CISCO SYSTEMS INC
Form 10-Q
May 25, 2006
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 April 29, 2006

OR

¨ TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from ______ to ______

Commission file number 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 a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act).

Large Accelerated Filer x Accelerated Filer ¨ Non-Accelerated Filer ¨

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

As of May 19, 2006, 6,104,624,386 shares of the registrant s common stock were outstanding.

Table of Contents

TABLE OF CONTENTS

CISCO SYSTEMS, INC.

FORM 10-Q

FOR THE QUARTER ENDED APRIL 29, 2006

INDEX

		Page
Part I.	**Financial Information**	
Item 1.	Financial Statements (Unaudited)	
	Consolidated Statements of Operations for the three and nine months ended April 29, 2006 and April 30, 2005	3
	Consolidated Balance Sheets at April 29, 2006 and July 30, 2005	4
	Consolidated Statements of Cash Flows for the nine months ended April 29, 2006 and April 30, 2005	5
	Consolidated Statements of Shareholders Equity for the nine months ended April 29, 2006 and April 30, 2005	6
	Notes to Consolidated Financial Statements	7
Item 2.	Management s Discussion and Analysis of Financial Condition and Results of Operations	40
Item 3.	Quantitative and Qualitative Disclosures About Market Risk	77
Item 4.	Controls and Procedures	80
Part II.	**Other Information**	
Item 1.	Legal Proceedings	80
Item 2.	Unregistered Sales of Equity Securities and Use of Proceeds	80
Item 3.	Defaults Upon Senior Securities	81
Item 4.	Submission of Matters to a Vote of Security Holders	81
Item 5.	Other Information	81
Item 6.	Exhibits	82
	Signature	83

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	
	April 29, 2006	April 30, 2005	April 29, 2006	April 30, 2005
NET SALES:				
Product	$ 6,155	$ 5,189	$ 17,183	$ 15,328
Service	1,167	998	3,317	2,892
Total net sales	7,322	6,187	20,500	18,220
COST OF SALES:				
Product	2,193	1,697	5,718	5,012
Service	403	355	1,180	1,005
Total cost of sales	2,596	2,052	6,898	6,017
GROSS MARGIN	4,726	4,135	13,602	12,203
OPERATING EXPENSES:				
Research and development	1,041	823	3,003	2,439
Sales and marketing	1,547	1,190	4,431	3,452
General and administrative	298	244	858	702
Amortization of purchased intangible assets	99	54	214	171
In-process research and development	88	6	90	20
Total operating expenses	3,073	2,317	8,596	6,784
OPERATING INCOME	1,653	1,818	5,006	5,419
Interest income, net	142	142	464	399
Other income, net	17	8	17	65
Interest and other income, net	159	150	481	464
INCOME BEFORE PROVISION FOR INCOME TAXES	1,812	1,968	5,487	5,883
Provision for income taxes	412	563	1,451	1,682
NET INCOME	$ 1,400	$ 1,405	$ 4,036	$ 4,201
Net income per share:				
Basic	$ 0.23	$ 0.22	$ 0.65	$ 0.64

Diluted	$ 0.22	$ 0.21	$ 0.64	$ 0.63
Shares used in per-share calculation:				
Basic	6,160	6,435	6,184	6,529
Diluted	6,289	6,541	6,300	6,656

See Notes to Consolidated Financial Statements. Net income for the third quarter of fiscal 2006 included stock-based compensation expense under SFAS 123(R) of $209 million, net of tax, which consisted of stock-based compensation expense of $188 million, net of tax, related to employee stock options and employee stock purchases and stock-based compensation expense of $21 million, net of tax, related to acquisitions and investments. Net income for the third quarter of fiscal 2005 included stock-based compensation expense of $43 million, net of tax, related to acquisitions and investments. Net income for the first nine months of fiscal 2006 included stock-based compensation expense under SFAS 123(R) of $672 million, net of tax, which consisted of stock-based compensation expense of $604 million, net of tax, related to employee stock options and employee stock purchases and stock-based compensation expense of $68 million, net of tax, related to acquisitions and investments. Net income for the first nine months of fiscal 2005 included stock-based compensation expense of $115 million, net of tax, related to acquisitions and investments. There was no stock-based compensation expense related to employee stock options and employee stock purchases under SFAS 123 in the third quarter and first nine months of fiscal 2005 because the Company did not adopt the recognition provisions of SFAS 123.

Net income including pro forma stock-based compensation expense as previously disclosed in the notes to the Consolidated Financial Statements for the third quarter and first nine months of fiscal 2005 was $1.2 billion or $0.18 per diluted share, and $3.4 billion or $0.52 per diluted share, respectively. See Note 10 to the Consolidated Financial Statements for additional information.

Table of Contents

CISCO SYSTEMS, INC.

CONSOLIDATED BALANCE SHEETS

(in millions, except par value)

(Unaudited)

	April 29, 2006	July 30, 2005
ASSETS		
Current assets:		
Cash and cash equivalents	$ 4,237	$ 4,742
Investments	13,946	11,313
Accounts receivable, net of allowance for doubtful accounts of $180 at April 29, 2006 and $162 at July 30, 2005	2,980	2,216
Inventories	1,313	1,297
Deferred tax assets	1,484	1,475
Prepaid expenses and other current assets	1,527	967
Total current assets	25,487	22,010
Property and equipment, net	3,479	3,320
Goodwill	9,186	5,295
Purchased intangible assets, net	2,356	549
Other assets	2,574	2,709
TOTAL ASSETS	$ 43,082	$ 33,883
LIABILITIES AND SHAREHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 837	$ 735
Income taxes payable	1,346	1,511
Accrued compensation	1,431	1,317
Deferred revenue	4,300	3,854
Other accrued liabilities	2,516	2,094
Total current liabilities	10,430	9,511
Long-term debt	6,346	
Deferred revenue	1,188	1,188
Other long-term liabilities	495	
Total liabilities	18,459	10,699
Minority interest	8	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; 6,164 and 6,331 shares issued and outstanding at April 29, 2006 and July 30, 2005, respectively	24,132	22,394
Retained earnings	121	506
Accumulated other comprehensive income	362	274

Total shareholders equity	24,615	23,174
TOTAL LIABILITIES AND SHAREHOLDERS EQUITY	$ 43,082	$ 33,883

See Notes to Consolidated Financial Statements.

Table of Contents

CISCO SYSTEMS, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS

(in millions)

(Unaudited)

	Nine Months Ended	
	April 29, 2006	April 30, 2005
Cash flows from operating activities:		
Net income	$ 4,036	$ 4,201
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	856	757
Stock-based compensation expense related to employee stock options and employee stock purchases	839	
Stock-based compensation expense related to acquisitions and investments	75	120
Provision for doubtful accounts	22	3
Provision for inventory	125	161
Deferred income taxes	(79)	216
Tax benefits from employee stock option plans		196
Excess tax benefits from stock-based compensation	(385)	
In-process research and development	90	20
Net (gains) losses and impairment charges on investments	(74)	(83)
Other	31	
Change in operating assets and liabilities, net of effects of acquisitions:		
Accounts receivable	(588)	(407)
Inventories	54	(229)
Prepaid expenses and other current assets	(228)	24
Lease receivables, net	(98)	(123)
Accounts payable	(86)	41
Income taxes payable	273	277
Accrued compensation	65	(213)
Deferred revenue	414	315
Other accrued liabilities	240	(144)
Net cash provided by operating activities	5,582	5,132
Cash flows from investing activities:		
Purchases of investments	(17,154)	(15,088)
Proceeds from sales and maturities of investments	14,539	17,147
Acquisition of property and equipment	(595)	(470)
Acquisition of businesses, net of cash and cash equivalents	(5,347)	(611)
Change in investments in privately held companies	(158)	(160)
Purchase of minority interest of Cisco Systems, K.K. (Japan)	(25)	(9)
Other	(31)	92
Net cash (used in) provided by investing activities	(8,771)	901
Cash flows from financing activities:		
Issuance of common stock	1,282	592
Repurchase of common stock	(5,478)	(7,743)
Issuance of debt	6,481	

Excess tax benefits from stock-based compensation	385	
Other	14	37
Net cash provided by (used in) financing activities	2,684	(7,114)
Net decrease in cash and cash equivalents	(505)	(1,081)
Cash and cash equivalents, beginning of period	4,742	3,722
Cash and cash equivalents, end of period	$ 4,237	$ 2,641

See Notes to Consolidated Financial Statements.

5

Table of Contents

CISCO SYSTEMS, INC.

CONSOLIDATED STATEMENTS OF SHAREHOLDERS EQUITY

(in millions)

(Unaudited)

Nine Months Ended April 30, 2005	Shares of Common Stock	Common Stock and Additional Paid-In Capital	Retained Earnings	Accumulated Other Comprehensive Income	Total Shareholders Equity
BALANCE AT JULY 31, 2004	6,735	$ 22,450	$ 3,164	$ 212	$ 25,826
Net income			4,201		4,201
Change in unrealized gains and losses on investments, net of tax				16	16
Other				76	76
Comprehensive income					4,293
Issuance of common stock	62	592			592
Repurchase of common stock	(410)	(1,380)	(6,363)		(7,743)
Tax benefits from employee stock option plans		196			196
Purchase acquisitions	23	472			472
Stock-based compensation related to acquisitions and investments		120			120
BALANCE AT APRIL 30, 2005	6,410	$ 22,450	$ 1,002	$ 304	$ 23,756

Nine Months Ended April 29, 2006	Shares of Common Stock	Common Stock and Additional Paid-In Capital	Retained Earnings	Accumulated Other Comprehensive Income	Total Shareholders Equity
BALANCE AT JULY 30, 2005	6,331	$ 22,394	$ 506	$ 274	$ 23,174
Net income			4,036		4,036
Change in unrealized gains and losses on investments, net of tax				8	8
Other				80	80
Comprehensive income					4,124
Issuance of common stock	128	1,282			1,282
Repurchase of common stock	(296)	(1,057)	(4,421)		(5,478)
Tax benefits from employee stock option plans		418			418
Purchase acquisitions	1	187			187
Stock-based compensation expense related to employee stock options and employee stock purchases		833			833
Stock-based compensation expense related to acquisitions and investments		75			75
BALANCE AT APRIL 29, 2006	6,164	$ 24,132	$ 121	$ 362	$ 24,615

Supplemental Information

In September 2001, the Company s Board of Directors authorized a stock repurchase program. As of April 29, 2006, the Company s Board of Directors has authorized the repurchase of up to $35 billion of common stock under this program. For additional information regarding stock repurchases, see Note 9 to the Consolidated Financial Statements. The purchase price of shares of common stock repurchased was reflected as a reduction to retained earnings and common stock and additional paid-in capital. Issuance of common stock and the tax benefit related to employee stock option plans are recorded in shareholders equity as an increase to common stock and additional paid-in capital. The stock repurchases since the inception of this program are summarized in the table below (in millions):

	Shares of Common Stock	Common Stock and Additional Paid-In Capital	Retained Earnings	Accumulated Other Comprehensive Income	Total Shareholders Equity
Repurchases of common stock	1,792	$ 5,759	$ 26,872	$	$ 32,631

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 2006 and fiscal 2005 are 52-week fiscal years.

Basis of Presentation

The accompanying financial data as of April 29, 2006 and for the three and nine months ended April 29, 2006 and April 30, 2005 has been prepared by the Company, without audit, pursuant to the rules and regulations of the Securities and Exchange Commission (the SEC). Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States have been condensed or omitted pursuant to such rules and regulations. The July 30, 2005 Consolidated Balance Sheet was derived from audited financial statements, but does not include all disclosures required by accounting principles generally accepted in the United States. 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 Current Report on Form 8-K filed February 10, 2006.

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 April 29, 2006, results of operations for the three and nine months ended April 29, 2006 and April 30, 2005, and cash flows and shareholders equity for the nine months ended April 29, 2006 and April 30, 2005, as applicable, have been made. The results of operations for the three and nine months ended April 29, 2006 are not necessarily indicative of the operating results for the full fiscal year or any future periods.

Stock-Based Compensation Expense

On July 31, 2005, the Company adopted Statement of Financial Accounting Standards No. 123 (revised 2004), Share-Based Payment, (SFAS 123(R)) which requires the measurement and recognition of compensation expense for all share-based payment awards made to employees and directors including employee stock options and employee stock purchases related to the Employee Stock Purchase Plan (employee stock purchases) based on estimated fair values. SFAS 123(R) supersedes the Company s previous accounting under Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees (APB 25) for periods beginning in fiscal 2006. In March 2005, the SEC issued Staff Accounting Bulletin No. 107 (SAB 107) relating to SFAS 123(R). The Company has applied the provisions of SAB 107 in its adoption of SFAS 123(R).

The Company adopted SFAS 123(R) using the modified prospective transition method, which requires the application of the accounting standard as of July 31, 2005, the first day of the Company s fiscal year 2006. The

CISCO SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

Company s Consolidated Financial Statements as of and for the three and nine months ended April 29, 2006 reflect the impact of SFAS 123(R). In accordance with the modified prospective transition method, the Company s Consolidated Financial Statements for prior periods have not been restated to reflect, and do not include, the impact of SFAS 123(R). Stock-based compensation expense recognized under SFAS 123(R) for the three and nine months ended April 29, 2006 was $284 million and $914 million, respectively, which consisted of stock-based compensation expense related to employee stock options and employee stock purchases of $261 million and $839 million, respectively, and stock-based compensation expense related to acquisitions and investments of $23 million and $75 million, respectively. Stock-based compensation expense of $44 million and $120 million for the three and nine months ended April 30, 2005, respectively, was related to acquisitions and investments which the Company had been recognizing under previous accounting standards. There was no stock-based compensation expense related to employee stock options and employee stock purchases recognized during the three and nine months ended April 30, 2005. See Note 10 for additional information.

SFAS 123(R) requires companies to estimate the fair value of share-based payment awards on the date of grant using an option-pricing model. The value of the portion of the award that is ultimately expected to vest is recognized as expense over the requisite service periods in the Company s Consolidated Statement of Operations. Prior to the adoption of SFAS 123(R), the Company accounted for stock-based awards to employees and directors using the intrinsic value method in accordance with APB 25 as allowed under Statement of Financial Accounting Standards No. 123, Accounting for Stock-Based Compensation (SFAS 123). Under the intrinsic value method, no stock-based compensation expense had been recognized in the Company s Consolidated Statement of Operations, other than as related to acquisitions and investments, because the exercise price of the Company s stock options granted to employees and directors equaled the fair market value of the underlying stock at the date of grant.

Stock-based compensation expense recognized during the period is based on the value of the portion of share-based payment awards that is ultimately expected to vest during the period. Stock-based compensation expense recognized in the Company s Consolidated Statement of Operations for the three and nine months ended April 29, 2006 included compensation expense for share-based payment awards granted prior to, but not yet vested as of July 30, 2005 based on the grant date fair value estimated in accordance with the pro forma provisions of SFAS 123 and compensation expense for the share-based payment awards granted subsequent to July 30, 2005 based on the grant date fair value estimated in accordance with the provisions of SFAS 123(R). In conjunction with the adoption of SFAS 123(R), the Company changed its method of attributing the value of stock-based compensation to expense from the accelerated multiple-option approach to the straight-line single option method. Compensation expense for all share-based payment awards granted on or prior to July 30, 2005 will continue to be recognized using the accelerated multiple-option approach while compensation expense for all share-based payment awards granted subsequent to July 30, 2005 is recognized using the straight-line single-option method. As stock-based compensation expense recognized in the Consolidated Statement of Operations for the third quarter and first nine months of fiscal 2006 is based on awards ultimately expected to vest, it has been reduced for estimated forfeitures. SFAS 123(R) requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. In the Company s pro forma information required under SFAS 123 for the periods prior to fiscal 2006, the Company accounted for forfeitures as they occurred.

Upon adoption of SFAS 123(R), the Company also changed its method of valuation for share-based awards granted beginning in fiscal 2006 to a lattice-binomial option-pricing model (lattice-binomial model) from the Black-Scholes option-pricing model (Black-Scholes model) which was previously used for the Company s pro forma information required under SFAS 123. For additional information, see Note 10. The Company s

CISCO SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

determination of fair value of share-based payment awards on the date of grant using an option-pricing model is affected by the Company s stock price as well as assumptions regarding a number of highly complex and subjective variables. These variables include, but are not limited to, the Company s expected stock price volatility over the term of the awards, and actual and projected employee stock option exercise behaviors. Option-pricing models were developed for use in estimating the value of traded options that have no vesting or hedging restrictions and are fully transferable. Because the Company s employee stock options have certain characteristics that are significantly different from traded options, and because changes in the subjective assumptions can materially affect the estimated value, in management s opinion, the existing valuation models may not provide an accurate measure of the fair value of the Company s employee stock options. Although the fair value of employee stock options is determined in accordance with SFAS 123(R) and SAB 107 using an option-pricing model, that value may not be indicative of the fair value observed in a willing buyer/willing seller market transaction.

On November 10, 2005, the Financial Accounting Standards Board (FASB) issued FASB Staff Position No. FAS 123(R)-3 Transition Election Related to Accounting for Tax Effects of Share-Based Payment Awards. The Company has elected to adopt the alternative transition method provided in the FASB Staff Position for calculating the tax effects of stock-based compensation pursuant to SFAS 123(R). The alternative transition method includes simplified methods to establish the beginning balance of the additional paid-in capital pool (APIC pool) related to the tax effects of employee stock-based compensation, and to determine the subsequent impact on the APIC pool and Consolidated Statements of Cash Flows of the tax effects of employee stock-based compensation awards that are outstanding upon adoption of SFAS 123(R).

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 primarily consist of employee stock options and restricted common stock.

Statement of Financial Accounting Standards No. 128, Earnings per Share, requires that employee equity share options, nonvested shares and similar equity instruments granted by the Company be treated as potential common shares outstanding in computing diluted earnings per share. Diluted shares outstanding include the dilutive effect 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 amount the employee must pay for exercising stock options, the amount of compensation cost for future service that the Company has not yet recognized, and the amount of tax benefits that would be recorded in additional paid-in capital when the award becomes deductible are assumed to be used to repurchase shares.

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 (Continued)

(Unaudited)

3. Business Combinations

Acquisition of Scientific-Atlanta, Inc.

On February 24, 2006, Cisco completed the acquisition of Scientific-Atlanta, Inc. (the Acquisition), a global provider of set-top boxes, end-to-end video distribution networks and video system integration. Cisco believes video is emerging as the key strategic application in the service provider triple play bundle of consumer entertainment, communication and online services. Cisco believes the combined entity creates an end-to-end solution for carrier networks and the digital home and delivers large scale video systems to extend Cisco s commitment to and leadership in the service provider market.

Pursuant to the terms of the merger agreement, the Company paid a cash amount of $43.00 per share in exchange for each outstanding share of Scientific-Atlanta common stock and assumed each Scientific-Atlanta stock option which was outstanding immediately prior to the effective time of the merger. Each unvested Scientific-Atlanta stock option became fully vested immediately prior to the completion of the merger. The total Scientific-Atlanta stock options assumed converted into options to purchase approximately 32.1 million shares of Cisco common stock. The total purchase price of the Acquisition was as follows (in millions):

	Amount
Cash	$ 6,907
Fair value of Scientific-Atlanta, Inc. stock options assumed	163
Acquisition related transaction costs	17
Total purchase price	$ 7,087

The fair value of Scientific-Atlanta stock options assumed was determined using a lattice-binomial model. The use of the lattice-binomial model and method of determining the variables is consistent with the Company s valuation of stock options in accordance with SFAS 123(R). See Note 10 to the Consolidated Financial Statements. Under the purchase method of accounting, the total purchase price as shown in the table above is allocated to the tangible and identifiable intangible assets acquired and liabilities assumed based on their estimated fair values. The purchase price was allocated using the information currently available. The Company may adjust the preliminary purchase price allocation after obtaining more information regarding, among other things, asset valuations, liabilities assumed, and revisions of preliminary estimates. The purchase price allocation will be finalized in fiscal 2007.

Table of Contents

CISCO SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

The Company allocated the purchase price to tangible assets, liabilities and identifiable intangible assets acquired, as well as in-process research and development, based on their estimated fair values. The excess of purchase price over the aggregate fair values was recorded as goodwill. The fair value assigned to identifiable intangible assets acquired was based on estimates and assumptions determined by management. The acquired goodwill was assigned to each of the reportable segments. Purchased intangibles are amortized on a straight-line basis over their respective useful lives. The total preliminary allocation of the purchase price is as follows (in millions):

	Amount
Cash and cash equivalents	$ 1,747
Investments	137
Accounts receivable	195
Inventories	191
Property and equipment, net	254
Goodwill	3,757
Intangible assets	1,949
Other current and noncurrent assets	106
Accounts payable	(187)
Deferred revenue	(32)
Other current and long-term liabilities	(473)
Deferred tax liabilities, net	(645)
In-process research and development	88
Total preliminary purchase price allocation	$ 7,087

None of the goodwill recorded as part of the Scientific-Atlanta acquisition will be deductible for United States federal income tax purposes. Goodwill will be deductible for state income tax purposes in those states in which the Company elected to step up its basis in the acquired assets.

Intangible assets consist primarily of customer relationships, technology and other intangibles. The customer relationships intangible assets relate to Scientific-Atlanta s ability to sell existing, in-process and future versions of its products to its existing customers. Technology intangibles include a combination of patented and unpatented technology, trade secrets, and computer software that represent the foundation for current and planned new products. The following table presents details of the purchased intangible assets acquired as part of the Acquisition (in millions, except years):

Intangible Assets	Estimated Useful Life (in Years)	Amount
Customer relationships	7.0	$ 1,346
Technology	3.5	546
Other	2.0	57
Total		$ 1,949

Prior to the Company s acquisition of Scientific-Atlanta and as previously disclosed by Scientific-Atlanta in its filings with the SEC, the SEC and the U.S. Department of Justice had been examining the conduct of Scientific-Atlanta and certain officers and employees of Scientific-Atlanta with respect to agreements with

Table of Contents

CISCO SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

Adelphia Communications Corporation and Charter Communications, Inc. Scientific-Atlanta s financial statements and statements to its own investors are not at issue. Scientific-Atlanta has reached a tentative settlement with representatives of the staff of the SEC s Enforcement Division in connection with its investigation, which is subject to approval by the SEC. Under the proposed settlement, Scientific-Atlanta would agree without admitting or denying the allegations, to the entry of a court order that would enjoin any violations of certain reporting provisions of the federal securities laws and to pay $20 million. Reflecting the proposed settlement, this amount was included in other current liabilities in Scientific-Atlanta s balance sheet.

Pro forma financial information

The unaudited financial information in the table below summarizes the combined results of operations of Cisco and Scientific-Atlanta, on a pro forma basis, as though the companies had been combined as of the beginning of each of the periods presented. The pro forma financial information is presented for informational purposes only and is not indicative of the results of operations that would have been achieved if the Acquisition and issuance of $6.5 billion of debt in February 2006 (see Note 7 to the Consolidated Financial Statements) had taken place at the beginning of each of the periods presented. The pro forma financial information for the three and nine months ended April 29, 2006 also includes incremental stock-based compensation expense due to the acceleration of Scientific-Atlanta employee stock options prior to the Acquisition, investment banking fees, and other acquisition related costs, recorded in Scientific-Atlanta s historical results of operations during February 2006. The pro forma financial information for all periods presented also includes the purchase accounting adjustments on historical Scientific-Atlanta inventory, adjustments to depreciation on acquired property and equipment, a charge for in-process research and development, amortization charges from acquired intangible assets, adjustments to interest income and expense, and related tax effects.

The unaudited pro forma financial information for the three months ended April 29, 2006 combines the results for Cisco for the three months ended April 29, 2006, which include the results of Scientific-Atlanta subsequent to February 24, 2006 (the acquisition date), and the historical results for Scientific-Atlanta for the month ended February 24, 2006. The unaudited pro forma financial information for the nine months ended April 29, 2006 combines the results for Cisco for the nine months ended April 29, 2006, which include the results of Scientific-Atlanta subsequent to February 24, 2006, and the historical results for Scientific-Atlanta for the six months ended December 30, 2005 and the month ended February 24, 2006. The unaudited pro forma financial information for the three and nine months ended April 30, 2005 combines the historical results for Cisco for those periods, with the historical results for Scientific-Atlanta for the three and nine months ended April 1, 2005. The following table summarizes the pro forma financial information (in millions, except per share amounts):

	Three Months Ended		Nine Months Ended	
	April 29, 2006	April 30, 2005	April 29, 2006	April 30, 2005
Net sales	$ 7,485	$ 6,677	$ 21,648	$ 19,604
Net income	$ 1,299	$ 1,283	$ 3,822	$ 3,967
Basic earnings per share	$ 0.21	$ 0.20	$ 0.62	$ 0.61
Diluted earnings per share	$ 0.21	$ 0.20	$ 0.61	$ 0.60

The above pro forma results of operations include only the impacts of the Scientific-Atlanta acquisition, because the effects of the other acquisitions detailed below, individually and in the aggregate, were not material to the Company s results.

Table of Contents

CISCO SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

Other Purchase Acquisitions

During the third quarter of fiscal 2006, the Company also completed the following acquisition:

Acquisition of SyPixx Networks, Inc. to further develop the Company s portfolio of physical security products

During the second quarter of fiscal 2006, the Company completed the following acquisitions:

Acquisition of Intellishield Alert Manager, a unit of Cybertrust, to augment the Company s current portfolio of Security Lifecycle Services that are designed to assist customers in making their networks more secure

Purchase of select assets and intellectual property of Digital Fairway Corporation to develop a unified, automated Enterprise-class provisioning platform supporting the Company s range of enterprise IP communications products

During the first quarter of fiscal 2006, the Company completed the following acquisitions:

Acquisition of KiSS Technology A/S to develop networked entertainment products for the consumer

Purchase of the assets of Nemo Systems, Inc. to provide technology in the network memory space that is designed to allow customers to scale network systems and line card bandwidth while reducing the overall cost of networking systems

Acquisition of Sheer Networks, Inc. to provide technology that is designed to adapt to network changes, scale to large networks, and help extend new technologies and services to simplify the task of monitoring and maintaining complex networks

A summary of the purchase acquisitions, other than the Scientific-Atlanta acquisition, is as follows for the nine months ended April 29, 2006 (in millions):

Acquisition	Shares Issued	Purchase Consideration	Assumed Liabilities	In-Process R&D Expense	Purchased Intangible Assets	Goodwill
KiSS Technology A/S	1	$ 51	$ 18	$ 2	$ 19	$ 39
Nemo Systems, Inc.		5	1		10	
Sheer Networks, Inc.		96	7		29	56
Intellishield Alert Manager		15			5	10
Digital Fairway		13			13	
SyPixx Networks, Inc.		37	3		12	29

Total	1	$ 217	$ 29	$ 2	$ 88	$ 134

Under the terms of the definitive agreements, the purchase consideration for the acquisitions in the first nine months of fiscal 2006 consisted of cash and shares of Cisco common stock and stock options assumed. The Consolidated Financial Statements include the operating results of each business from the date of acquisition. Pro forma results of operations for these acquistions have not been presented because the effects of the acquisitions, individually or in the aggregate, were not material to the Company s results.

Table of Contents

CISCO SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

In-Process Research and Development

The Company s methodology for allocating the purchase price for purchase acquisitions to in-process research and development (in-process R&D) is determined through established valuation techniques in the high-technology communications equipment industry. In-process R&D is expensed upon acquisition because technological feasibility has not been established and no future alternative uses exist. Total in-process R&D expense was $88 million and $6 million for the three months ended April 29, 2006 and April 30, 2005, respectively. Total in-process R&D expense was $90 million and $20 million for the nine months ended April 29, 2006 and April 30, 2005, respectively. The acquisition of Scientific-Atlanta accounted for $88 million of the in-process R&D during the three and nine months ended April 29, 2006, which related primarily to projects associated with Scientific-Atlanta s advanced models of digital set-tops, network software enhancements and upgrades, and data products and transmission products.

Purchased Intangible Assets

The following table presents details of the purchased intangible assets acquired during the nine months ended April 29, 2006 (in millions, except years):

	Technology		Customer Relationships		Other		
Acquisition	**Weighted Average Useful Life (in Years)**	**Amount**	**Weighted Average Useful Life (in Years)**	**Amount**	**Weighted Average Useful Life (in Years)**	**Amount**	**Total**
KiSS Technology A/S	4.5	$ 11	5.5	$ 6	5.0	$ 2	$ 19
Nemo Systems, Inc.	4.5	10					10
Sheer Networks, Inc.	4.5	16	6.0	11	4.5	2	29
Intellishield Alert Manager	4.0	2	7.0	3			5
Digital Fairway	5.5	13					13
Scientific-Atlanta, Inc.	3.5	546	7.0	1,346	2.0	57	1,949
SyPixx Networks, Inc.	5.0	7	5.0	5			12
Total		$ 605		$ 1,371		$ 61	$ 2,037

14

Table of Contents

CISCO SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

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

	Gross	Accumulated Amortization	Net
April 29, 2006			
Technology	$ 1,096	$ (251)	$ 845
Customer relationships	1,565	(124)	1,441
Trade names	68	(30)	38
Other	98	(66)	32
Total	$ 2,827	$ (471)	$ 2,356
July 30, 2005			
Technology	$ 880	$ (501)	$ 379
Customer relationships	188	(53)	135
Trade names	64	(35)	29
Other	66	(60)	6
Total	$ 1,198	$ (649)	$ 549

The estimated future amortization expense of purchased intangible assets as of April 29, 2006 is as follows (in millions):

Fiscal Year	Amount
2006 (remaining three months)	$ 149
2007	535
2008	482
2009	392
2010	280
Thereafter	518
Total	$ 2,356

Table of Contents

CISCO SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

Goodwill

Beginning in fiscal 2006, the Company s reportable segments were changed to the following theaters: United States and Canada, European Markets, Emerging Markets, Asia Pacific, and Japan. As a result, the Company reallocated goodwill at July 31, 2005 to these reportable segments. The following table presents the changes in goodwill allocated to the Company s reportable segments during the nine months ended April 29, 2006 (in millions):

	Balance at July 31, 2005	Goodwill recorded as part of the Scientific-Atlanta acquisition	Goodwill recorded as part of other acquisitions	Other	Balance at April 29, 2006
United States and Canada	$ 3,304	$ 3,135	$ 97	$ (30)	$ 6,506
European Markets	744	340	20	8	1,112
Emerging Markets	253	282	8		543
Asia Pacific	266		8		274
Japan	728		23		751
Total	$ 5,295	$ 3,757	$ 156	$ (22)	$ 9,186

In the table above, Goodwill recorded as part of other acquisitions includes $22 million of goodwill recorded as part of the Company s purchase of the remaining portion of the minority interest of Cisco Systems, K.K. (Japan) during the first quarter of fiscal 2006, and Other in the table above includes currency translation adjustments and adjustments related to income taxes.

Compensation Expense Related to Acquisitions and Investments

The following table presents the compensation expense related to acquisitions and investments (in millions):

	Three Months Ended		Nine Months Ended	
	April 29, 2006	April 30, 2005	April 29, 2006	April 30, 2005
Stock-based compensation related to acquisitions and investments	$ 23	$ 44	$ 75	$ 120
Cash compensation related to acquisitions and investments	9	3	27	6
Total	$ 32	$ 47	$ 102	$ 126

Compensation Expense Related to Purchase Acquisitions

In connection with the Company s purchase acquisitions and asset purchases, the Company has agreed to pay certain additional amounts of up to $90 million in cash contingent upon achieving certain agreed-upon technology, development, product, or other milestones or continued employment of certain employees with the Company. In each case, any additional amounts paid will be recorded as compensation expense. During the third quarter and first nine months of fiscal 2006, the Company recorded $4 million and $15 million, respectively, of additional

compensation expense pursuant to these agreements, and as of April 29, 2006, the Company has recorded an aggregate of $15 million of additional compensation expense pursuant to these agreements.

Table of Contents

CISCO SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

Beginning in fiscal 2006, stock-based compensation expense related to purchase acquisitions is calculated under SFAS 123(R) and recognized over the remaining vesting periods. During the third quarter and the first nine months of fiscal 2006, the Company recorded stock-based compensation expense of $23 million and $75 million, respectively, related to acquisitions and investments and credited additional paid-in capital. Prior to fiscal 2006, a portion of the purchase consideration for purchase acquisitions was recorded as deferred stock-based compensation. Deferred stock-based compensation represented 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 was amortized as stock-based compensation expense related to acquisitions over the remaining respective vesting periods. The balance for deferred stock-based compensation was reflected as a reduction to 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 April 30, 2005 (in millions):

	Three Months Ended April 30, 2005	Nine Months Ended April 30, 2005
Balance at beginning of period	$ 148	$ 153
Purchase acquisitions	23	94
Amortization	(30)	(106)
Canceled unvested options	(3)	(3)
Balance at end of period	$ 138	$ 138

Compensation Expense Relating to Acquisitions of Variable Interest Entities

In connection with the Company s acquisitions of variable interest entities, the Company has agreed to pay certain additional amounts of up to $180 million in cash contingent upon achieving certain agreed-upon technology, development, product, or other milestones or continued employment of certain employees with the Company. In each case, any additional amounts paid will be recorded as compensation expense. During the third quarter and first nine months of fiscal 2006, the Company recorded $5 million and $12 million, respectively, of additional compensation expense pursuant to these agreements. As of April 29, 2006, the Company has recorded an aggregate of $22 million of additional compensation expense pursuant to these agreements.

Table of Contents

CISCO SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

4. Balance Sheet Details

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

	April 29, 2006	July 30, 2005
Inventories		
Raw materials	$ 164	$ 82
Work in process	336	431
Finished goods:		
Distributor inventory and deferred cost of sales	411	385
Manufacturing finished goods	208	184
Total finished goods	619	569
Service-related spares	158	180
Demonstration systems	36	35
Total	$ 1,313	$ 1,297
Property and equipment, net		
Land, buildings, and leasehold improvements	$ 3,625	$ 3,492
Computer equipment and related software	1,336	1,244
Production, engineering, and other equipment	3,589	3,095
Operating lease assets	143	136
Furniture and fixtures	360	355
	9,053	8,322
Less, accumulated depreciation and amortization	(5,574)	(5,002)
Total	$ 3,479	$ 3,320
Other assets		
Deferred tax assets	$ 856	$ 1,308
Investments in privately held companies	548	421
Income tax receivable	279	277
Lease receivables, net	398	353
Other	493	350
Total	$ 2,574	$ 2,709
Deferred revenue		
Service	$ 3,938	$ 3,618
Product		
Unrecognized revenue on product shipments and other deferred revenue	1,145	1,201
Cash receipts related to unrecognized revenue from two-tier distributors	405	223

	1,550	1,424
Total	$ 5,488	$ 5,042
Reported as:		
Current	$ 4,300	$ 3,854
Noncurrent	1,188	1,188
Total	$ 5,488	$ 5,042

Table of Contents

CISCO SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

5. Lease Receivables, Net

Lease receivables represent sales-type and direct-financing leases resulting from the sale of the Company s and complementary third-party products and services. These lease arrangements typically have terms from two to three years and are generally collateralized by a security interest in the underlying assets. The current portion of lease receivables, net, is recorded in prepaid expenses and other current assets, and the noncurrent portion is recorded in other assets in the Consolidated Balance Sheets. The net lease receivables are summarized as follows as of April 29, 2006 and July 30, 2005 (in millions):

	April 29, 2006	July 30, 2005
Gross lease receivables	$ 863	$ 731
Unearned income and other allowances	(164)	(130)
Total	$ 699	$ 601
Reported as:		
Current	$ 301	$ 248
Noncurrent	398	353
Total	$ 699	$ 601

Contractual maturities of the gross lease receivables at April 29, 2006 were as follows (in millions):

Fiscal Year	Amount
2006 (remaining three months)	$ 119
2007	294
2008	204
2009	96
2010	69
Thereafter	81
Total	$ 863

Actual cash collections may differ from the contractual maturities due to early customer buyouts, refinancings, or defaults.

Table of Contents

CISCO SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

6. Investments

The following tables summarize the Company s investments (in millions):

April 29, 2006	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Fixed income securities:				
U.S. government notes and bonds	$ 4,955	$	$ (54)	$ 4,901
Corporate notes, bonds, and asset-backed securities	7,240	2	(87)	7,155
Municipal notes and bonds	807		(3)	804
Total fixed income securities	13,002	2	(144)	12,860
Publicly traded equity securities and mutual funds	740	348	(2)	1,086
Total	$ 13,742	$ 350	$ (146)	$ 13,946

July 30, 2005	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Fixed income securities:				
U.S. government notes and bonds	$ 3,453	$ 2	$ (25)	$ 3,430
Corporate notes, bonds, and asset-backed securities	6,299	3	(63)	6,239
Municipal notes and bonds	705		(2)	703
Total fixed income securities	10,457	5	(90)	10,372
Publicly traded equity securities	514	433	(6)	941
Total	$ 10,971	$ 438	$ (96)	$ 11,313

Effective October 29, 2005 the Company changed the method of classification of its investments previously classified as long-term investments to current assets and prior period balances have been reclassified to conform to the current period s presentation. This new method classifies these securities as current or long-term based on the nature of the securities and the availability for use in current operations while the prior classification was based on the maturities of the investments. The Company believes this method is preferable because it is more reflective of the Company s assessment of its overall liquidity position. In conjunction with this change in classification of investments, the Company changed the classification of deferred taxes related to the unrealized gains and losses on long-term investments from noncurrent assets to current assets.

The following table summarizes the maturities of the Company s fixed income securities at April 29, 2006 (in millions):

	Amortized Cost	Fair Value

Less than one year	$ 3,250	$ 3,240
Due in 1 to 2 years	3,364	3,333
Due in 2 to 5 years	5,314	5,220
Due after 5 years	1,074	1,067
Total	$ 13,002	$ 12,860

CISCO SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

Actual maturities may differ from the contractual maturities because borrowers have the right to call or prepay certain obligations.

7. Borrowings

In February 2006, the Company issued $500 million of senior floating interest rate notes due 2009 (the 2009 Notes), $3 billion of 5.25% senior notes due 2011 (the 2011 Notes) and $3 billion of 5.50% senior notes due 2016 (the 2016 Notes), for an aggregate principal amount of $6.5 billion. The 2011 Notes and the 2016 Notes are redeemable by the Company at any time, subject to a make-whole premium. To achieve its interest rate risk management objectives, the Company entered into $6 billion notional amount of interest rate swaps. In effect, these swaps convert the fixed interest rates of the 2011 Notes and the 2016 Notes to floating interest rates based on the London InterBank Offered Rate (LIBOR). Gains and losses in the value of the interest rate swaps offset changes in the fair value of the underlying debt. See Note 8 to the Consolidated Financial Statements. As of April 29, 2006, the Company was in compliance with all debt-related covenants.

The following table summarizes the Company s long-term debt (in millions):

	April 29, 2006	Effective Rate(1)
2009 Notes	$ 500	4.85%
2011 Notes	3,000	4.97%
2016 Notes	3,000	5.20%
Other	5	
Aggregate principal amount	6,505	
Unamortized discount	(19)	
SFAS 133 fair value adjustment	(140)	
Total	$ 6,346	

(1) The effective rate for the fixed-rate notes reflects the variable rate in effect as of April 29, 2006 on the interest rate swaps designated as a fair value hedges of the fixed-rate notes, plus the amortization of the discount.

Interest is payable quarterly on the 2009 Notes and semi-annually on the 2011 Notes and 2016 Notes. Interest expense, net of the effects of hedging, was $60 million for the three and nine months ended April 29, 2006 and was included in interest income, net in the Consolidated Statements of Operations. There was no cash paid for interest during the three and nine months ended April 29, 2006. Using available market data, the fair value of the notes approximated the book value as of April 29, 2006.

Table of Contents

CISCO SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

8. Commitments and Contingencies

Operating Leases

The Company leases office space in several U.S. locations, as well as locations in Canada; European Markets; Emerging Markets; Asia Pacific; and Japan. Future annual minimum lease payments under all noncancelable operating leases with an initial term in excess of one year as of April 29, 2006 were as follows (in millions):

Fiscal Year	Amount
2006 (remaining three months)	$ 66
2007	205
2008	147
2009	111
2010	99
Thereafter	583
Total	$ 1,211

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 manage manufacturing lead times and 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 is firm, noncancelable, and unconditional commitments. As of April 29, 2006, the Company had total purchase commitments for inventory of approximately $1.7 billion, compared with $954 million as of July 30, 2005.

In addition to the above, the Company records a liability for firm, noncancelable, and unconditional purchase commitments for quantities in excess of its future demand forecasts consistent with the Company s allowance for inventory. As of April 29, 2006, the liability for these firm, noncancelable, and unconditional purchase commitments was $153 million, compared with $107 million as of July 30, 2005, and was included in other accrued liabilities.

Other Commitments

The Company has entered into an agreement to invest approximately $800 million in venture funds managed by SOFTBANK Corp. and its affiliates (SOFTBANK) that are required to be funded on demand. The total commitment is to be invested in venture funds and 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 April 29, 2006, the Company had invested $516 million in the venture funds pursuant to the commitment, compared with $414 million as of July 30, 2005. In addition, as of April 29, 2006, the Company had invested $49 million in the senior debt pursuant to the commitment, all of which has been repaid. As of July 30, 2005, the Company had invested $49 million in the senior debt pursuant to the commitment, of which $47 million had been repaid.

Table of Contents

CISCO SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

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. These funding commitments were approximately $46 million as of April 29, 2006, compared with approximately $56 million as of July 30, 2005.

Variable Interest Entities

In the ordinary course of business, the Company has investments in privately held companies and provides financing to certain customers through its wholly owned subsidiaries, which may be considered to be variable interest entities. The Company has evaluated its investments in privately held companies and customer financings and determined that there were no significant unconsolidated variable interest entities as of April 29, 2006.

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 issued subject to the recognition and disclosure requirements of FIN 45 as of April 29, 2006 and July 30, 2005 were not material. As of April 29, 2006 and July 30, 2005, the Company s product warranty liability recorded in other accrued liabilities was $299 million and $259 million, respectively. The following table summarizes the activity related to the product warranty liability during the nine months ended April 29, 2006 and April 30, 2005 (in millions):

	Nine Months Ended	
	April 29, 2006	**April 30, 2005**
Balance at beginning of period	$ 259	$ 239
Provision for warranties issued	283	303
Fair value of warranty liability acquired from Scientific-Atlanta	44	
Payments	(287)	(291)
Balance at end of period	$ 299	$ 251

The Company accrues for warranty costs as part of its cost of sales based on associated material product costs, technical support labor costs, and associated overhead. The products sold are generally covered by a warranty for periods ranging from 90 days to five years, and for some products, the Company provides a limited lifetime warranty. The provision for warranties during the nine months ended April 29, 2006 included $6 million of stock-based compensation expense related to employee stock options and employee stock purchases under SFAS 123(R).

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 parties 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.

CISCO SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

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 effect on the Company s operating results, financial position, or cash flows.

Derivative Instruments

The Company uses derivative instruments to manage exposures to foreign currency, interest rate, and equity security price risks. The Company s objective in holding derivatives is to reduce the volatility of earnings and cash flows associated with changes in foreign currency, interest rates, and equity security prices. The Company s derivatives expose it to credit risk to the extent that the counterparties may be unable to meet the terms of the agreement. The Company seeks to reduce such risks 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 material losses as a result of defaults by counterparties.

Foreign Currency Derivatives

The Company conducts business globally 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 reduce the short-term effects 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, net, in the Consolidated Statements of Operations and offset foreign exchange gains and losses from the revaluation of intercompany balances or other current assets, investments, or 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 with maturities of up to two years related to long-term customer financings. 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 and forward contracts. 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 and subsequently reclassified into earnings when the hedged exposure affects earnings. The ineffective portion, if any, 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 April 29, 2006 and July 30, 2005 are summarized as follows (in millions):

	April 29, 2006		July 30, 2005	
	Notional	**Fair Value**	**Notional**	**Fair Value**
Forward contracts:				
Purchased	$ 1,402	$ 2	$ 1,011	$ (5)
Sold	$ 655	$ (6)	$ 450	$ 9
Option contracts:				
Purchased	$ 393	$ 14	$ 1,028	$ 10
Sold	$ 485	$ (1)	$ 1,002	$ (7)

Table of Contents

CISCO SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

Interest Rate Derivatives

The Company s primary objective for holding fixed income and debt securities is to achieve an appropriate investment return consistent with preserving principal and managing risk. To realize these objectives, the Company may utilize interest rate swaps or other derivatives designated as fair value or cash flow hedges. The Company has entered into $1 billion of interest rate swaps designated as fair value hedges of its investment portfolio. Under these interest rate swap contracts, the Company makes fixed-rate interest payments and receives interest payments based on LIBOR. The effect of these swaps is to convert fixed-rate returns to floating-rate returns based on LIBOR for a portion of the Company s fixed income portfolio. The gains and losses related to changes in the value of the interest rate swaps are included in other income, net, in the Consolidated Statements of Operations and offset the changes in fair value of the underlying hedged investment. As of April 29, 2006 and July 30, 2005, the fair values of the interest rate swaps designated as hedges of the Company s investments were $44 million and $15 million, respectively, and were reflected in prepaid expenses and other current assets in the Consolidated Balance Sheets.

In conjunction with its issuances of fixed rate senior notes in February 2006, the Company entered into $6 billion of interest rate swaps designated as fair value hedges of the fixed rate debt. Under these interest rate swap contracts, the Company receives fixed-rate interest payments and makes interest payments based on LIBOR plus a fixed number of basis points. The effect of these swaps is to convert fixed-rate interest expense to a floating rate interest expense based on LIBOR. The gains and losses related to changes in the value of the interest rate swaps are included in other income, net, in the Consolidated Statements of Operations and offset the changes in fair value of the underlying hedged debt. As of April 29, 2006 the fair value of the interest rate swaps was $140 million and was reflected in other long-term liabilities in the Consolidated Balance Sheets.

Equity Derivatives

The Company maintains a portfolio of publicly traded equity securities which are subject to price risk. The Company may hold equity securities for strategic purposes or to provide diversification for the Company s overall investment portfolio. In order to manage its exposure to changes in the fair value of certain equity securities, the Company may, from time to time, enter into equity derivative contracts. As of April 29, 2006, the Company had entered into forward sale and option agreements on certain publicly traded equity securities designated as fair value hedges. The gains and losses due to changes in the value of the hedging instruments are included in other income, net, in the Consolidated Statements of Operations and offset the change in the fair value of the underlying hedged investment. As of April 29, 2006, the notional and fair value amounts of the derivatives were $198 million and $113 million, respectively. As of July 30, 2005, the notional and fair value amounts of the derivatives were $198 million and $19 million, respectively.

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 the Company 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. The Company believes the claims are without merit and intend to defend the actions vigorously. While the Company believes there is no legal basis for liability, due to the uncertainty surrounding the litigation process, the Company is unable to reasonably estimate a range of loss, if any, at this time.

CISCO SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

On February 16, 2005, a purported shareholder derivative lawsuit was filed in the Superior Court of California, County of Santa Clara, against various of the Company s officers and directors and naming the Company as a nominal defendant. The lawsuit includes claims for breach of fiduciary duty, unjust enrichment, constructive trust and violations of the California Corporations Code, is based upon allegations of wrongdoing in connection with option grants and compensation to officers and directors, the timing of option grants, and the Company s stock repurchase program, and seeks unspecified compensation and other damages, rescission of options and other relief.

In addition, the Company is subject to legal proceedings, claims, and litigation arising in the ordinary course of business, including intellectual property litigation. 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.

9. Shareholders Equity

Stock Repurchase Program

In September 2001, the Company s Board of Directors authorized a stock repurchase program. As of April 29, 2006, the Company s Board of Directors had authorized the repurchase of up to $35 billion of common stock under this program. During the first nine months of fiscal 2006, the Company repurchased and retired 296 million shares of Cisco common stock at an average price of $18.48 per share for an aggregate purchase price of $5.5 billion. As of April 29, 2006, the Company had repurchased and retired 1.8 billion shares of Cisco common stock for an average price of $18.21 per share for an aggregate purchase price of $32.6 billion since inception of the stock repurchase program, and the remaining authorized amount for stock repurchases under this program was $2.4 billion with no termination date.

The purchase price for the shares of the Company s stock repurchased was reflected as a reduction to shareholders equity. In accordance with Accounting Principles Board Opinion No. 6, Status of Accounting Research Bulletins, the Company is required to allocate the purchase price of the repurchased shares as a reduction to retained earnings and common stock and additional paid-in capital.

Comprehensive Income

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

	Three Months Ended		Nine Months Ended	
	April 29, 2006	**April 30, 2005**	**April 29, 2006**	**April 30, 2005**
Net income	$ 1,400	$ 1,405	$ 4,036	$ 4,201
Other comprehensive income:				
Change in unrealized gains and losses on investments, net of tax	1	(43)	9	(62)
Other	40	(14)	80	76
Other comprehensive income before minority interest	1,441	1,348	4,125	4,215
Change in minority interest	(4)		(1)	78
Total	$ 1,437	$ 1,348	$ 4,124	$ 4,293

Table of Contents

CISCO SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

10. Employee Benefit Plans

Employee Stock Purchase Plan

The Company has an Employee Stock Purchase Plan, which includes its sub-plan, the International Employee Stock Purchase Plan (together the Purchase Plan), under which 321.4 million shares of the Company s stock have been reserved for issuance. Eligible employees may purchase a limited number of shares of the Company s stock at a discount of up to 15% of the market value at certain plan-defined dates. The Purchase Plan terminates on January 3, 2010. The Company did not issue any shares under the Purchase Plan during the three months ended April 29, 2006 and April 30, 2005. During the nine months ended April 29, 2006 and April 30, 2005, the Company issued 11 million and 10 million shares, respectively, under the Purchase Plan. At April 29, 2006, 109 million shares were available for issuance under the Purchase Plan.

Employee Stock Option Plans

Stock Option Program Description

As of April 29, 2006, the Company had four stock incentive plans: the 2005 Stock Incentive Plan (the 2005 Plan), the 1996 Stock Incentive Plan (the 1996 Plan), the 1997 Supplemental Stock Incentive Plan (the Supplemental Plan), and the Cisco Systems, Inc. SA Acquisition Long-Term Incentive Plan (the Acquisition 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.

The maximum number of shares issuable over the term of the 2005 Plan is limited to 350 million shares. The 2005 Plan permits the granting of stock options, stock grants, stock units and stock appreciation rights to employees (including employee directors and officers) and consultants of the Company and its subsidiaries and affiliates, and non-employee directors of the Company. Options granted under the 2005 Plan have an exercise price of at least 100% of the fair market value of the underlying stock on the grant date and expire no later than nine years from the grant date. The options will generally become exercisable for 20% of the option shares one year from the date of grant and then ratably over the following 48 months. The Compensation and Management Development Committee of the Board of Directors has the discretion to use a different vesting schedule. Stock appreciation rights may be awarded in combination with stock options or stock grants and such awards shall provide that the stock appreciation rights will not be exercisable unless the related stock options or stock grants are forfeited. Stock grants may be awarded in combination with nonstatutory stock options, and such awards may provide that the stock grants will be forfeited in the event that the related nonstatutory stock options are exercised.

The maximum number of shares issuable over the term of the 1996 Plan is limited to 2.5 billion shares. Options granted under the 1996 Plan have an exercise price equal to the fair market value of the underlying stock on the grant date and expire no later than nine years from the grant date. The options will generally become exercisable for 20% or 25% of the option shares one year from the date of grant and then ratably over the following 48 or 36 months, respectively. Certain other grants have utilized a 60-month ratable vesting schedule. In addition, the Board of Directors, or other committee administering the plan, has the discretion to use a different vesting schedule and has done so from time to time. Since the inception of the 1996 Plan, the Company has granted options to virtually all employees, and the majority has been granted to employees below the vice president level.

CISCO SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

In 1997, the Company adopted the Supplemental Plan, under which options can be granted or shares can be directly issued to eligible employees. Officers and members of the Company s Board of Directors are not eligible to participate in the Supplemental Plan. Nine million shares have been reserved for issuance under the Supplemental Plan, of which 3 million options were granted. All option grants have an exercise price equal to the fair market value of the underlying stock on the grant date. The Company no longer makes option grants or direct share issuances under the Supplemental Plan.

Effective upon completion of the Company s acquisition of Scientific-Atlanta, the Company adopted the Acquisition Plan. The Acquisition Plan constitutes an assumption, amendment, restatement and renaming of the 2003 Long-Term Incentive Plan of Scientific-Atlanta. The Acquisition Plan permits the grant of options, stock grants, stock units and stock appreciation rights to certain employees of the Company and its subsidiaries and affiliates who had been employed by Scientific-Atlanta or its subsidiaries. An aggregate of 14.8 million shares of the Company s common stock had been reserved and are available for issuance under the Acquisition Plan on a discretionary basis, subject to limitations set forth in the Acquisition Plan.

Distribution and Dilutive Effect of Options

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

	Nine Months Ended	
	April 29, 2006	**April 30, 2005**
Shares of common stock outstanding	6,164	6,410
Granted and assumed	219	214
Canceled/forfeited/expired	(67)	(47)
Net options granted	152	167
Grant dilution(1)	2.5%	2.6%
Exercised	118	52
Exercise dilution(2)	1.9%	0.8%

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 April 29, 2006 were 6.2 billion shares and 6.3 billion shares, respectively. Statement of Financial Accounting Standards No. 128, Earnings per Share, requires that employee equity share options, nonvested shares and similar equity instruments granted by the Company are treated as potential common shares in computing diluted earnings per share. Diluted shares outstanding include the dilutive effect 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 amount that the employee must pay for exercising stock options, the amount of compensation cost for future service that the Company has not yet recognized, and the amount of tax benefits that would be recorded in additional paid-in capital when the award becomes deductible are assumed to be used to repurchase shares. During the nine months ended April 29, 2006, the dilutive effect of in-the-money employee stock options was approximately 119 million shares or 1.9% of the basic shares outstanding based on the Company s average share price of $18.74.

Table of Contents

CISCO SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

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 year ended July 30, 2005 and July 31, 2004, respectively, were in excess of $100,000. The following table summarizes the options granted to the Named Executive Officers during the periods indicated (in millions, except percentages):

	Nine Months Ended	
	April 29, 2006	April 30, 2005
Options granted to the Named Executive Officers	2.9	4.0
Options granted to the Named Executive Officers as a % of net options granted	1.9%	2.3%
Options granted to the Named Executive Officers as a % of outstanding shares	0.05%	0.06%
Cumulative options held by Named Executive Officers as % of total options outstanding	3.3%	3.7%

General Option Information

A summary of option activity follows (in millions, except per-share amounts):

		Options Outstanding	
	Options Available for Grant	Number Outstanding	Weighted-Average Exercise Price per Share
Balance at July 31, 2004	390	1,350	$ 25.34
Granted and assumed	(244)	244	18.70
Exercised		(93)	8.44
Canceled/forfeited/expired	63	(65)	31.63
Additional shares reserved	14		
Balance at July 30, 2005	223	1,436	$ 25.02
Granted and assumed	(219)	219	18.18
Exercised		(118)	9.53
Canceled/forfeited/expired	64	(67)	29.72
Additional shares reserved	398		
Balance at April 29, 2006	466	1,470	$ 25.03

The total pretax intrinsic value of options exercised during the three months and nine months ended April 29, 2006 was $736 million and $1.1 billion, respectively. The Company has, in connection with the acquisitions of various companies, assumed the stock option plans of the acquired companies or issued replacement options.

Table of Contents

CISCO SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

The following table summarizes significant ranges of outstanding and exercisable options as of April 29, 2006 (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 13.04	211	4.02	$ 10.83	$ 2,135	157	$ 10.76	$ 1,599
13.05 17.70	187	4.97	15.90	941	142	15.79	731
17.71 18.57	226	7.23	18.05	654	60	18.49	147
18.58 19.31	184	7.34	19.14	331	53	19.13	96
19.32 20.53	200	5.90	19.86	217	116	19.98	112
20.54 38.06	190	3.73	26.63	3	157	27.55	1
38.07 72.56	272	3.13	54.71		272	54.71	
Total	1,470	5.10	$ 25.03	$ 4,281	957	$ 28.80	$ 2,686

The aggregate intrinsic value in the preceding table represents the total pretax intrinsic value, based on options with an exercise price less than the Company s closing stock price of $20.95 as of April 29, 2006, which would have been received by the option holders had those option holders exercised their options as of that date. The total number of in-the-money options exercisable as of April 29, 2006 was 529 million. As of July 30, 2005, 906 million outstanding options were exercisable, and the weighted average exercise price was $28.80.

The following table presents the option exercises for the nine months ended April 29, 2006, and option values as of that date for the Named Executive Officers (in millions):

			Number of Securities Underlying Unexercised Options at April 29, 2006		Intrinsic Value of Unexercised In-the-Money Options at April 29, 2006	
	Number of Shares Acquired on Exercise	Value Realized	Exercisable	Unexercisable	Exercisable	Unexercisable
Named Executive Officers	10	$ 108	39	9	$ 104	$ 28

Table of Contents

CISCO SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

Valuation and Expense Information under SFAS 123(R)

On July 31, 2005, the Company adopted SFAS 123(R), which requires the measurement and recognition of compensation expense for all share-based payment awards made to the Company s employees and directors including employee stock options and employee stock purchases related to the Purchase Plan based on estimated fair values. The following table summarizes stock-based compensation expense, and the related tax benefit, related to employee stock options and employee stock purchases under SFAS 123(R) for the three and nine months ended April 29, 2006 which was allocated as follows (in millions):

	Three Months Ended		Nine Months Ended	
	April 29, 2006	April 30, 2005	April 29, 2006	April 30, 2005
Cost of sales product	$ 11	$	$ 41	$
Cost of sales service	28		90	
Stock-based compensation expense included in cost of sales	39		131	
Research and development	86		279	
Sales and marketing	107		340	
General and administrative	29		89	
Stock-based compensation expense included in operating expenses	222		708	
Total stock-based compensation expense related to employee stock options and employee stock purchases	261		839	
Tax benefit	(73)		(235)	
Stock-based compensation expense related to employee stock options and employee stock purchases, net of tax	$ 188	$	$ 604	$

Stock-based compensation of $23 million and $75 million related to acquisitions and investments for the three and nine months ended April 29, 2006 is disclosed in Note 3 and is not included in the above table. There was no stock-based compensation expense recognized for the three and nine months ended April 30, 2005 other than as related to acquisitions and investments. As of April 29, 2006, total compensation cost related to nonvested stock options not yet recognized was $1.9 billion which is expected to be recognized over the next 38 months on a weighted-average basis.

Table of Contents

CISCO SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

The table below reflects net income and diluted net income per share for the three and nine months ended April 29, 2006 compared with the pro forma information for the three and nine months ended April 30, 2005 as follows (in millions except per-share amounts):

	Three Months Ended		Nine Months Ended	
	April 29, 2006	April 30, 2005	April 29, 2006	April 30, 2005
Net income as reported for prior periods(1)	N/A	$ 1,405	N/A	$ 4,201
Stock-based compensation expense related to employee stock options and employee stock purchases	$ (261)	(377)	$ (839)	(1,265)
Tax benefit	$ 73	151	$ 235	506
Stock-based compensation expense related to employee stock options and employee stock purchases, net of tax(2)	$ (188)	(226)	$ (604)	(759)
Net income, including the effect of stock-based compensation expense(3)	$ 1,400	1,179	$ 4,036	3,442
Diluted net income per share as reported for prior periods(1)	N/A	$ 0.21	N/A	$ 0.63
Diluted net income per share, including the effect of stock-based compensation expense(3)	$ 0.22	$ 0.18	$ 0.64	$ 0.52

(1) Net income and net income per share prior to fiscal 2006 did not include stock-based compensation expense for employee stock options and employee stock purchases under SFAS 123 because the Company did not adopt the recognition provisions of SFAS 123.
(2) Stock-based compensation expense prior to fiscal 2006 is calculated based on the pro forma application of SFAS 123.
(3) Net income and net income per share prior to fiscal 2006 represents pro forma information based on SFAS 123.

Stock-based compensation expense, net of tax, in the table above includes the effects of new U.S. tax regulations effective in fiscal 2005 that require intercompany reimbursement of certain stock-based compensation expenses.

Upon adoption of SFAS 123(R), the Company began estimating the value of employee stock options on the date of grant using a lattice-binomial model. Prior to the adoption of SFAS 123(R), the value of each employee stock option was estimated on the date of grant using the Black-Scholes model for the purpose of the pro forma financial information in accordance with SFAS 123.

Table of Contents

CISCO SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

The Company s employee stock options have various restrictions including vesting provisions and restrictions on transfer and hedging, among others, and are often exercised prior to their contractual maturity. Lattice-binomial models are more capable of incorporating the features of the Company s employee stock options than closed-form models such as the Black-Scholes model. The use of a lattice-binomial model requires the use of extensive actual employee exercise behavior data and the use of a number of complex assumptions including expected volatility, risk-free interest rate, expected dividends, kurtosis, and skewness. The weighted-average estimated value of employee stock options granted during the three and nine months ended April 29, 2006 was $5.78 and $5.07 per share, respectively, using the lattice-binomial model with the following weighted-average assumptions:

	Three Months Ended April 29, 2006	Nine Months Ended April 29, 2006
Expected volatility	22.4%	23.6%
Risk-free interest rate	4.7%	4.2%
Expected dividends	0.0%	0.0%
Kurtosis	4.3	4.2
Skewness	(0.67)	(0.61)

The Company used the implied volatility for two-year traded options on the Company s stock as the expected volatility assumption required in the lattice-binomial model consistent with SFAS 123(R) and SAB 107. Prior to fiscal 2006, the Company had used its historical stock price volatility in accordance with SFAS 123 for purposes of its pro forma information. The selection of the implied volatility approach was based upon the availability of actively traded options on the Company s stock and the Company s assessment that implied volatility is more representative of future stock price trends than historical volatility.

The risk-free interest rate assumption is based upon observed interest rates appropriate for the term of the Company s employee stock options. The dividend yield assumption is based on the Company s history and expectation of dividend payouts. The estimated kurtosis and skewness are technical measures of the distribution of stock price returns, which affect expected employee exercise behaviors that are based on the Company s stock price return history as well as consideration of academic analyses.

The expected life of employee stock options represents the weighted-average period the stock options are expected to remain outstanding and is a derived output of the lattice-binomial model. The expected life of employee stock options is impacted by all of the underlying assumptions and calibration of the Company s model. The lattice-binomial model assumes that employees exercise behavior is a function of the option s remaining vested life and the extent to which the option is in-the-money. The lattice-binomial model estimates the probability of exercise as a function of these two variables based on the entire history of exercises and cancellations on all past option grants made by the Company. The expected life for option grants made during the three and nine months ended April 29, 2006 derived from the lattice-binomial model was 6.7 and 6.6 years, respectively.

As stock-based compensation expense recognized in the Consolidated Statement of Operations for the first nine months of fiscal 2006 is based on awards ultimately expected to vest, it has been reduced for estimated forfeitures. SFAS 123(R) requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. Forfeitures were estimated based on historical experience. In the Company s pro forma information required under SFAS 123 for the periods prior to fiscal 2006, the Company accounted for forfeitures as they occurred. The Company expects forfeitures to be 3% annually.

Table of Contents

CISCO SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

Pro Forma Information Under SFAS 123 for Periods Prior to Fiscal 2006

Pro forma information regarding option grants made to the Company s employees and directors and employee stock purchases related to the Purchase Plan is as follows. (in millions, except per-share amounts):

	Three Months Ended April 30, 2005	Nine Months Ended April 30, 2005
Net income as reported	$ 1,405	$ 4,201
Stock-based compensation expense, net of tax	(226)	(759)
Net income pro forma	$ 1,179	$ 3,442
Basic net income per share as reported	$ 0.22	$ 0.64
Diluted net income per share as reported	$ 0.21	$ 0.63
Basic net income per share pro forma	$ 0.18	$ 0.53
Diluted net income per share pro forma	$ 0.18	$ 0.52

The weighted-average estimated value of employee stock options granted during the three and nine months ended April 30, 2005 were $6.01 and $6.18, respectively using the Black-Scholes model with the following weighted-average assumptions:

	Three Months Ended April 30, 2005	Nine Months Ended April 30, 2005
Expected volatility	39.6%	39.6%
Risk-free interest rate	4.0%	3.5%
Expected dividends	0.0%	0.0%
Expected life (in years)	3.4	3.3

Prior to fiscal 2006, the Company used an option-pricing model to indirectly estimate the expected life of the stock options. The expected life and expected volatility of the stock options were based upon historical and other economic data trended into the future. Forfeitures of employee stock options were accounted for on an as-incurred basis.

Accuracy of Fair Value Estimates

The Company uses third-party analyses to assist in developing the assumptions used in, as well as calibrating, its lattice-binomial model. The Company is responsible for determining the assumptions used in estimating the fair value of its share-based payment awards.

The Company s determination of fair value of share-based payment awards on the date of grant using an option-pricing model is affected by the Company s stock price as well as assumptions regarding a number of highly complex and subjective variables. These variables include, but are not limited to the Company s expected stock price volatility over the term of the awards, and actual and projected employee stock option exercise behaviors. Option-pricing models were developed for use in estimating the value of traded options that have no vesting or hedging restrictions and are fully transferable. Because the Company s employee stock options have certain characteristics that are significantly different from traded

options, and because changes in the subjective assumptions can materially affect the estimated value, in management s opinion, the existing valuation models

CISCO SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

may not provide an accurate measure of the fair value of the Company s employee stock options. Although the fair value of employee stock options is determined in accordance with SFAS 123(R) and SAB 107 using an option-pricing model, that value may not be indicative of the fair value observed in a willing buyer/willing seller market transaction.

Defined Benefit and Deferred Compensation Plans Assumed from Scientific-Atlanta

Upon completion of the acquisition of Scientific-Atlanta, the Company assumed certain defined benefit plans related to employee pensions and other post employment benefits. Scientific-Atlanta had a defined benefit pension plan covering substantially all of its domestic employees and defined benefit pension plans covering certain international employees (collectively, the pension plans), a restoration retirement plan for certain domestic employees (restoration plan), supplemental executive retirement plans for certain key officers (SERPs), and subsidized health care and life insurance benefits for eligible retirees (retiree medical and life). The fair value of the liabilities of these plans was determined at the February 24, 2006 measurement date and includes the recognition of all amounts previously unrecognized for net gains and losses and prior service costs. The fair value determination of the liabilities reflects the Company s intent to integrate the Scientific-Atlanta employee benefit programs with those of the Company. As a result, no additional benefits will be accrued under the pension plans, the restoration plan, and the SERPs after February 2008.

The following table sets forth projected benefit obligations, plan assets, and amounts recorded in other long-term liabilities as of April 29, 2006, using February 24, 2006 as a measurement date for all actuarial calculations of asset and liability values and significant actuarial assumptions (in millions):

	Pension Plans	Restoration Plan	SERPs	Total
Projected benefit obligations (PBO)	$ 140	$ 9	$ 53	$ 202
Fair Value of Plan Assets	(94)			(94)
Accrued Benefit Liability	$ 46	$ 9	$ 53	$ 108

The accumulated benefit obligations under these plans were $191 million as of April 29, 2006 and represent the total benefits earned by active and retired employees discounted at an assumed interest rate. Earned benefits for active employees are based on their current pay and service. The accumulated postretirement benefit obligation of the retiree medical and life was $12 million as of April 29, 2006. To determine the expected long-term rate of return on the assets for the various plans, the Company considered the historical and expected returns on the plan assets, as well as the current and expected allocation of the plan assets. Significant actuarial assumptions for each plan were as follows:

	Pension Plans	Restoration Plan	SERPs	Retiree Medical and Life
Weighted-Average Assumptions:				
Discount rate	5.3%	5.3%	5.6%	5.6%
Expected return on plan assets	8.0%	N/A	N/A	N/A
Rate of compensation increase	5.0%	5.0%	5.0%	N/A

Plan assets are invested in publicly traded equity securities, fixed-income securities and cash and cash equivalents. The equity portfolio is diversified between domestic growth, value and index components and an international investment component. The fixed-income portfolio is managed by utilizing intermediate term

CISCO SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

instruments of high credit quality. The Company s recorded periodic pension cost related to the defined benefit pension plans and post retirement benefits was not material for the three and nine months ending April 29, 2006. The Company also assumed a deferred compensation plan for certain officers and directors of Scientific-Atlanta. As of April 29, 2006, the deferred compensation liability under this plan was approximately $100 million and was recorded in other long-term liabilities.

11. Income Taxes

The effective tax rate was 22.7% in the third quarter of fiscal 2006 and 26.4% for the first nine months of fiscal 2006. The effective tax rate was 28.6% for the third quarter and first nine months of fiscal 2005. The tax provision rate for the third quarter and first nine months of fiscal 2006 included a benefit of approximately $124 million from the favorable settlement of a tax audit in a foreign jurisdiction.

The Company paid income taxes of $1.261 billion and $1.001 billion for the nine months ended April 29, 2006 and April 30, 2005, respectively. The Company s income taxes currently payable have been reduced by the tax benefits from employee stock option transactions. These benefits totaled $418 million and $196 million for the nine months ended April 29, 2006 and April 30, 2005, 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 27, 2002 through July 31, 2004 are under examination by the Internal Revenue Service. The Company believes that adequate amounts have been reserved for any adjustments which may ultimately result from these examinations.

On October 22, 2004, the American Jobs Creation Act of 2004 (the Jobs Creation Act) was signed into law. The Jobs Creation Act created a temporary incentive for U.S. corporations to repatriate accumulated income earned abroad by providing an 85 percent dividends received deduction for certain dividends from controlled foreign corporations. In the first nine months of fiscal 2006, the Company distributed cash from its foreign subsidiaries and will report an extraordinary dividend (as defined in the Jobs Creation Act) of $1.2 billion and a related tax liability of approximately $63 million in its fiscal 2006 federal income tax return. This amount was previously provided for in the provision for income taxes and is included in income taxes payable. This distribution does not change the Company s intention to indefinitely reinvest undistributed earnings of certain of its foreign subsidiaries in operations outside the United States.

On November 10, 2005, the FASB issued FASB Staff Position No. FAS 123(R)-3 Transition Election Related to Accounting for Tax Effects of Share-Based Payment Awards. The Company has elected to adopt the alternative transition method provided in the FASB Staff Position for calculating the tax effects of stock-based compensation pursuant to SFAS 123(R). The alternative transition method includes simplified methods to establish the beginning balance of the additional paid-in capital pool (APIC pool) related to the tax effects of employee stock-based compensation, and to determine the subsequent impact on the APIC pool and Consolidated Statements of Cash Flows of the tax effects of employee stock-based compensation awards that are outstanding upon adoption of SFAS 123(R).

Table of Contents

CISCO SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

12. 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 local-area networks (LANs) and wide-area networks (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.

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, because management does not currently use the information to measure the performance of the operating segments. As a result of organizational changes, beginning in fiscal 2006, the Company s reportable segments were changed to the following theaters: United States and Canada, European Markets, Emerging Markets, Asia Pacific, and Japan, and the Company has recast the geographic theater data from the prior periods to reflect this change in reportable segments to conform to the current year s presentation. Prior to fiscal 2006, the Company had four reportable segments: the Americas; Europe, the Middle East, and Africa (EMEA); Asia Pacific; and Japan.

Summarized financial information by theater for the three and nine months ended April 29, 2006 and April 30, 2005, based on the Company s internal management system is as follows (in millions):

	Three Months Ended		Nine Months Ended	
	April 29, 2006	April 30, 2005	April 29, 2006	April 30, 2005
Net sales:				
United States and Canada	$ 4,138	$ 3,313	$ 11,258	$ 9,713
European Markets	1,595	1,479	4,496	4,215
Emerging Markets	604	410	1,760	1,302
Asia Pacific	648	603	2,003	1,792
Japan	337	382	983	1,198
	$ 7,322	$ 6,187	$ 20,500	$ 18,220
Gross margin:				
United States and Canada	$ 2,642	$ 2,188	$ 7,361	$ 6,385
European Markets	1,037	1,011	3,028	2,896
Emerging Markets	395	281	1,209	913
Asia Pacific	413	400	1,308	1,205
Japan	239	255	696	804
Total	$ 4,726	$ 4,135	$ 13,602	$ 12,203

Net sales in the United States were $3.9 billion and $3.2 billion for the three months ended April 29, 2006 and April 30, 2005, respectively. Net sales in the United States were $10.7 billion and $9.3 billion for the nine months ended April 29, 2006 and April 30, 2005, respectively.

37

Table of Contents

CISCO SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

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

	Three Months Ended		Nine Months Ended	
	April 29, 2006	April 30, 2005	April 29, 2006	April 30, 2005
Net sales:				
Routers	$ 1,519	$ 1,443	$ 4,356	$ 4,023
Switches	2,691	2,385	7,999	7,330
Advanced Technologies	1,688	1,189	4,223	3,421
Other	257	172	605	554
Product	6,155	5,189	17,183	15,328
Service	1,167	998	3,317	2,892
Total	$ 7,322	$ 6,187	$ 20,500	$ 18,220

The Company refers to some of its products and technologies as advanced technologies. As of April 29, 2006, the Company had identified nine advanced technologies for particular focus: application networking services, enterprise IP communications, home networking, hosted small business systems, optical networking, security, storage area networking, video systems and wireless technology. The Company continues to identify additional advanced technologies for focus and investment in the future, and the Company s investments in some previously identified advanced technologies may be curtailed or eliminated depending on market developments. During the first nine months of fiscal 2006, the Company reclassified net sales of switches, advanced technology and other products for the prior periods to conform to the current period presentation.

The majority of the Company s assets as of April 29, 2006 and July 30, 2005 were attributable to its U.S. operations. For the three and nine months ended April 29, 2006 and April 30, 2005, no single customer accounted for 10% or more of the Company s net sales.

Property and equipment information is based on the physical location of the assets. The following table presents property and equipment information for geographic areas (in millions):

	April 29, 2006	July 30, 2005
Property and equipment, net:		
United States	$ 3,117	$ 2,959
International	362	361
Total	$ 3,479	$ 3,320

Table of Contents

CISCO SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

13. 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	
	April 29, 2006	April 30, 2005	April 29, 2006	April 30, 2005
Net income	$ 1,400	$ 1,405	$ 4,036	$ 4,201
Weighted-average shares basic	6,160	6,435	6,184	6,529
Effect of dilutive potential common shares	129	106	116	127
Weighted-average shares diluted	6,289	6,541	6,300	6,656
Net income per share basic	$ 0.23	$ 0.22	$ 0.65	$ 0.64
Net income per share diluted	$ 0.22	$ 0.21	$ 0.64	$ 0.63

Dilutive potential common shares consist of employee stock options and restricted common stock. Employee stock options to purchase approximately 1.0 billion shares for the three and nine months ended April 29, 2006 and approximately 938 million and 851 million shares for the three and nine months ended April 30, 2005, respectively, were outstanding, but were not included in the computation of diluted earnings per share because 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 (the Securities Act) and the Securities Exchange Act of 1934 (the Exchange Act). 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, ar words and similar expressions are intended 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, 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, including those identified below, under Risk Factors, and elsewhere herein. Therefore, actual results may differ materially and adversely from those expressed in any forward-looking statements. We undertake no obligation to revise or update any forward-looking statements for any reason.

Overview

Financial Results

Our results for the third quarter and first nine months of fiscal 2006 reflected increases in net sales, net income, and net income per share from the corresponding periods of fiscal 2005, if the effect of pro forma stock-based compensation were included in the calculation of net income and net income per share for the third quarter and first nine months of fiscal 2005. In February 2006, we completed the acquisition of Scientific-Atlanta, a global provider of set-top boxes, end-to-end video distribution networks and video integration systems, which contributed $407 million in net sales for the third quarter of fiscal 2006. With this acquisition, we have added video to the convergence of data, voice and mobility technologies. We have continued to achieve a good balance in year-over-year revenue growth from our geographic segments, customer markets, and product families. Revenue increased from the corresponding periods of fiscal 2005 and the increase was primarily in the United States and the Emerging Markets theater. Revenue declined in our Japan theater. Our switching revenue increased year-over-year by 12.8% and 9.1% for the three and nine month periods, respectively. We experienced higher sales for our routers of 5.3% and 8.3% for the same periods. Sales of our advanced technologies increased by 42.0% and 23.4% for the third quarter and first nine months of fiscal 2006 primarily due to the acquisition of Scientific-Atlanta. The product revenue from Scientific-Atlanta increased sales of advanced technologies by approximately 30% and 11% for the third quarter and first nine month period comparisons, respectively.

For the third quarter and the first nine months of fiscal 2006, our gross margins decreased compared to the corresponding periods of fiscal 2005. The decrease in gross margins from the corresponding periods was primarily related to the acquisition of Scientific-Atlanta, because the Scientific-Atlanta business model has lower gross margin rates as compared to the Cisco model. Other factors contributing to the decrease in gross margins were the sales of certain switching and routing products, the effect of stock-based compensation expense under SFAS 123(R), which were partially offset by lower manufacturing costs related to lower component costs and value engineering and other manufacturing-related costs and higher volume. Operating expenses as a percentage of net sales increased year-over-year due primarily to increased sales and engineering headcount and the effects of our adoption of SFAS 123(R). Our headcount is expected to continue to increase, as a result of our planned investments in sales personnel. During the third quarter of fiscal 2006, a tax benefit of $124 million relating to the favorable settlement of a tax audit in a foreign jurisdiction was recorded as a reduction to our provision for income taxes.

Table of Contents

For fiscal 2006, in addition to our general strategy, we will continue to focus particular attention on five key areas: the commercial market segment; additional sales coverage; growing and expanding our advanced technologies; our evolving support model; and the Emerging Markets theater. We have added, and intend to continue to add, resources in these five key areas. Indicative of the opportunities in our markets, we continue to encounter price-focused competition, including competitors from Asia, and in particular China. In addition, our communications industry peers have indicated some concerns in their business outlook although our business momentum is positive.

During the third quarter and first nine months of fiscal 2006, we generated cash flows from operations of $2.3 billion and $5.6 billion, respectively. Our cash and cash equivalents and investments were $18.2 billion at the end of the third quarter of fiscal 2006, compared with $16.1 billion at the end of fiscal 2005. We raised $6.5 billion of cash in our debt offering and used $5.0 billion for the Scientific-Atlanta acquisition, net of cash and investments acquired. We used $5.5 billion of cash to repurchase 296 million shares of our common stock during the first nine months of fiscal 2006. Days sales outstanding in accounts receivable at the end of the third quarter of fiscal 2006 were 36 days, compared with 31 days at the end of the fourth quarter of fiscal 2005. Our inventory in absolute terms was relatively flat from our prior fiscal year end, July 30, 2005 and annualized inventory turns were 7.7 as compared with 6.6 in the fourth quarter of fiscal 2005. The inventory levels and turns reflected the first phase of our transition to lean manufacturing and the addition of Scientific-Atlanta inventory during the third quarter of fiscal 2006.

Beginning in fiscal 2006, we adopted SFAS 123(R) on a modified prospective basis. The following table provides a comparison of net income, if the effect of pro forma stock-based compensation expense as disclosed in the notes to the Consolidated Financial Statements prior to fiscal 2006 were included for prior periods (in millions, except per-share amounts):

	Three Months Ended		Nine Months Ended	
	April 29, 2006	**April 30, 2005**	**April 29, 2006**	**April 30, 2005**
Net income as reported for prior periods(1)	N/A	$ 1,405	N/A	$ 4,201
Stock-based compensation expense related to employee stock options and employee stock purchases	$ (261)	(377)	$ (839)	(1,265)
Tax benefit	$ 73	151	$ 235	506
Stock-based compensation expense related to employee stock options and employee stock purchases, net of tax(2)	$ (188)	(226)	$ (604)	(759)
Net income, including the effect of stock-based compensation expense(3)	$ 1,400	1,179	$ 4,036	3,442
Diluted net income per share as reported for prior periods(1)	N/A	$ 0.21	N/A	$ 0.63
Diluted net income per share, including the effect of stock-based compensation expense(3)	$ 0.22	$ 0.18	$ 0.64	$ 0.52

(1) Net income and net income per share prior to fiscal 2006 did not include stock-based compensation expense related to employee stock options and employee stock purchases under SFAS 123 because we did not adopt the recognition provisions of SFAS 123.

(2) Stock-based compensation expense prior to fiscal 2006 is calculated based on the pro forma application of SFAS 123 as previously disclosed in the notes to the Consolidated Financial Statements.

(3) Net income and net income per share prior to fiscal 2006 represent pro forma information based on SFAS 123 as previously disclosed in the notes to the Consolidated Financial Statements.

Table of Contents

Critical Accounting Estimates

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 Current Report on Form 8-K filed February 10, 2006 describes the significant accounting policies and methods used in the preparation of the Consolidated Financial Statements. The accounting policies described below are significantly affected by critical accounting estimates. Such accounting policies require significant 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

Our networking and communications products are generally integrated with software that is essential to the functionality of the equipment. We provide unspecified software upgrades and enhancements related to the equipment through our maintenance contracts, for most of our products. Accordingly, we account for revenue in accordance with Statement of Position No. 97-2, Software Revenue Recognition, and all related interpretations. For sales of products where software is incidental to the equipment, we apply the provisions of Staff Accounting Bulletin No. 101, Revenue Recognition in Financial Statements and Staff Accounting Bulletin No. 104, Revenue Recognition, and all 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.

Contracts, Internet commerce agreements, 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 recognition criteria for each element are met. The amount of product and service revenue recognized is impacted by our judgments as to whether an arrangement includes multiple elements and, if so, whether vendor-specific objective evidence of fair value exists. Changes to the elements in an arrangement and our ability to establish vendor-specific objective evidence for those elements could affect the timing of the revenue recognition. Our total deferred revenue for products was $1.6 billion and $1.4 billion as of April 29, 2006 and July 30, 2005, respectively. Technical support services revenue is deferred and recognized ratably over the period during which the services are to be performed, which is typically from one to three years. Advanced services revenue is recognized upon delivery or completion of performance. Our total deferred revenue for services was $3.9 billion and $3.6 billion as of April 29, 2006 and July 30, 2005, respectively.

We make sales to distributors and retail partners and recognize revenue based on a sell-through method using information provided by them. Our distributors and retail partners participate in various cooperative marketing and other programs, and we maintain estimated accruals and allowances for these programs. If actual credits received by our distributors and retail partners for these 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 $3.0 billion and $2.2 billion as of April 29, 2006 and July 30, 2005, respectively. The allowance for doubtful accounts was $180 million, or

Table of Contents

5.7% of the gross accounts receivable balance, as of April 29, 2006 and $162 million, or 6.8% of the gross accounts receivable balance, as of July 30, 2005. 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.

The provision for doubtful accounts was $22 million and $3 million for the first nine months of fiscal 2006 and 2005, respectively. 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 future sales returns is established based on historical trends in product return rates. The reserve for future sales returns as of April 29, 2006 and July 30, 2005 was $70 million and $63 million, respectively, and was 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 & Liability for Purchase Commitments

Our inventory balance was $1.3 billion as of April 29, 2006 and July 30, 2005. Our inventory allowance was $170 million and $159 million as of April 29, 2006 and July 30, 2005, respectively. We provide allowances for inventory 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 is 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 $125 million and $161 million for the first nine months of fiscal 2006 and 2005, 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. Inventory management remains an area of focus as we balance the need to maintain strategic inventory levels to ensure competitive lead times and the risk of inventory obsolescence.

In addition, we record a liability for firm, noncancelable, and unconditional purchase commitments for quantities in excess of our future demand forecasts consistent with our allowance for inventory. As of April 29, 2006, the liability for these firm, noncancelable, and unconditional purchase commitments was $153 million, compared with $107 million as of July 30, 2005, and was included in other accrued liabilities.

Warranty Costs

The liability for product warranties, included in other accrued liabilities, was $299 million as of April 29, 2006, compared with $259 million as of July 30, 2005. See Note 8 to the Consolidated Financial Statements. Our products are generally covered by a warranty for periods ranging from 90 days to 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, technical support labor costs, and associated overhead. Material cost is estimated based primarily 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 estimated based primarily upon historical trends in the rate of customer cases and the cost to support the customer cases within the warranty period. Overhead cost is applied based on estimated time to support warranty activities.

The provision for product warranties issued during the first nine months of fiscal 2006 and 2005 was $283 million and $303 million, respectively. The provision for warranty in the first nine months of fiscal 2006

included $6 million of stock-based compensation expense related to employee stock options and employee stock purchases under SFAS 123(R). The decrease in the provision for product warranties was due to lower warranty claims. If we experience an increase in warranty claims compared with our historical experience, or if the cost of servicing warranty claims is greater than the expectations on which the accrual has been based, our gross margin could be adversely affected.

Stock-based Compensation Expense

On July 31, 2005, we adopted Statement of Financial Accounting Standards No. 123 (revised 2004), Share-Based Payment, (SFAS 123(R)) which requires the measurement and recognition of compensation expense for all share-based payment awards made to our employees and directors including employee stock options and employee stock purchases related to the Employee Stock Purchase Plan (employee stock purchases) based on estimated fair values. Stock-based compensation expense recognized under SFAS 123(R) for the three and nine months ended April 29, 2006 was $284 million and $914 million, respectively, which consisted of stock-based compensation expense related to employee stock options and employee stock purchases of $261 million and $839 million, respectively, and stock-based compensation expense related to acquisitions and investments of $23 million and $75 million, respectively. For the three and nine months ended April 30, 2005, stock-based compensation expense of $44 million and $120 million was related to acquisitions and investments which we had been recognizing under previous accounting standards. There was no stock-based compensation expense related to employee stock options and employee stock purchases recognized during the three and nine months ended April 30, 2005. See Note 10 to the Consolidated Financial Statements for additional information.

Upon adoption of SFAS 123(R), we began estimating the value of employee stock options on the date of grant using a lattice-binomial model. Prior to the adoption of SFAS 123(R), the value of each employee stock option was estimated on the date of grant using the Black-Scholes model for the purpose of the pro forma financial information in accordance with SFAS 123. The determination of fair value of share-based payment awards on the date of grant using an option-pricing model is affected by our stock price as well as assumptions regarding a number of highly complex and subjective variables. These variables include, but are not limited to the expected stock price volatility over the term of the awards, and actual and projected employee stock option exercise behaviors. The use of a lattice-binomial model requires the use of extensive actual employee exercise behavior data and the use of a number of complex assumptions including expected volatility, risk-free interest rate, expected dividends, kurtosis, and skewness. The weighted-average estimated value of employee stock options granted during the three and nine months ended April 29, 2006 was $5.78 and $5.07 per share, respectively, using the lattice-binomial model with the following weighted-average assumptions:

	Three Months Ended April 29, 2006	Nine Months Ended April 29, 2006
Expected volatility	22.4%	23.6%
Risk-free interest rate	4.7%	4.2%
Expected dividends	0.0%	0.0%
Kurtosis	4.3	4.2
Skewness	(0.67)	(0.61)

We used the implied volatility for two-year traded options on our stock as the expected volatility assumption required in the lattice-binomial model consistent with SFAS 123(R) and SAB 107. Prior to fiscal 2006, we had used our historical stock price volatility in accordance with SFAS 123 for purposes of our pro forma information. The selection of the implied volatility approach was based upon the availability of actively traded options on our stock and our assessment that implied volatility is more representative of future stock price trends than historical volatility.

The risk-free interest rate assumption is based upon observed interest rates appropriate for the term of our employee stock options. The dividend yield assumption is based on the history and expectation of dividend

payouts. The estimated kurtosis and skewness are technical measures of the distribution of stock price returns, which affect expected employee exercise behaviors that are based on our stock price return history as well as consideration of academic analyses.

As stock-based compensation expense recognized in the Consolidated Statement of Operations for the third quarter and first nine months of fiscal 2006 is based on awards ultimately expected to vest, it has been reduced for estimated forfeitures. SFAS 123(R) requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. Forfeitures were estimated based on historical experience.

If factors change and we employ different assumptions in the application of SFAS 123(R) in future periods, the compensation expense that we record under SFAS 123(R) may differ significantly from what we have recorded in the current period.

Investment Impairments

Our publicly traded equity securities are reflected in the Consolidated Balance Sheets at a fair value of $814 million as of April 29, 2006, compared with $941 million as of July 30, 2005. See Note 6 to the Consolidated Financial Statements. We recognize an impairment charge when the declines in the fair values of our publicly traded equity securities below their cost basis are judged to be other-than-temporary. The ultimate value realized on these equity securities is subject to market price volatility until they are sold. We consider various factors in determining whether we should recognize an impairment charge, including 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 investee, 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 were no impairment charges on publicly traded equity securities for the first nine months of fiscal 2006. The impairment charge on publicly traded equity securities for the first nine months of fiscal 2005 was $5 million.

We also have investments in privately held companies, some of which are in the startup or development stages. As of April 29, 2006, our investments in privately held companies were $548 million, compared with $421 million as of July 30, 2005, and were included in other assets. See Note 4 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 because 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 $2 million and $6 million during the third quarter of fiscal 2006 and 2005, respectively, and were $13 million and $29 million for the first nine months of fiscal 2006 and 2005, 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 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 in the Consolidated Balance Sheets as of April 29, 2006 and July 30, 2005 was $9.2 billion and $5.3 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. Beginning in fiscal 2006, the reportable segments were changed to the following theaters: United States and Canada; European Markets; Emerging Markets; Asia Pacific; and Japan. As a result,

Table of Contents

we reallocated goodwill at July 31, 2005 to these reportable segments. There was no impairment of goodwill during the first nine months of fiscal 2006 or fiscal 2005.

Income Taxes

We are subject to income taxes in both the United States and numerous foreign jurisdictions. Significant judgment is required in evaluating our tax positions and determining our provision for income taxes. During the ordinary course of business, there are many transactions and calculations for which the ultimate tax determination is uncertain. We establish reserves for tax-related uncertainties based on estimates of whether, and the extent to which, additional taxes and interest will be due. These reserves are established when, despite our belief that our tax return positions are fully supportable, we believe that certain positions are likely to be challenged and may not be sustained on review by tax authorities. We adjust these reserves in light of changing facts and circumstances, such as the closing of a tax audit. The provision for income taxes includes the impact of reserve provisions and changes to reserves that are considered appropriate, as well as the related net interest.

Our effective tax rates differ from the statutory rate primarily due to acquisition-related costs, stock-based compensation, research and experimentation tax credits, state taxes, and the tax impact of foreign operations. The effective tax rate was 22.7% in the third quarter of fiscal 2006 and 26.4% for the first nine months of fiscal 2006. The effective tax rate was 28.6% for the third quarter and first nine months of fiscal 2005. 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 or liabilities, or by changes in tax laws, regulations, accounting principles, 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.

Table of Contents

Net Sales

As a result of organizational changes, beginning in fiscal 2006, the Company s reportable segments were changed to the following theaters: United States and Canada, European Markets, Emerging Markets, Asia Pacific, and Japan and we have recast our geographic theater data to reflect this change in reportable segments to conform to the current year s presentation. Prior to fiscal 2006, the Company had four reportable segments: the Americas; Europe, the Middle East, and Africa (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			
	April 29, 2006	April 30, 2005	Variance in Dollars	Variance in Percent	April 29, 2006	April 30, 2005	Variance in Dollars	Variance in Percent
Net sales:								
United States and Canada	$ 4,138	$ 3,313	$ 825	24.9%	$ 11,258	$ 9,713	$ 1,545	15.9%
Percentage of net sales	*56.5%*	*53.6%*			*54.9%*	*53.3%*		
European Markets	1,595	1,479	116	7.8%	4,496	4,215	281	6.7%
Percentage of net sales	*21.8%*	*23.9%*			*21.9%*	*23.1%*		
Emerging Markets	604	410	194	47.3%	1,760	1,302	458	35.2%
Percentage of net sales	*8.2%*	*6.6%*			*8.6%*	*7.2%*		
Asia Pacific	648	603	45	7.5%	2,003	1,792	211	11.8%
Percentage of net sales	*8.9%*	*9.7%*			*9.8%*	*9.8%*		
Japan	337	382	(45)	(11.8)%	983	1,198	(215)	(17.9)%
Percentage of net sales	*4.6%*	*6.2%*			*4.8%*	*6.6%*		
Total	$ 7,322	$ 6,187	$ 1,135	18.3%	$ 20,500	$ 18,220	$ 2,280	12.5%

Net sales during the three and nine months ending April 29, 2006 included $407 million of sales relating to the acquisition of Scientific-Atlanta, which consisted of $386 million in product revenue and $21 million in service revenue.

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

	Three Months Ended				Nine Months Ended			
	April 29, 2006	April 30, 2005	Variance in Dollars	Variance in Percent	April 29, 2006	April 30, 2005	Variance in Dollars	Variance in Percent
Net sales:								
Product	$ 6,155	$ 5,189	$ 966	18.6%	$ 17,183	$ 15,328	$ 1,855	12.1%
Service	1,167	998	169	16.9%	3,317	2,892	425	14.7%
Total	$ 7,322	$ 6,187	$ 1,135	18.3%	$ 20,500	$ 18,220	$ 2,280	12.5%

Table of Contents

Net Product Sales by Theater

The increase in net product sales was due to the impact of the continued gradual recovery in the global economic environment coupled with increased information technology-related capital spending in our enterprise, service provider, commercial, and consumer markets, and the acquisition of Scientific-Atlanta. The following table is a breakdown of net product sales by theater (in millions, except percentages):

	Three Months Ended				Nine Months Ended			
	April 29, 2006	April 30, 2005	Variance in Dollars	Variance in Percent	April 29, 2006	April 30, 2005	Variance in Dollars	Variance in Percent
Net product sales:								
United States and Canada	$ 3,339	$ 2,611	$ 728	27.9%	$ 8,953	$ 7,660	$ 1,293	16.9%
Percentage of net product sales	*54.3%*	*50.3%*			*52.1%*	*50.0%*		
European Markets	1,391	1,307	84	6.4%	3,960	3,743	217	5.8%
Percentage of net product sales	*22.6%*	*25.2%*			*23.0%*	*24.4%*		
Emerging Markets	557	375	182	48.5%	1,630	1,202	428	35.6%
Percentage of net product sales	*9.0%*	*7.2%*			*9.5%*	*7.8%*		
Asia Pacific	572	543	29	5.3%	1,780	1,619	161	9.9%
Percentage of net product sales	*9.3%*	*10.5%*			*10.4%*	*10.6%*		
Japan	296	353	(57)	(16.1)%	860	1,104	(244)	(22.1)%
Percentage of net product sales	*4.8%*	*6.8%*			*5.0%*	*7.2%*		
Total	$ 6,155	$ 5,189	$ 966	18.6%	$ 17,183	$ 15,328	$ 1,855	12.1%

The increase in net product sales in the United States and Canada theater was due to an increase in net product sales to all of our customer markets, led by strength in the enterprise, service provider and commercial markets, and the acquisition of Scientific-Atlanta, which contributed approximately $310 million of net product sales in this theater during the third quarter and first nine months of fiscal 2006. However, sales to the U.S. federal government grew at a slower rate. We believe our sales to the U.S. federal government remain subject to a possible realignment of government spending priorities and timing of budget roll-outs, which could adversely affect these sales in future periods. The increase in net product sales in the European Markets theater was due to continued improvement in net product sales in Germany and France and also included the net product revenue from Scientific-Atlanta of approximately $30 million during the third quarter and first nine months of fiscal 2006. Net product sales in the Emerging Markets theater increased primarily as a result of continued product deployment by service providers and growth in enterprise markets and reflects the commonality of opportunities in our Emerging Markets theater. Net product sales relating to Scientific-Atlanta included in the Emerging Markets theater were approximately $35 million during the third quarter and first nine months of fiscal 2006. The increase in net product sales in Asia Pacific occurred primarily as a result of continued infrastructure builds, broadband acceleration, and investments by Asian telecommunication carriers, especially in China, India, Australia, and New Zealand. Net product sales in the Japan theater have continued to be characterized by cautious spending from the service providers. Although we continue to face ongoing economic and other challenges in the theater, the Japan theater did experience an increase in net product sales relative to the second quarter of fiscal 2006.

Table of Contents

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			
	April 29, 2006	April 30, 2005	Variance in Dollars	Variance in Percent	April 29, 2006	April 30, 2005	Variance in Dollars	Variance in Percent
Net product sales:								
Routers	$ 1,519	$ 1,443	$ 76	5.3%	$ 4,356	$ 4,023	$ 333	8.3%
Percentage of net product sales	*24.7%*	*27.8%*			*25.4%*	*26.3%*		
Switches	2,691	2,385	306	12.8%	7,999	7,330	669	9.1%
Percentage of net product sales	*43.7%*	*46.0%*			*46.5%*	*47.8%*		
Advanced Technologies	1,688	1,189	499	42.0%	4,223	3,421	802	23.4%
Percentage of net product sales	*27.4%*	*22.9%*			*24.6%*	*22.3%*		
Other	257	172	85	49.4%	605	554	51	9.2%
Percentage of net product sales	*4.2%*	*3.3%*			*3.5%*	*3.6%*		
Total	$ 6,155	$ 5,189	$ 966	18.6%	$ 17,183	$ 15,328	$ 1,855	12.1%

Routers

The increase in net product sales related to routers in the third quarter and first nine months of fiscal 2006 was due to higher revenue from all of our router categories. Our sales of high-end routers, which represent a larger proportion of our total router sales compared with midrange and low-end routers, increased by approximately $25 million and approximately $170 million over the third quarter and first nine months of fiscal 2005, respectively. Our high-end router sales are primarily to service providers, which tend to make large and sporadic purchases.

Sales of our midrange and low-end routers collectively increased by approximately $55 million and $160 million over the same periods. In fiscal 2005, we introduced the integrated services router. For the third quarter and first nine months of fiscal 2006, sales of integrated services routers represented approximately 45% and 41%, respectively, of our total revenue from midrange and low-end routers compared with approximately 30% and 16% of our total revenue from midrange and low-end routers in the respective periods of fiscal 2005.

Switches

The increase in net product sales related to switches in both the third quarter and first nine months of fiscal 2006 was due to sales of local-area network (LAN) fixed switches and LAN modular switches. The increase in sales of LAN switches was a result of the continued adoption of new technologies by our customers, resulting in higher sales of our high-end modular switches, the Catalyst 6500 Series, and fixed switches, including Cisco Catalyst 3560 Series and Cisco Catalyst 3750 Series.

Advanced Technologies

Sales of our advanced technologies included net product sales of $361 million related to Scientific-Atlanta during the third quarter of fiscal 2006. The product revenue from Scientific-Atlanta increased sales of advanced technologies by approximately 30% and 11% for the third quarter and first nine month period comparisons, respectively.

Enterprise IP communications sales increased by approximately $75 million and $220 million from the third quarter and first nine months of fiscal 2005, respectively, primarily due to sales of IP phones and associated software as our customers transitioned from an analog-based to an IP-based infrastructure. Sales of security products increased by approximately $25 million and $100 million during the third quarter and first nine months of fiscal 2006, respectively, primarily due to module and line-card sales related to our routers and LAN modular switches as customers continued to emphasize network security. Sales of storage area networking products increased by approximately $20 million and $70 million during the third quarter and first nine months of fiscal 2006, respectively. Wireless LAN product sales increased by approximately $45 million and $95 million, respectively, during the same periods. Storage area networking and wireless LAN product sales increased primarily due to new customers and continued deployments with existing customers. Home networking product sales increased by approximately $65 million and $105 million during the third quarter and first nine months of fiscal 2006, respectively, primarily due to the growth of our wireless and wired router businesses, and the acquisition of Scientific-Atlanta which contributed approximately $45 million of home networking product sales during the third quarter and first nine months . We experienced continued weakness in optical sales during the third quarter, with sales decreasing by approximately $10 million and $70 million, compared to the third quarter and first nine months of fiscal 2005, respectively. The acquisition of Scientific-Atlanta contributed approximately $25 million of optical product sales during the third quarter and first nine months of fiscal 2006. Our sales of optical products will no longer be included in our Advanced Technologies product category beginning in fiscal 2007. Sales of video systems products of approximately $290 million in the third quarter of fiscal 2006 were primarily related to the acquisition of Scientific-Atlanta. Video systems include solutions and systems dedicated to enable video-specific systems, including both transmission and subscriber equipment, sold directly to service providers. Application networking services products and hosted small-business systems, which were identified as advanced technologies in the second quarter of fiscal 2006, did not represent a significant amount of revenue for either period.

Other Product Revenue

Sales of our other products included net product sales of $25 million related to Scientific-Atlanta during the third quarter of fiscal 2006. The remaining increase in other product revenue was primarily due to the strength in sales of our cable solutions to service providers.

Factors That May Impact Net Product Sales

Net product sales may continue to be affected by changes in the geopolitical environment and global economic conditions; competition, including price-focused competitors from Asia, especially China; new product introductions; sales cycles and product implementation cycles; changes in the mix of our customers between service provider and enterprise markets; 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. In addition, sales to the service provider market have been characterized by large and often sporadic purchases, especially relating to our router sales and sales of certain of our advanced technologies. In addition, service provider customers typically have longer implementation cycles, require a broader range of services, including network design services, and often have acceptance provisions that can lead to a delay in revenue recognition. To improve customer satisfaction, we continue to focus on managing our manufacturing lead-time performance, 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, including those caused by any possible disruption related to our recently announced transition to lean

Table of Contents

manufacturing, 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. For additional factors that may impact net product sales, see the following section entitled Risk Factors.

Our distributors and retail partners participate in various cooperative marketing and other programs. In addition, increasing sales to our distributors and retail partners 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 for sales to our distributors and retail partners based on a sell-through method using information provided by them, and we maintain estimated accruals and allowances for all cooperative marketing and other programs.

Net Service Revenue

The increase in net service revenue was primarily due to increased technical support service contract initiations and renewals associated with higher product sales, which have resulted in a larger installed base of equipment being serviced, and revenue from advanced services, which relates to consulting support services for our technologies for specific networking needs.

Gross Margin

The following table shows the gross margin for each theater (in millions, except percentages):

	Three Months Ended				Nine Months Ended			
	Amount		Percentage		Amount		Percentage	
	April 29, 2006	April 30, 2005	April 29, 2006	April 30, 2005	April 29, 2006	April 30, 2005	April 29, 2006	April 30, 2005
Gross margin:								
United States and Canada	$ 2,642	$ 2,188	63.8%	66.0%	$ 7,361	$ 6,385	65.4%	65.7%
European Markets	1,037	1,011	65.0%	68.4%	3,028	2,896	67.3%	68.7%
Emerging Markets	395	281	65.4%	68.5%	1,209	913	68.7%	70.1%
Asia Pacific	413	400	63.7%	66.3%	1,308	1,205	65.3%	67.2%
Japan	239	255	70.9%	66.8%	696	804	70.8%	67.1%
Total	$ 4,726	$ 4,135	64.5%	66.8%	$ 13,602	$ 12,203	66.4%	67.0%

The decrease in gross margins was primarily related to the acquisition of Scientific-Atlanta, which decreased gross margins by approximately 2% and 1% for the three and nine month period comparisons, respectively. Net sales for Scientific-Atlanta were primarily related to the United States and Canada theater.

The following table shows the gross margin for products and services (in millions, except percentages):

	Three Months Ended				Nine Months Ended			
	Amount		Percentage		Amount		Percentage	
	April 29, 2006	April 30, 2005	April 29, 2006	April 30, 2005	April 29, 2006	April 30, 2005	April 29, 2006	April 30, 2005
Gross margin:								
Product	$ 3,962	$ 3,492	64.4%	67.3%	$ 11,465	$ 10,316	66.7%	67.3%
Service	764	643	65.5%	64.4%	2,137	1,887	64.4%	65.2%
Total	$ 4,726	$ 4,135	64.5%	66.8%	$ 13,602	$ 12,203	66.4%	67.0%

Product Gross Margin

Product gross margin during the third quarter of fiscal 2006 includes the effect of $57 million of stock-based compensation expense related to employee stock options and employee stock purchases under SFAS 123(R), amortization of purchased intangible assets, and inventory adjustments related to purchase accounting, which reduced product gross margin percentage by 0.9%. The remaining decrease in product gross margin during the third quarter was due to the following factors. Changes in the mix of products sold decreased product gross margin by approximately 4.0%, with 2.5% of this decrease being related to the inclusion of net product sales from Scientific-Atlanta and the remainder being due to sales of certain switching and routing products. Sales discounts and rebates decreased product gross margin by approximately 0.5%. Lower overall manufacturing costs related to lower component costs and value engineering and other manufacturing related costs increased product gross margin by approximately 1.5%. Value engineering is the process by which production costs are reduced through component redesign, board configuration, test processes, and transformation processes. Higher shipment volume also increased product gross margin by 1.0%.

Product gross margin during the first nine months of fiscal 2006 includes the effect on our product cost of sales of $87 million of stock-based compensation expense related to employee stock options and employee stock purchases under SFAS 123(R), amortization of purchased intangible assets on our product cost of sales, and inventory adjustments related to purchase accounting, which reduced product gross margin percentage by 0.5% during the period. Changes in the mix of products sold decreased product gross margin by approximately 2.0%, with 1.0% of this decrease being related to the inclusion of net product sales from Scientific-Atlanta and the remainder being due to sales of certain switching products. Sales discounts and rebates decreased product gross margin by approximately 0.5%. Lower overall manufacturing costs related to lower component costs and value engineering and other manufacturing related costs increased product gross margin by approximately 1.5%. Higher shipment volume also increased product gross margin by 1.0%.

Product gross margin may continue to 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; introduction of new products, including products with price-performance advantages; our ability to reduce production costs; entry into new markets, including markets with different pricing and cost structures; changes in distribution channels; price competition, including competitors from Asia and especially China; changes in geographic mix; sales discounts; increases in material or labor costs; excess inventory and obsolescence charges; warranty costs; changes in shipment volume; loss of cost savings due to changes in component pricing; impact of value engineering; inventory holding charges; and how well we execute on our strategy and operating plans.

Service Gross Margin

Service gross margin during the third quarter and first nine months of fiscal 2006 includes the effect on our service costs of sales of $28 million and $90 million, respectively, of stock-based compensation expense related to employee stock options and employee stock purchases under SFAS 123(R), which reduced service gross margin percentage by 2.4% and 2.7% during the respective periods. There was no stock-based compensation expense related to employee stock options and employee stock purchases in the corresponding periods of fiscal 2005. Our service gross margins benefited from higher revenue on a relatively stable cost base. Our service gross margin from technical support services is higher than the service gross margins from our advanced services. 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 and the timing of our adding personnel and resources to support this business. Our revenue from advanced services may continue to increase to a higher proportion of total service revenue due to our continued focus on providing comprehensive support to our customers networking devices, applications, and infrastructures.

Table of Contents

Stock-Based Compensation Expense

On July 31, 2005, we adopted SFAS 123(R), which requires the measurement and recognition of compensation expense for all share-based payment awards made to employees and directors including employee stock options and employee stock purchases based on estimated fair values. The following table summarizes stock-based compensation expense related to employee stock options and employee stock purchases under SFAS 123(R) for the three and nine months ended April 29, 2006 which was allocated as follows (in millions):

	Three Months Ended		Nine Months Ended	
	April 29, 2006	April 30, 2005	April 29, 2006	April 30, 2005
Cost of sales product	$ 11	$	$ 41	$
Cost of sales service	28		90	
Stock-based compensation expense included in cost of sales	39		131	
Research and development	86		279	
Sales and marketing	107		340	
General and administrative	29		89	
Stock-based compensation expense included in operating expenses	222		708	
Total stock-based compensation expense related to employee stock options and employee stock purchases	261		839	
Tax benefit	(73)		(235)	
Stock-based compensation expense related to employee stock options and employee stock purchases, net of tax	$ 188	$	$ 604	$

Stock-based compensation related to acquisitions and investments of $23 million and $75 million for the three and nine months ended April 29, 2006, respectively is disclosed in Note 3 and is not included in the above table. There was no stock-based compensation expense recognized for the three or nine months ended April 30, 2005 other than as related to acquisitions and investments.

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

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

	Three Months Ended				Nine Months Ended			
	April 29, 2006	April 30, 2005	Variance in Dollars	Variance in Percent	April 29, 2006	April 30, 2005	Variance in Dollars	Variance in Percent
Research and development	$ 1,041	$ 823	$ 218	26.5%	$ 3,003	$ 2,439	$ 564	23.1%
Percentage of net sales	*14.2%*	*13.3%*			*14.6%*	*13.4%*		
Sales and marketing	1,547	1,190	357	30.0%	4,431	3,452	979	28.4%
Percentage of net sales	*21.1%*	*19.2%*			*21.6%*	*18.9%*		
General and administrative	298	244	54	22.1%	858	702	156	22.2%
Percentage of net sales	*4.1%*	*3.9%*			*4.2%*	*3.9%*		
Total	$ 2,886	$ 2,257	$ 629	27.9%	$ 8,292	$ 6,593	$ 1,699	25.8%
Percentage of net sales	*39.4%*	*36.5%*			*40.4%*	*36.2%*		

R&D expenses increased during the third quarter and first nine months of fiscal 2006 primarily due to higher headcount-related expenses reflecting our continued investment in R&D efforts in routers, switches, advanced technologies and other product technologies, the effect of stock-based compensation expense related to employee stock options and employee stock purchases under SFAS 123(R), and the acquisition of Scientific-

53

Table of Contents

Atlanta, which contributed $36 million of additional R&D expenses. 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.

During the third quarter and first nine months of fiscal 2006, sales and marketing expenses increased primarily due to increases in sales expenses of approximately $290 million and $830 million, respectively. Sales expenses in both periods increased primarily due to an increase in headcount-related expenses, an increase in sales program expenses, and the acquisition of Scientific-Atlanta, which contributed $13 million of additional sales expenses. Sales expenses also reflect stock-based compensation expense related to employee stock options and employee stock purchases under SFAS 123(R) of $82 million and $268 million during the third quarter and first nine months of fiscal 2006, respectively. Marketing expenses include $25 million and $72 million of stock-based compensation expense related to employee stock options and employee stock purchases under SFAS 123(R) during the same periods. Scientific-Atlanta contributed $10 million of additional marketing expenses during the third quarter and first nine months of fiscal 2006.

General and administrative expenses during the respective periods increased primarily because of stock-based compensation expense related to employee stock options and employee stock purchases under SFAS 123(R), and the acquisition of Scientific-Atlanta, which included $16 million of additional general and administrative expenses during the third quarter and first nine months of fiscal 2006.

Our headcount increased by 8,631 employees during the third quarter of fiscal 2006, and by 9,883 employees during the first nine months of fiscal 2006. Our quarter-end headcount increased by 11,246 employees over the end of the third quarter of fiscal 2005. Acquisitions accounted for approximately 7,900 of the quarter-end headcount increase. Our headcount is expected to increase, especially our planned investments in sales headcount, as we continue to focus on five key areas: the commercial market segment; additional sales coverage; advanced technologies; our evolving support model; and the Emerging Markets theater. As a result, if we do not achieve the benefits anticipated from these investments, our operating results may be adversely affected.

Amortization of Purchased Intangible Assets

Amortization of purchased intangible assets included in operating expenses was $99 million in the third quarter of fiscal 2006, compared with $54 million in the third quarter of fiscal 2005. Amortization of purchased intangible assets included in operating expenses was $214 million in the first nine months of fiscal 2006, compared with $171 million in the first nine months of fiscal 2005.

For additional information regarding purchased intangibles, see Note 3 to the Consolidated Financial Statements. Amortization of purchased intangible assets included in cost of sales was $24 million in the third quarter and first nine months of fiscal 2006. There was no amortization of purchased intangible assets included in cost of sales during fiscal 2005.

In-Process Research and Development

Our methodology for allocating the purchase price relating to purchase acquisitions to in-process R&D is determined through established valuation techniques in the high-technology communications equipment industry. In-process R&D expense in the third quarter of fiscal 2006 and fiscal 2005 was $88 million and $6 million, respectively. In-process R&D expense in the first nine months of fiscal 2006 and fiscal 2005 was $90 million and $20 million, respectively. See Note 3 to the Consolidated Financial Statements for additional information regarding the acquisitions completed in the first nine months of fiscal 2006 and the in-process R&D recorded for each acquisition. In-process R&D was expensed upon acquisition because technological feasibility had not been established and no future alternative uses existed. The acquisition of Scientific-Atlanta accounted for $88 million

Table of Contents

of the in-process R&D during the third quarter and first nine months of fiscal 2006, which related primarily to projects associated with Scientific-Atlanta s advanced models of digital set-tops, network software enhancements and upgrades, and data products and transmission products.

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 lifecycle. 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.

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. 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.

The following table summarizes the key assumptions underlying the valuation for our purchase acquisitions completed in the first nine months of fiscal 2006 for which in-process R&D was recorded (in millions, except percentages):

Acquisition	In-Process R&D Expense	Estimated Cost to Complete Technology at Time of Acquisition	Risk-Adjusted Discount Rate for In-Process R&D
KiSS Technology A/S	$ 2	$ 1	22%
Scientific-Atlanta, Inc.	88	93	17%

The key assumptions primarily consist of an expected completion date for the in-process projects; estimated costs to complete the projects; revenue and expense projections, assuming the products have entered the market; and discount rates based on the risks associated with the development lifecycle of the in-process technology acquired. Failure to achieve the expected levels of revenue and net income from these products will negatively impact the return on investment expected at the time that the acquisitions were completed and may result in impairment charges. Actual results from the purchase acquisitions to date did not have a material adverse impact on our business and operating results.

Interest and Other Income, Net

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

	Three Months Ended		Nine Months Ended	
	April 29, 2006	April 30, 2005	April 29, 2006	April 30, 2005
Interest income	$ 202	$ 142	$ 524	$ 399
Interest expense	(60)		(60)	
Total	$ 142	$ 142	$ 464	$ 399

The increase in interest income during the third quarter of fiscal 2006 was attributable to higher average balances of cash, cash equivalents and investments and higher average interest rates as compared to the same

Table of Contents

period of fiscal 2005. The increase in interest income for the first nine months of fiscal 2006 was attributable to higher average interest rates as compared to the corresponding period of fiscal 2005. The interest expense was attributable to the issuance of $6.5 billion in senior unsecured notes during the third quarter of fiscal 2006.

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

	Three Months Ended		Nine Months Ended	
	April 29, 2006	April 30, 2005	April 29, 2006	April 30, 2005
Net gains (losses) on investments in fixed income and publicly traded equity securities	$ 34	$ 6	$ 20	$ 86
Impairment charges on publicly traded equity securities				(5)
Net gains on investments in privately held companies	21	9	67	31
Impairment charges on investments in privately held companies	(2)	(6)	(13)	(29)
Net gains and impairment charges on investments	53	9	74	83
Other	(36)	(1)	(57)	(18)
Total	$ 17	$ 8	$ 17	$ 65

The other losses of $36 million and $57 million for the third quarter and the first nine months of fiscal 2006, respectively, consisted primarily of contributions of publicly traded equity securities and products to charitable organizations.

Provision for Income Taxes

The effective tax rate was 22.7% for the third quarter of fiscal 2006 and 26.4% for the first nine months of fiscal 2006. The effective tax rate was 28.6% for the third quarter and first nine months of fiscal 2005. The effective tax rate differs from the statutory rate primarily due to acquisition-related costs, stock-based compensation, research and experimentation tax credits, state taxes, and the tax impact of foreign operations. The tax provision rate for the third quarter and first nine months of fiscal 2006 included a benefit of approximately $124 million from the favorable settlement of a tax audit in a foreign jurisdiction.

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 or liabilities, or by changes in tax laws, regulations, accounting principles, 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.

On October 22, 2004, the American Jobs Creation Act of 2004 (the Jobs Creation Act) was signed into law. The Jobs Creation Act created a temporary incentive for U.S. corporations to repatriate accumulated income earned abroad by providing an 85 percent dividends received deduction for certain dividends from controlled foreign corporations. In the first nine months of fiscal 2006, we distributed cash from our foreign subsidiaries and will report an extraordinary dividend (as defined in the Jobs Creation Act) of $1.2 billion and a related tax liability of approximately $63 million in our fiscal 2006 federal income tax return. This amount was previously provided for in the provision for income taxes and is included in income taxes payable.

Table of Contents

Liquidity and Capital Resources

The following sections discuss the effects of changes in our balance sheet and cash flows, contractual obligations, other commitments, and the stock repurchase program on our liquidity and capital resources.

Balance Sheet and Cash Flows

Cash and Cash Equivalents and Investments

The following table summarizes our cash and cash equivalents and investments (in millions):

	April 29, 2006	July 30, 2005	Increase (Decrease)
Cash and cash equivalents	$ 4,237	$ 4,742	$ (505)
Fixed income securities	12,860	10,372	2,488
Publicly traded equity securities and mutual funds	1,086	941	145
Total	$ 18,183	$ 16,055	$ 2,128

The increase in cash and cash equivalents and investments was primarily a result of approximately $6.5 billion of cash provided by the issuance of debt, cash provided by operating activities of $5.6 billion, and cash provided by the issuance of common stock of $1.3 billion related to employee stock option exercises and employee stock purchases, offset by acquisitions of businesses of $5.2 billion, net of cash and investments acquired, the repurchase of common stock of $5.5 billion, and capital expenditures of $595 million.

Effective October 29, 2005, we changed the method of classification of our investments previously classified as long-term investments to current assets, and prior period balances have been reclassified to conform to the current period s presentation. This new method classifies these securities as current or long-term based on the nature of the securities and the availability for use in current operations while the prior classification was based on the maturities of the investments. We believe this method is preferable because it is more reflective of our assessment of the overall liquidity position. In conjunction with this change in classification of investments, we changed the classification of deferred taxes related to the unrealized gains and losses on long-term investments from noncurrent assets to current assets.

As of April 29, 2006, the majority of our cash and cash equivalents and investments were held outside of the United States in certain of our foreign subsidiaries. If these cash and cash equivalents and investments were distributed to the United States in the form of dividends or otherwise, we would be subject to additional U.S. income taxes (subject to an adjustment for foreign tax credits) and foreign withholding taxes.

We expect that cash provided by operating activities may fluctuate in future periods as a result of a number of factors, including fluctuations in our operating results, shipment linearity, accounts receivable collections, inventory management, stock option expensing, and the timing and amount of tax and other payments. Shipment linearity is a measure of the level of shipments throughout a particular quarter. For additional discussion, see the following section entitled Risk Factors.

Accounts Receivable, Net

The following table summarizes our accounts receivable, net (in millions):

	April 29, 2006	July 30, 2005	Increase (Decrease)
Accounts receivable, net	$ 2,980	$ 2,216	$ 764

The increase in accounts receivable was due to increased sales and the addition of $248 million of accounts receivable related to Scientific-Atlanta. Days sales outstanding (DSO) in accounts receivable as of April 29, 2006

57

and July 30, 2005 were 36 days and 31 days, respectively. Our accounts receivable and DSO are primarily impacted by shipment linearity and collections performance. 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 a quarter, which will result in a shorter amount of time to collect the related accounts receivable and increased DSO.

Inventories

The following table summarizes our inventories (in millions):

	April 29, 2006	July 30, 2005	Increase (Decrease)
Raw materials	$ 164	$ 82	$ 82
Work in process	336	431	(95)
Finished goods:			
Distributor inventory and deferred cost of sales	411	385	26
Manufacturing finished goods	208	184	24
Total finished goods	619	569	50
Service-related spares	158	180	(22)
Demonstration systems	36	35	1
Total	$ 1,313	$ 1,297	$ 16

Annualized inventory turns were 7.7 in the third quarter of fiscal 2006, which includes the effect on our cost of sales of $39 million of stock-based compensation expense related to employee stock options and employee stock purchases under SFAS 123(R), amortization of purchased intangible assets of $24 million, and $22 million of inventory adjustments related to purchase accounting on our product cost of sales. Annualized inventory turns were 6.6 in the fourth quarter of fiscal 2005. Our finished goods consist of distributor inventory and deferred cost of sales and manufacturing finished goods. Distributor inventory and deferred cost of sales are related to unrecognized revenue on shipments to distributors and retail partners and shipments to enterprise and service provider customers. Manufacturing finished goods consist primarily of build-to-order and build-to-stock products, including home networking products. Service-related spares consist of reusable equipment related to our technical support and warranty activities. All inventories are accounted for at the lower of cost or market.

In the third quarter of fiscal 2006, we began the first phase of transition to what we refer to as a lean manufacturing model. Lean manufacturing is an industry-standard model that seeks to drive efficiency and flexibility in manufacturing processes and in the broader supply chain. Over time, consistent with what we have experienced thus far, we expect this process will result in incremental increases in purchase commitments with corresponding decreases in core manufacturing inventory.

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. We believe the amount of our inventory is appropriate for our current revenue levels.

Table of Contents

Deferred Revenue

The breakdown of deferred revenue at April 29, 2006 and July 30, 2005 was as follows (in millions):

	April 29, 2006	July 30, 2005	Increase (Decrease)
Service	$ 3,938	$ 3,618	$ 320
Product			
Unrecognized revenue on product shipment and other deferred revenue	1,145	1,201	(56)
Cash receipts related to unrecognized revenue from two-tier distributors	405	223	182
	1,550	1,424	126
Total	$ 5,488	$ 5,042	$ 446
Reported as:			
Current	$ 4,300	$ 3,854	$ 446
Noncurrent	1,188	1,188	
Total	$ 5,488	$ 5,042	$ 446

The increase in deferred revenue is primarily a result of increased deferred service revenue, which reflects a seasonal increase in the volume of technical support contract initiations and renewals partially offset by the ongoing amortization of deferred service revenue.

Contractual Obligations

Long-Term Debt

The following table summarizes our long-term debt (in millions):

	April 29, 2006	July 30, 2005	Increase (Decrease)
2009 Notes	$ 500	$	$ 500
2011 Notes	3,000		3,000
2016 Notes	3,000		3,000
Other	5		5
Aggregate principal amount	6,505		6,505
Unamortized discount	(19)		(19)
SFAS 133 fair value adjustment	(140)		(140)
Total	$ 6,346	$	$ 6,346

In February 2006, we issued $500 million of senior floating interest rate notes due 2009 (the 2009 Notes), $3.0 billion of 5.25% senior notes due 2011 (the 2011 Notes) and $3.0 billion of 5.50% senior notes due 2016 (the 2016 Notes), for an aggregate principal amount of $6.5 billion. The 2011 Notes and the 2016 Notes are redeemable by us at any time, subject to a make-whole premium. To achieve our interest rate risk management objectives, we entered into $6.0 billion notional amount of interest rate swaps. In effect, these swaps convert the fixed interest rates of the 2011 Notes and the 2016 Notes to floating interest rates based on LIBOR. Higher interest rates would result in increased interest expense. We presently mitigate this risk by investing a portion of our interest bearing assets in instruments with similar interest rate characteristics as the swapped debt. Gains and losses in the value of the interest rate swaps offset changes in the fair value of the underlying debt. See Note 8 to the

Consolidated Financial Statements. As of April 29, 2006, we were in compliance with all debt-related covenants.

Operating Leases

We lease office space in several U.S. locations, as well as locations in Canada and all of our geographic segments. The future minimum lease payments under all our noncancelable operating leases with an initial term in excess of one year as of April 29, 2006 were $1.2 billion. For additional information see Note 8 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 manage manufacturing lead times and 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 is firm, noncancelable, and unconditional commitments. As of April 29, 2006, we had total purchase commitments for inventory of approximately $1.7 billion, compared with $954 million as of July 30, 2005. Approximately $250 million of the increase in purchase commitments for inventory was a result of the addition of Scientific-Atlanta. The initial implementation of the lean manufacturing model also increased the amount of our purchase commitments by approximately $150 million, and the remaining increase in purchase commitments was primarily attributable to our higher sales.

In addition to the above, we record a liability for firm, noncancelable, and unconditional purchase commitments for quantities in excess of our future demand forecasts consistent with our allowance for inventory. As of April 29, 2006, the liability for these firm, noncancelable, and unconditional purchase commitments was $153 million, compared with $107 million as of July 30, 2005, and was included in other accrued liabilities.

Other Commitments

We have entered into an agreement to invest approximately $800 million in venture funds managed by SOFTBANK Corp. and its affiliates (SOFTBANK) that are required to be funded on demand. The total commitment is to be invested in venture funds and 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 April 29, 2006, we had invested $516 million in the venture funds pursuant to the commitment, compared with $414 million as of July 30, 2005. In addition, as of April 29, 2006, we had invested $49 million in the senior debt pursuant to the commitment, all of which has been repaid. As of July 30, 2005, we had invested $49 million in the senior debt pursuant to the commitment, of which $47 million had been repaid.

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 $46 million as of April 29, 2006, compared with approximately $56 million as of July 30, 2005.

Off-Balance Sheet Arrangements

We consider our investments in unconsolidated variable interest entities to be off-balance sheet arrangements. In the ordinary course of business, we have investments in privately held companies and provide financing to certain customers through our wholly owned subsidiaries, which may be considered to be variable interest entities. We have evaluated our investments in these privately held companies and customer financings and have determined that there were no significant unconsolidated variable interest entities as of April 29, 2006.

Table of Contents

Certain events can require a reassessment of our investments in privately held companies or customer financings to determine if they are variable interest entities and if we would be regarded as the primary beneficiary. As a result of such events, we may be required to make additional disclosures or consolidate these entities. Because we may not control these entities, we may not have the ability to influence these events.

Stock Repurchase Program

In September 2001, our Board of Directors authorized a stock repurchase program. As of April 29, 2006, our Board of Directors had authorized the repurchase of up to $35 billion of common stock under this program. During the first nine months of fiscal 2006, we repurchased and retired 296 million shares of Cisco common stock at an average price of $18.48 per share for an aggregate purchase price of $5.5 billion. As of April 29, 2006, we had repurchased and retired 1.8 billion shares of Cisco common stock for an average price of $18.21 per share for an aggregate purchase price of $32.6 billion since inception of the stock repurchase program, and the remaining authorized amount for stock repurchases under this program was $2.4 billion with no termination date.

The purchase price for the shares of our common stock repurchased was reflected as a reduction to shareholders equity. In accordance with Accounting Principles Board Opinion No. 6, Status of Accounting Research Bulletins, we are required to allocate the purchase price of the repurchased shares as a reduction to retained earnings then as a reduction of common stock and additional paid-in capital. Issuance of common stock and the tax benefit related to employee stock option plans are recorded as an increase to common stock and additional paid-in capital.

Liquidity and Capital Resource Requirements

Based on past performance and current expectations, we believe our cash and cash equivalents, investments, and cash generated from operations, as described above, will satisfy our working capital needs, capital expenditures, investment requirements, stock repurchases, contractual obligations, commitments (see Note 8 to the Consolidated Financial Statements), future customer financings, and other liquidity requirements associated with our operations through at least the next 12 months. We have in the past and may in the future have an accumulated deficit as a result of the accounting effect of stock repurchases and this would not be reflective of our financial performance or our liquidity. 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 other transactions, arrangements, or other relationships with unconsolidated entities or other persons that are reasonably likely to materially affect liquidity or the availability of our requirements for capital resources.

Table of Contents

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 our 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 numerous factors. These factors include:

- Fluctuations in demand for our products and services, especially with respect to Internet businesses and telecommunications service providers, in part due to the changing global economic environment
- 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 movement toward industry consolidation among both our competitors and our customers
- The introduction and market acceptance of new technologies and products and our success in new markets, including emerging and advanced technologies, as well as the adoption of new networking standards
- Variations in sales channels, product costs, or mix of products sold
- The timing, size, and mix of orders from customers
- Manufacturing and customer 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 our 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

Benefits anticipated from our investments in engineering, sales and manufacturing activities

Changes in accounting rules, such as recording expenses for employee stock option grants and changes in tax accounting principles

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

Our operating results may be adversely affected by unfavorable economic and market conditions and the uncertain geopolitical environment

Economic conditions worldwide have contributed to slowdowns in the communications and networking industries and may 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
- Risk of excess and obsolete inventories
- Excess facilities and manufacturing capacity
- Higher overhead costs as a percentage of revenue and higher interest expense

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, and changes in energy costs 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 revenue for a particular period is difficult to predict, and a shortfall in revenue may harm our operating results

As a result of a variety of factors discussed in this report, our revenue for a particular quarter is difficult to predict. Our net sales may grow at a slower rate than in past periods, or 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 have exceeded net bookings, or manufacturing issues have delayed shipments, leading to nonlinearity in shipping patterns. In addition to making it difficult to predict revenue for a particular period, nonlinearity in shipping can increase costs, because irregular shipment patterns result in periods of underutilized capacity and periods in which 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 in which we and our contract manufacturers are operating at higher levels of capacity, it is possible that revenue for a quarter could be adversely affected if such matters occur and are not remediated within the same quarter.

In addition, to improve customer satisfaction, we continue to attempt to improve our manufacturing lead-time performance, 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 to 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 because 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

We expect gross margin to vary over time, and our level of product gross margin may not be sustainable

Our level of product gross margins may not be sustainable and may continue to be adversely affected by numerous factors, including:

- Changes in customer, geographic, or product mix, including mix of configurations within each product group
- Introduction of new products, including products with price-performance advantages
- Our ability to reduce production costs
- Entry into new markets, including markets with different pricing and cost structures, through acquisitions, such as our acquisition of Scientific-Atlanta, or internal development
- Sales discounts
- Increases in material or labor costs
- Excess inventory and inventory holding charges
- 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
- Lower than expected benefits from value engineering
- Increased price competition, including competitors from Asia, especially China
- Changes in distribution channels
- Increased warranty costs
- How well we execute on our strategy and operating plans

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 and the addition of personnel and other resources to support higher levels of service business in future periods.

Disruption of or changes in our distribution model 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 revenue and gross margins could be adversely affected.

A substantial portion of our products and services is sold through our channel partners and the remainder is sold through direct sales. Our channel partners include systems integrators, service providers, other resellers, distributors, and retail partners. Systems integrators and service providers typically sell directly to end-users and often provide system installation, technical support, professional services, and other support services in addition to network equipment sales. Systems integrators also typically integrate our products into an overall solution, and a number of service providers are also systems integrators. Distributors stock inventory and typically sell to systems integrators, service providers, and other resellers. In addition, home networking products are generally sold through distributors and retail partners. We refer to sales through distributors and retail partners as our two-tier system of sales to the end customer. Revenue from distributors and retail partners is recognized based on a sell-through method using information provided by them. These distributors and retail partners 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. If sales through indirect channels increase, this may

lead to greater difficulty in forecasting the mix of our products and, to a 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, 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.

Some factors could result in disruption of or changes in our distribution model, which could harm our sales and margins, including the following:

- We compete with some of 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
- Some of our channel partners may demand that we absorb a greater share of the risks that their customers may ask them to bear
- Some of our channel partners may have insufficient financial resources and may not be able to withstand changes in business conditions

Our inventory management relating to our sales to our two-tier distribution channel is complex, and excess inventory may harm our gross margins

We must manage our inventory relating to sales to our distributors and retail partners effectively, because inventory held by them could affect our results of operations. Our distributors and retail partners may increase orders during periods of product shortages, cancel orders if their inventory is too high, or delay orders in anticipation of new products. They also may adjust their orders in response to the supply of our products and the products of our competitors that are available to them and in response to seasonal fluctuations in end-user demand. Revenue to our distributors and retail partners is recognized based on a sell-through method using information provided by them, and they are generally given business terms that allow them to return a portion of inventory, receive credits for changes in selling price, and participate in various cooperative marketing programs. 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. If we ultimately determine that we have excess inventory, we may have to reduce our prices and write-down inventory, which in turn could result in lower gross margins.

Sales to the service provider market are especially volatile, and weakness 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, especially relating to our router sales and sales of certain of our advanced technologies, in addition to longer sales cycles. We have experienced significant weakness 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 to which service providers are affected by regulatory, economic, and business conditions in the country of operations. Although some service providers may be increasing capital expenditures over the depressed levels that have prevailed over the last few years, weakness in orders from this industry could have a material adverse effect on our business, operating results, and financial condition. Slowdowns in the general economy, overcapacity, changes in the service provider market, regulatory developments and constraints on capital availability have had a material adverse effect on many of our service provider customers, with many of these customers going out of business or substantially reducing their expansion plans. These conditions have materially harmed our business and operating results, and we expect 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, which 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 issues, manufacturing 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 revenue 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 in the future:

New markets in which we participate may grow quickly, which may make it difficult to quickly obtain significant component capacity

As we acquire companies and new technologies, we may be dependent, at least initially, on unfamiliar supply chains or relatively small supply partners

We face competition for certain components, which are supply-constrained, from existing competitors and companies in other markets

Manufacturing capacity and component supply constraints, including those caused by any possible disruption related to our recently announced transition to lean manufacturing, 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 improve manufacturing lead time performance 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 8 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 our products could materially adversely affect our business, operating results, and financial condition and could materially damage

Table of Contents

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 used, 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 our 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.

Our key manufacturing facilities for Scientific-Atlanta s products are located in Juarez, Mexico and we may be materially and adversely affected by any type of disaster at this facility.

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 emerging and advanced technology markets. As we continue to expand our sales globally, we may see new competition in different geographic regions. In particular, we are seeing price-focused competitors from Asia, especially China, and we anticipate this will continue.

Our competitors include 3Com; Alcatel; Avaya; Avici Systems; Brocade Communications Systems, Inc.; Check Point Software Technologies; Ciena; D-Link Corporation; Dell; Enterasys Networks; Extreme Networks; F5 Networks, Inc.; Force10 Networks, Inc.; Foundry Networks; Fujitsu; Hewlett-Packard Company; Huawei Technologies; Juniper Networks; Lucent Technologies; McDATA Corporation; Motorola, Inc.; NETGEAR, Inc.; Nokia; Nortel Networks; Redback Networks; Siemens AG; Sycamore Networks; and Symbol Technologies, Inc., 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, some 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 also from other competitors, 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. Companies with whom we have strategic alliances in some areas may be competitors in other areas.

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 introduce new products, including products with price-performance advantages

- The ability to reduce production costs
- The ability to provide value-added features such as security, reliability, and investment protection
- Conformance to standards
- Market presence
- 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, suppliers and strategic alliance partners 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 that the Internet and the various networks associated with it, including corporate intranets, cable, broadband and dialup networks, and voice and video networks will evolve to include embedded resources and the virtualization of applications and services to produce an integrated, intelligent system, or as we refer to it, an Intelligent Information Network. This is our vision for the evolution of networking from connectivity products to intelligent systems. As such, many of our strategic initiatives and investments are aimed at meeting the requirements that an Intelligent Information Network would demand. 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 developing new products before knowing whether our investments will result in products the market will accept. In particular, if our model of the evolution of networking from connectivity products to intelligent systems does not emerge as we believe it will, many of our strategic initiatives and investments may be of no or limited 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, net sales and earnings. The success of new products depends 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 identify as emerging technologies or advanced technologies may not prove to have the market success we anticipate, and we may not successfully identify and invest in other emerging or advanced technologies.

We are increasing our investment in engineering and sales activities and these investments may achieve delayed, or lower than expected, benefits which could harm our operating results

We intend to continue to add personnel and other resources to both our engineering and sales functions as we focus on developing emerging technologies, the next wave of advanced technologies, growing the commercial market segment, capitalizing on our emerging market opportunities, enhancing our evolving support model and increasing our market share gains. We are likely to recognize the costs associated with these investments earlier than some of the anticipated benefits, and the return on these investments may be lower, or

may develop more slowly, than we expect. If we do not achieve the benefits anticipated from these investments, or if the achievement of these benefits is delayed, our operating results may be adversely affected.

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 who depend on the continued growth of the Internet. To the extent that an economic slowdown and reduction in capital spending adversely affect spending on Internet infrastructure, we could 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. Because 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 charges related to discontinuances of certain of our products or businesses and asset impairments

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, and future goodwill impairment tests may 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 depends 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, systems, technologies, products, and personnel of the acquired companies, particularly companies with large and widespread operations and/or complex products, such as Scientific-Atlanta

- Diversion of management s attention from normal daily operations of the business and the challenges of managing larger and more widespread operations resulting from acquisitions

- 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 revenue to offset increased expenses associated with acquisitions

Table of Contents

- The potential loss of key employees, customers, distributors, vendors and other business partners of the companies we acquire following and continuing after announcement of acquisition plans

Acquisitions may also cause us to:

- Issue common stock that would dilute our current shareholders percentage ownership
- Use a substantial portion of our cash resources or incur debt as we did recently when we issued and sold $6.5 billion in senior unsecured notes to fund our acquisition of Scientific-Atlanta
- Significantly increase our interest expense, leverage and debt service requirements if we incur additional debt to pay for an acquisition
- Assume liabilities
- Record goodwill and nonamortizable 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
- Become subject to intellectual property or other litigation

Mergers and acquisitions of high-technology companies are inherently risky and subject to many factors outside of our control, 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 could materially harm our business and operating results. 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 resulted 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 factors above, including the risk factor 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 for example, 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 entry into the consumer market, has

subjected and will subject us to additional risks, particularly to those markets, including the effects of general market conditions and reduced consumer confidence.

Table of Contents

Product quality problems could lead to reduced revenue, 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 preshipment testing programs will be adequate to detect all defects, either ones in individual products or ones that could affect numerous shipments, which might interfere with customer satisfaction, reduce sales opportunities, or affect gross margins. In the past, we have had to replace certain components and provide remediation in response to the discovery of defects or bugs in products that we had shipped. Although the cost of such remediation has not been material in the past, there can be no assurance that such a 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, damage to our reputation, inventory costs, or product reengineering expenses, any of which could have a material impact on our revenue, 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 our 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, maintain a manufacturing facility for a substantial portion of our video systems products in Juarez, Mexico, and also depend on non-U.S. operations of our contract manufacturers and our distribution partners. For the first nine months of fiscal 2006 and the first nine months of fiscal 2005, we derived approximately 48% and 49%, respectively, of our net sales 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, economic instability or natural disasters in a specific country or region; environmental and trade protection measures and other regulatory requirements, which may affect our ability to import our products to, export our products from, or sell our products in various countries, such as, the Restriction of Hazardous Substances Directive (RoHS) adopted in February 2003 by the European Union; political considerations that affect service provider and government spending patterns; health or similar issues, such as a pandemic or epidemic; 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 evolve, and they could have a material adverse impact on our financial results and cash flows. Historically, our primary exposures have related to nondollar-denominated sales in Japan, Canada, and Australia and certain nondollar-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

Table of Contents

increase the cost of local operating expenses and procurement of raw materials to the extent that we must purchase components in foreign currencies.

Currently, we enter into foreign exchange forward contracts to reduce the short-term impact of foreign currency fluctuations on certain foreign currency receivables, investments, and payables. In addition, we periodically 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.

Our exposure to the credit risks relating to our financing activities described above may increase if there is an economic slowdown. 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 distributors and retail partners. These distributors and retail partners 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 business terms. However, distributors 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. Although we have been issued numerous patents and other patent applications are currently pending, there can be no assurance that any of these patents or other proprietary rights will not be challenged, invalidated, or circumvented or that our rights will, in fact, provide competitive advantages to us. Furthermore, many key aspects of networking technology are governed by industrywide 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. Although 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 innovative products that 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 or even possible to determine in advance whether a product or any of its components infringes or will infringe on 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, or that our indemnification by our suppliers will be adequate to cover our 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 amounts. 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 licenses 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 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 nonexclusive 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 IP, encryption technology, sales taxes on Internet product sales, 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. Competition for these personnel is intense, especially in the Silicon Valley area of Northern California. Stock option grants are designed to reward employees for their long-term contributions and provide incentives for them to remain with us. Volatility, lack of positive performance in our stock price or changes to our overall compensation program, including our stock incentive program, may also adversely affect our ability to retain key employees, virtually 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 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, regulations, accounting principles 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.

In July 2005, the FASB issued an Exposure Draft of a proposed Interpretation Accounting for Uncertain Tax Positions an interpretation of FASB Statement No. 109. The proposed Interpretation proposes changes to the current accounting for uncertain tax positions. While we cannot predict with certainty the rules in the final Interpretation, there is risk that the final Interpretation could result in a cumulative effect charge to earnings upon adoption, increases in future effective tax rates, and/or increases in future interperiod effective tax rate volatility.

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, a hurricane 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. Efforts to limit the ability of malicious third parties to disrupt the operations of the Internet or undermine our own security efforts may meet with resistance. In addition, the continued threat of terrorism and heightened security and military action in response to this threat, or any future acts of 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 widespread 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 our 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 publicly traded companies, the values of which are subject to market price volatility to the extent unhedged. If the public equities market declines, 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 year ended July 30, 2005. Our investments in private companies are subject to risk of loss of investment capital. These investments are inherently risky because 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 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

Table of Contents

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.

Beginning with fiscal 2006, we are required to recognize expense for stock based compensation related to employee stock options and employee stock purchases, and there is no assurance that the expense that we are required to recognize measures accurately the value of our share-based payment awards, and the recognition of this expense could cause the trading price of our common stock to decline

On July 31, 2005, we adopted SFAS 123(R) which requires the measurement and recognition of compensation expense for all stock-based compensation based on estimated fair values. As a result, starting with fiscal 2006, our operating results contain a charge for stock-based compensation expense related to employee stock options and employee stock purchases. This charge is in addition to stock-based compensation expense we have recognized in prior periods related to acquisitions and investments. The application of SFAS 123(R) requires the use of an option-pricing model to determine the fair value of share-based payment awards. This determination of fair value is affected by our stock price as well as assumptions regarding a number of highly complex and subjective variables. These variables include, but are not limited to, our expected stock price volatility over the term of the awards, and actual and projected employee stock option exercise behaviors. Option-pricing models were developed for use in estimating the value of traded options that have no vesting or hedging restrictions and are fully transferable. Because our employee stock options have certain characteristics that are significantly different from traded options, and because changes in the subjective assumptions can materially affect the estimated value, in management s opinion the existing valuation models may not provide an accurate measure of the fair value of our employee stock options. Although the fair value of employee stock options is determined in accordance with SFAS 123(R) and SAB 107 using an option-pricing model, that value may not be indicative of the fair value observed in a willing buyer/willing seller market transaction.

As a result of the adoption of SFAS 123(R), beginning with fiscal 2006, our earnings were lower than they would have been had we not been required to adopt SFAS 123(R). This will continue to be the case for future periods. We cannot predict the effect that this adverse impact on our reported operating results will have on the trading price of our common stock.

Our stock price may be volatile

Historically, our common stock had 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, security of our products 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 and the announcement of proposed and completed acquisitions or other significant transactions, or any difficulties associated with such transactions, by us or our current or potential competitors, may materially adversely affect the market price of our common stock in the future. Additionally, volatility, lack of positive performance in our stock price or changes to our overall compensation program including our stock incentive program may adversely affect our ability to retain key employees, virtually all of whom are compensated, in part, based on the performance of our stock price.

We have issued $6.5 billion of senior unsecured notes, and there can be no assurance that our operating results and financial condition will not be adversely affected

On February 22, 2006, we issued senior unsecured notes in an aggregate principal amount of $6.5 billion that mature at specific dates in 2009, 2011 and 2016. The notes that mature in 2009 bear floating-rate interest payable quarterly while the notes that mature in 2011 and 2016 bear fixed-rate interest payable semi-annually. We have entered into certain interest rate swaps to, in effect, convert the interest rates of the fixed interest notes into floating-rates based on LIBOR. Higher short-term interest rates would accordingly result in increased interest expense. While we presently mitigate this risk by investing a portion of our interest bearing assets in instruments with returns based on LIBOR, there can be no assurance that we will maintain a matched portfolio in the future. The instruments governing the notes contain certain covenants applicable to us and our subsidiaries that may adversely affect our ability to incur certain liens or engage in certain types of sale and leaseback transactions. We have not previously undertaken substantial amounts of debt for borrowed money. There can be no assurance that our incurrence of this debt will be a better means of providing liquidity to us than would our use of our existing cash resources, including cash currently held offshore. Further, we cannot be assured that our maintenance of this indebtedness will not adversely affect our operating results or financial condition. In addition, changes by any rating agency to our credit rating can negatively impact the value and liquidity of both our debt and equity securities.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

Investments

We maintain an investment portfolio of various holdings, types, and maturities. See Note 6 to the Consolidated Financial Statements. These securities are generally classified as available-for-sale and consequently are recorded in the Consolidated Balance Sheets at fair value with unrealized gains or losses, to the extent unhedged, reported as a separate component of accumulated other comprehensive income, net of tax.

Fixed Income Securities

At any time, a sharp rise in interest rates could have a material adverse impact on the fair value of our investment portfolio. Conversely, declines in interest rates could have a material impact on interest earnings for our investment portfolio. These instruments are not leveraged as of April 29, 2006, and are held for purposes other than trading.

Publicly Traded Equity Securities

The values of our equity investments in several publicly traded companies are subject to market price volatility. The following tables present the hypothetical changes in fair value of publicly traded equity securities, excluding hedged equity securities, held at April 29, 2006 that are sensitive to changes in market price (in millions):

	Valuation of Securities Given an X% Decrease in Each Stock s Price			Fair Value as of April 29, 2006	Valuation of Securities Given an X% Increase in Each Stock s Price		
	(35)%	(25)%	(15)%		15%	25%	35%
Publicly traded equity securities	$ 480	$ 554	$ 627	$ 738	$ 849	$ 923	$ 996

Our equity portfolio consists of securities with characteristics that most closely match the Standard & Poor s 500 Index or NASDAQ Composite Index. These equity securities are held for purposes other than trading. The modeling technique used measures the change in fair value arising from selected hypothetical changes in each stock s price. Stock price fluctuations of plus or minus 15%, 25%, and 35% were selected based on the

probability of their occurrence. There were no impairment charges on publicly traded equity securities in the first nine months of fiscal 2006. The impairment charge on publicly traded equity securities for the first nine months of fiscal 2005 was $5 million.

Investments In Privately Held Companies

We have invested in privately held companies, some of which are in the startup or development stages. These investments are inherently risky because the markets for the technologies or products these companies are developing are typically in the early stages and may never materialize. We could lose our entire initial investment in these companies. These investments are primarily carried at cost, which as of April 29, 2006 was $548 million, compared with $421 million at July 30, 2005, and are recorded in other assets in the Consolidated Balance Sheets. Our impairment charges on investments in privately held companies were $2 million and $6 million for the third quarter of 2006 and 2005, respectively, and were $13 million and $29 million for the first nine months of fiscal 2006 and 2005, respectively

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

Long-Term Debt

At any time, a sharp fall in interest rates could have a material adverse impact on the fair value of $6.0 billion of our fixed-rate debt. To minimize this risk, we have entered into $6.0 billion of interest rate swaps designated as fair value hedges of the fixed-rate debt. Conversely, a sharp rise in short-term interest rates could have a material adverse impact on interest expense. To mitigate this risk, we presently invest a portion of our total investment portfolio in interest bearing assets that have similar interest rate characteristics as the swapped debt.

Derivative Instruments

Foreign Currency Derivatives

We enter into foreign exchange forward contracts to reduce the short-term effect of foreign currency fluctuations on 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 and forward contracts with maturities up to 18 months. These hedging programs are not designed to provide foreign currency protection over longer time horizons. 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 and losses on foreign exchange contracts mitigate the variability in operating expenses associated with currency movements. Primarily because of our limited currency exposure to date, the effect of foreign currency fluctuations has not been material to our Consolidated Financial Statements. The effect of foreign currency fluctuations, net of hedging, decreased total research and development, sales and marketing, and general and administrative expenses by approximately 1% and 0.5% compared with the third quarter and first nine months of fiscal 2005, respectively. The impact of foreign currency fluctuations on sales has not been material because our sales are primarily denominated in U.S. dollars.

Table of Contents

Foreign exchange forward and option contracts as of April 29, 2006 are summarized as follows (in millions):

	Notional Amount	Fair Value
Forward contracts:		
Purchased	$ 1,402	$ 2
Sold	$ 655	$ (6)
Option contracts:		
Purchased	$ 393	$ 14
Sold	$ 485	$ (1)

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 customer 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 8 to the Consolidated Financial Statements.

Interest Rate Derivatives

Our primary objective for holding fixed income and debt securities is to achieve an appropriate investment return consistent with preserving principal and managing risk. To realize these objectives, we may utilize interest rate swaps or other derivatives designated as fair value or cash flow hedges. We have entered into $1.0 billion of interest rate swaps designated as fair value hedges of our investment portfolio. Under these interest rate swap contracts, we make fixed-rate interest payments and receive interest payments based on LIBOR. The effect of these swaps is to convert fixed-rate returns to floating rate returns based on LIBOR for a portion of our fixed income portfolio. The gains and losses related to changes in the value of the interest rate swaps are included in other income, net, in the Consolidated Statements of Operations and offset the changes in fair value of the underlying hedged investment. As of April 29, 2006 and July 30, 2005, the fair values of the interest rate swaps designated as hedges of our investments were $44 million and $15 million, respectively, and were reflected in prepaid expenses and other current assets in the Consolidated Balance Sheets.

In conjunction with our issuances of fixed rate senior notes in February 2006, we entered into $6.0 billion of interest rate swaps designated as fair value hedges of our fixed rate debt. Under these interest rate swap contracts, we receive fixed-rate interest payments and make interest payments based on LIBOR plus a fixed number of basis points. The effect of these swaps is to convert fixed-rate interest expense to floating rate interest expense based on LIBOR. Higher interest rates would result in increased interest expense. We presently mitigate this risk by investing a portion of our interest bearing assets in instruments with similar interest rate characteristics as the swapped debt. The gains and losses related to changes in the value of the interest rate swaps are included in other income, net, in the Consolidated Statements of Operations and offset the changes in fair value of the underlying hedged debt. As of April 29, 2006, the fair value of the interest rate swaps designated as hedges of our debt was $140 million and was reflected in other long-term liabilities in the Consolidated Balance Sheets.

Equity Derivatives

We maintain a portfolio of publicly traded equity securities which are subject to price risk. We may hold equity securities for strategic purposes or to provide diversification for our overall investment portfolio. In order to manage our exposure to changes in the fair value of certain equity securities, we may, from time to time, enter into equity derivative contracts. We have entered into forward sale and option agreements on certain publicly traded equity securities designated as fair value hedges. The gains and losses due to changes in the value of the

hedging instruments are included in other income, net, in the Consolidated Statements of Operations and offset the change in the fair value of the underlying hedged investment. As of April 29, 2006 the notional and fair value amounts of the derivatives were $198 million and $113 million, respectively. As of July 30, 2005 the notional and fair value amounts of the derivatives were $198 million and $19 million, respectively.

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 and is accumulated and communicated to our management, including our principal executive officer and principal financial officer, as appropriate to allow timely decisions regarding required disclosure.

Changes in internal control over financial reporting. There was no change in our internal control over financial reporting during our third quarter of fiscal 2006 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

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. While we believe there is no legal basis for liability, due to the uncertainty surrounding the litigation process, we are unable to reasonably estimate a range of loss, if any, at this time.

On February 16, 2005, a purported shareholder derivative lawsuit was filed in the Superior Court of California, County of Santa Clara, against various of our officers and directors and naming us as a nominal defendant. The lawsuit includes claims for breach of fiduciary duty, unjust enrichment, constructive trust and violations of the California Corporations Code, is based upon allegations of wrongdoing in connection with option grants and compensation to officers and directors, the timing of option grants, and our stock repurchase program, and seeks unspecified compensation and other damages, rescission of options and other relief.

In addition, we are subject to legal proceedings, claims, and litigation arising in the ordinary course of business, including intellectual property litigation. 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. For additional information regarding intellectual property litigation, see Risk Factors We may be found to infringe on intellectual property rights of others herein.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

(a) None.

Table of Contents

(b) None.

(c) Issuer Purchases of Equity Securities (in millions, except per-share amounts)

Period	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 29, 2006 to February 25, 2006	21	$ 18.93	21	$ 3,197
February 26, 2006 to March 25, 2006	15	$ 21.02	15	$ 2,886
March 26, 2006 to April 29, 2006	24	$ 21.14	24	$ 2,369
Total	60	$ 20.34	60	

(1) In September 2001, our Board of Directors authorized a stock repurchase program. As of April 29, 2006, our Board of Directors had authorized the repurchase of up to $35 billion of common stock under this program. During the third quarter of fiscal 2006, we repurchased and retired 60 million shares of our common stock at an average price of $20.34 per share for an aggregate purchase price of $1.2 billion. As of April 29, 2006, we had repurchased and retired 1.8 billion shares of our common stock at an average price of $18.21 per share for an aggregate purchase price of $32.6 billion since inception of the stock repurchase program, and the remaining authorized amount for stock repurchases under the program was $2.4 billion 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

None.

Table of Contents

Item 6. Exhibits

The following documents are filed as Exhibits to this report:

2.1	Agreement and Plan of Merger by and among Cisco Systems, Inc., Columbus Acquisition Corp. and Scientific-Atlanta, Inc. (incorporated by reference to Exhibit 2.1 of Form 8-K (File No. 001-05517) filed November 21, 2005)
4.1	Indenture, dated February 22, 2006, between Cisco Systems, Inc. and Deutsche Bank Trust Company Americas, as trustee (incorporated by reference to Exhibit 4.1 of Form 8-K (File No. 000-18225) filed February 22, 2006)
4.2	Forms of Global Note for the registrant s Floating Rate Notes due 2009, 5.25% Senior Notes due 2011 and 5.50% Senior Notes due 2016 (contained in Exhibit No. 4.1)
10.1	Cisco Systems, Inc. SA Acquisition Long-Term Incentive Plan (amends and restates the 2003 Long-Term Incentive Plan of Scientific-Atlanta), including related form agreements (incorporated by reference to Exhibit 99.4 to Form S-8 (File No. 333-132050) filed February 27, 2006
10.2	Underwriting Agreement, dated February 14, 2006, among the registrant and Citigroup Global Markets Inc., J.P. Morgan Securities Inc., Merrill Lynch, Pierce, Fenner & Smith Incorporated and Morgan Stanley & Co. Incorporated, as representatives of the several underwriters named therein (incorporated by reference to Exhibit 1.1 of Form 8-K (File No. 000-18225) filed February 21, 2006)
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

Schedules and exhibits have been omitted pursuant to Item 601(b)(2) of Regulation S-K. Cisco Systems, Inc. hereby undertakes to furnish supplementally copies of any of the omitted schedules and exhibits upon request by the Securities and Exchange Commission.

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.

Date: May 24, 2006

Cisco Systems, Inc.

By /s/ DENNIS D. POWELL
Dennis D. Powell, Senior Vice President and

Chief Financial Officer

(Principal financial officer and duly authorized signatory)

Table of Contents

EXHIBIT INDEX

EXHIBIT NO.	
2.1	Agreement and Plan of Merger by and among Cisco Systems, Inc., Columbus Acquisition Corp. and Scientific-Atlanta, Inc. (incorporated by reference to Exhibit 2.1 of Form 8-K (File No. 001-05517) filed November 21, 2005)
4.1	Indenture, dated February 22, 2006, between Cisco Systems, Inc. and Deutsche Bank Trust Company Americas, as trustee (incorporated by reference to Exhibit 4.1 of Form 8-K (File No. 000-18225) filed February 22, 2006)
4.2	Forms of Global Note for the registrant s Floating Rate Notes due 2009, 5.25% Senior Notes due 2011 and 5.50% Senior Notes due 2016 (contained in Exhibit No. 4.1)
10.1	Cisco Systems, Inc. SA Acquisition Long-Term Incentive Plan (amends and restates the 2003 Long-Term Incentive Plan of Scientific-Atlanta), including related form agreements (incorporated by reference to Exhibit 99.4 to Form S-8 (File No. 333-132050) filed February 27, 2006
10.2	Underwriting Agreement, dated February 14, 2006, among the registrant and Citigroup Global Markets Inc., J.P. Morgan Securities Inc., Merrill Lynch, Pierce, Fenner & Smith Incorporated and Morgan Stanley & Co. Incorporated, as representatives of the several underwriters named therein (incorporated by reference to Exhibit 1.1 of Form 8-K (File No. 000-18225) filed February 21, 2006)
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

Schedules and exhibits have been omitted pursuant to Item 601(b)(2) of Regulation S-K. Cisco Systems, Inc. hereby undertakes to furnish supplementally copies of any of the omitted schedules and exhibits upon request by the Securities and Exchange Commission.