, Use of Proceeds and Issuer Purchases of Equity Securities

(a) None.

(b) None.

(c) On February 19, 2004, we issued an aggregate of 22,589,929 shares of our common stock in connection with the acquisition of Andiamo Systems, Inc. The offer and sale of the securities were effected without registration in reliance on the exemption afforded by Section 3(a)(10) of the Securities Act of 1933, as amended. The issuance was approved, after a hearing upon the fairness of the terms and conditions of the transaction, by the California Department of Corporations under authority to grant such approval as expressly authorized by the laws of the State of California. In addition, from February 19, 2004 through March 26, 2004, following the exercise by 28 employees of options to purchase shares of our common stock that had been granted under Andiamo s 2001 Stock Option Plan and were assumed by us in connection with our acquisition of Andiamo, we issued an aggregate of 142,126 shares of our common stock for an aggregate purchase price of $64,770. All such sales of our common stock made by us pursuant to the exercise of these stock options were effected without registration in reliance on the exemption afforded by Rule 701 promulgated under the Securities Act of 1933, as amended.

(d) None.

Table of Contents

(e) Issuer Purchases of Equity Securities

(Shares in Millions)	Total Number of Shares Purchased	Average Price Paid Per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs (1)	Approximate Dollar Value of Shares that May Yet Be Purchased Under the Plans or Programs (1)
January 25, 2004 to February 28, 2004	52	$ 24.07	52	$ 6,887
February 29, 2004 to March 27, 2004	68	$ 22.78	68	$ 5,337
March 28, 2004 to May 1, 2004	11	$ 23.14	11	$ 5,084
Total	131	$ 23.32	131	

(1) Between September 2001 and September 2003, the Board of Directors authorized the repurchase of up to $20 billion of our outstanding common stock. During the first nine months of fiscal 2004, we repurchased and retired 318 million shares of our common stock at an average price of $22.29 per share for an aggregate purchase price of $7.1 billion. As of May 1, 2004, we had repurchased and retired 866 million shares of our common stock at an average price of $17.22 per share for an aggregate purchase price of $14.9 billion since inception of the stock repurchase program, and the remaining authorized amount for stock repurchases under this program was $5.1 billion with no termination date. In addition, on May 13, 2004, the Board of Directors authorized the repurchase of up to an additional $5 billion of our outstanding common stock with no termination date.

Item 3. Defaults Upon Senior Securities

None.

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

None.

Item 5. Other Information

On February 20, 2004, we announced that we had completed our acquisition of Andiamo Systems, Inc.

On April 15, 2004, we announced that we had completed our acquisition of Riverhead Networks, Inc.

On April 20, 2004, we announced that we had completed our acquisition of Twingo Systems, Inc.

Table of Contents

Item 6. Exhibits and Reports on Form 8-K

(a) Exhibits

The following documents are filed as Exhibits to this report:

10.3	Professional and Leadership Incentive Plan Fiscal Year 2004
31.1	Rule 13a-14(a)/15d-14(a) Certification of Principal Executive Officer
31.2	Rule 13a-14(a)/15d-14(a) Certification of Principal Financial Officer
32.1	Section 1350 Certification of Principal Executive Officer
32.2	Section 1350 Certification of Principal Financial Officer

(b) Reports on Form 8-K

We furnished one report on Form 8-K during the quarter ended May 1, 2004.

Date Furnished	Item No.	Description
February 3, 2004	Item 12	On February 3, 2004, we announced our results of operations for our fiscal second quarter ended January 24, 2004.*

* This furnished Form 8-K is not to be deemed filed or incorporated by reference into any filing.

Table of Contents

Signature

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.

	Cisco Systems, Inc.
Date: May 26, 2004	By /s/ Dennis D. Powell
	Dennis D. Powell, Senior Vice President
	and Chief Financial Officer
	(Principal financial officer and duly
	authorized signatory)

61

Table of Contents

EXHIBIT INDEX

EXHIBIT NO.	
10.3	Professional and Leadership Incentive Plan Fiscal Year 2004
31.1	Rule 13a-14(a)/15d-14(a) Certification of Principal Executive Officer
31.2	Rule 13a-14(a)/15d-14(a) Certification of Principal Financial Officer
32.1	Section 1350 Certification of Principal Executive Officer
32.2	Section 1350 Certification of Principal Financial Officer