CISCO SYSTEMS INC
Form 10-Q
December 10, 2001

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 OCTOBER 27, 2001

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 filing requirements for the past 90 days.

YES [X] NO [ ]

As of November 24, 2001, 7,334,911,767 shares of the registrant's common stock were outstanding.

FORM 10-Q FOR THE QUARTER ENDED OCTOBER 27, 2001

INDEX

		Page
Part I.	Financial Information	
Item 1.	Financial Statements (Unaudited)	
	a) Consolidated Statements of Operations for the three months ended October 27, 2001 and October 28, 2000	3
	b) Consolidated Balance Sheets at October 27, 2001 and July 28, 2001	4
	c) Consolidated Statements of Cash Flows for the three months ended October 27, 2001 and October 28, 2000	5
	d) Consolidated Statements of Shareholders' Equity for the three months ended October 27, 2001 and October 28, 2000	6
	e) Notes to Consolidated Financial Statements	7
Item 2.	Management's Discussion and Analysis of Financial Condition and Results of Operations	23
Item 3.	Quantitative and Qualitative Disclosures About Market Risk	45
Part II.	Other Information	
Item 1.	Legal Proceedings	46
Item 2.	Changes in Securities and Use of Proceeds	46
Item 4.	Submission of Matters to a Vote of Security Holders	47
Item 6.	Exhibits and Reports on Form 8-K	48
	Signature	49

PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

CISCO SYSTEMS, INC.
CONSOLIDATED STATEMENTS OF OPERATIONS
(IN MILLIONS, EXCEPT PER-SHARE AMOUNTS)
(UNAUDITED)

	Three Months Ended	
	October 27, 2001	October 28, 2000
NET SALES:		
Product	$ 3,656	$ 5,911
Services	792	608
Total net sales	4,448	6,519
COST OF SALES:		
Product	1,500	2,122
Services	256	256
Total cost of sales	1,756	2,378
GROSS MARGIN	2,692	4,141
OPERATING EXPENSES:		
Research and development	917	947
Sales and marketing	1,096	1,362
General and administrative	151	196
Amortization of goodwill	--	144
Amortization of purchased intangible assets	146	81
In-process research and development	37	509
Total operating expenses	2,347	3,239
OPERATING INCOME	345	902
Interest and other income (losses), net	(688)	420
INCOME (LOSS) BEFORE PROVISION FOR (BENEFIT FROM) INCOME TAXES	(343)	1,322
Provision for (benefit from) income taxes	(75)	524
NET INCOME (LOSS)	$ (268)	$ 798
Net income (loss) per share--basic	$ (0.04)	$ 0.11
Net income (loss) per share--diluted	$ (0.04)	$ 0.11
Shares used in per-share calculation--basic	7,307	7,093
Shares used in per-share calculation--diluted	7,307	7,580

See Notes to Consolidated Financial Statements.

3

CISCO SYSTEMS, INC.
CONSOLIDATED BALANCE SHEETS
(IN MILLIONS, EXCEPT PAR VALUE)
(UNAUDITED)

	October 27, 2001	July 2 2001
ASSETS		
Current assets:		
Cash and cash equivalents	$ 4,487	$ 4,
Short-term investments	2,873	2,
Accounts receivable, net of allowance for doubtful accounts of $311 at October 27, 2001 and $288 at July 28, 2001	1,181	1,
Inventories, net	1,301	1,
Deferred tax assets	2,271	1,
Lease receivables, net	395	
Prepaid expenses and other current assets	513	
Total current assets	13,021	12,
Investments	10,570	10,
Restricted investments	1,150	1,
Property and equipment, net	2,585	2,
Goodwill	3,300	3,
Purchased intangible assets, net	1,366	1,
Lease receivables, net	98	
Other assets	3,450	3,
TOTAL ASSETS	$ 35,540	$ 35,
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$ 459	$
Income taxes payable	276	
Accrued compensation	1,180	1,
Deferred revenue	2,784	2,
Other accrued liabilities	2,304	2,
Restructuring liabilities	316	
Total current liabilities	7,319	7,
Deferred revenue	751	
Total liabilities	8,070	8,
Minority interest	20	
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; 7,328 and 7,324 shares issued and outstanding at October 27, 2001 and July 28, 2001, respectively	20,372	20,
Retained earnings	6,800	7,
Accumulated other comprehensive income (loss)	278	(
Total shareholders' equity	27,450	27,
TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY	$ 35,540	$ 35,

See Notes to Consolidated Financial Statements.

4

CISCO SYSTEMS, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS
(IN MILLIONS)
(UNAUDITED)

	Three Months Ended	
	October 27, 2001	October 28, 2000
Cash flows from operating activities:		
Net income (loss)	$ (268)	$ 79
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Depreciation and amortization	459	43
Provision for doubtful accounts	26	1
Provision for (benefit from) inventory	(29)	14
Deferred income taxes	(540)	(29
Tax benefits from employee stock option plans	43	98
In-process research and development	25	47
Net (gains) losses on investments and provision for losses	971	3
Change in operating assets and liabilities:		
Accounts receivable	259	(60
Inventories	229	(86
Prepaid expenses and other current assets	70	(34
Accounts payable	(185)	25
Income taxes payable	34	2
Accrued compensation	122	(23
Deferred revenue	321	31
Other accrued liabilities	(83)	22
Restructuring liabilities	(70)	-
Net cash provided by operating activities	1,384	1,36
Cash flows from investing activities:		
Purchases of short-term investments	(2,327)	(1,52

Proceeds from sales and maturities of short-term investments	1,724	2,14
Purchases of investments	(2,790)	(4,13
Proceeds from sales and maturities of investments	2,040	4,11
Purchases of restricted investments	(19)	(5
Proceeds from sales and maturities of restricted investments	161	1
Acquisition of property and equipment	(292)	(52
Acquisition of businesses, net of cash and cash equivalents	14	3
Change in lease receivables, net	165	10
Purchases of investments in privately held companies	(19)	(31
Lease deposits	(73)	-
Purchase of minority interest of Cisco Systems, K.K. (Japan)	(37)	-
Other	(138)	(23
Net cash used in investing activities	(1,591)	(37
Cash flows from financing activities:		
Issuance of common stock	171	33
Repurchase of common stock	(350)	-
Other	--	(1
Net cash provided by (used in) financing activities	(179)	31
Net increase (decrease) in cash and cash equivalents	(386)	1,30
Cash and cash equivalents, beginning of period	4,873	4,23
Cash and cash equivalents, end of period	$ 4,487	$ 5,53

See Notes to Consolidated Financial Statements.

CISCO SYSTEMS, INC.
CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY
(IN MILLIONS)
(UNAUDITED)

Three Months Ended October 28, 2000	Common Stock Number of Shares	Common Stock and Additional Paid-In Capital	Retained Earnings	A Co
BALANCE AT JULY 29, 2000	7,138	$ 14,609	$ 8,358	$
Net income	--	--	798	
Change in unrealized gains and losses on investments	--	--	--	
Other	--	--	--	
Comprehensive loss	--	--	--	
Issuance of common stock	35	338	--	
Tax benefits from employee stock option plans	--	106	--	

Purchase acquisitions	17	1,027	--	
Amortization of deferred stock-based compensation	--	23	--	
BALANCE AT OCTOBER 28, 2000	7,190	$ 16,103	$ 9,156	$

Three Months Ended October 27, 2001	Common Stock Number of Shares	Common Stock and Additional Paid-In Capital	Retained Earnings
BALANCE AT JULY 28, 2001	7,324	$ 20,051	$ 7,344
Net loss	--	--	(268)
Change in unrealized gains and losses on investments	--	--	--
Other	--	--	--
Comprehensive income	--	--	--
Issuance of common stock	23	171	--
Repurchase of common stock	(27)	(74)	(276)
Tax benefits from employee stock option plans	--	43	--
Purchase acquisitions	8	128	--
Amortization of deferred stock-based compensation	--	53	--
BALANCE AT OCTOBER 27, 2001	7,328	$ 20,372	$ 6,800

See Notes to Consolidated Financial Statements.

6

CISCO SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(UNAUDITED)

1. DESCRIPTION OF BUSINESS

Cisco Systems, Inc. (the "Company" or "Cisco") is the worldwide leader in networking for the Internet. Cisco Internet Protocol ("IP")-based networking solutions are the foundation of the Internet and are installed at corporations, public institutions, telecommunication companies, and in a growing number of medium-sized commercial enterprises. Cisco provides a broad line of solutions for transporting data, voice, and video within buildings, across campuses, or around the world. Cisco solutions allow networks, both public and private, to operate with flexibility, security, and performance.

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 2002 and 2001 are 52-week fiscal years.

Basis of Presentation

The accompanying financial data as of October 27, 2001 and for the three months ended October 27, 2001 and October 28, 2000 has been prepared by the Company, without audit, pursuant to the rules and regulations of the Securities and Exchange Commission ("SEC"). Certain information and footnote disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles have been condensed or omitted pursuant to such rules and regulations. The July 28, 2001 Consolidated Balance Sheet was derived from audited financial statements, but does not include all disclosures required by generally accepted accounting principles. However, the Company believes that the disclosures are adequate to make the information presented not misleading. These Consolidated Financial Statements should be read in conjunction with the Consolidated Financial Statements and the notes thereto included in the Company's Annual Report on Form 10-K for the fiscal year ended July 28, 2001.

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 October 27, 2001, results of operations, cash flows, and shareholders' equity for the three months ended October 27, 2001 and October 28, 2000 have been made. The results of operations for the three months ended October 27, 2001 are not necessarily indicative of the operating results for the full fiscal year or any future periods.

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

Computation of Net Income (Loss) per Share

Basic net income (loss) 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. Diluted net loss per share is computed using the weighted-average number of common shares and excludes dilutive potential common shares outstanding, as their effect is antidilutive. Dilutive potential common shares primarily consist of employee stock options.

Goodwill and Purchased Intangible Assets

In July 2001, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards No. 141, "Business Combinations" ("SFAS 141") and Statement of Financial Accounting Standards No. 142, "Goodwill and Other Intangible Assets" ("SFAS 142"). SFAS 141 requires all business combinations to be accounted for using the purchase method of accounting and that certain intangible assets acquired in a business combination shall be recognized as assets apart from goodwill. SFAS 141 was effective for all business combinations

initiated after June 30, 2001. SFAS 142 requires goodwill to be tested for impairment under certain circumstances, and written down when impaired, rather than being amortized as previous standards required. Furthermore, SFAS 142 requires purchased intangible assets other than goodwill to be amortized over their useful lives unless these lives are determined to be indefinite. Purchased intangible assets are carried at cost less accumulated amortization. Amortization is computed over the useful lives of the respective assets, generally two to five years.

SFAS 142 is effective for fiscal years beginning after December 15, 2001; however, the Company has elected to early-adopt the standard effective the beginning of fiscal 2002. In accordance with SFAS 142, the Company ceased amortizing goodwill totaling $3.2 billion as of the beginning of fiscal 2002, including $55 million of acquired workforce intangible previously classified as purchased intangible assets, net of related deferred tax liabilities. As a result, in the first quarter of fiscal 2002, the Company did not recognize $199 million of goodwill amortization expense that would have been recognized had the previous standards been in effect.

The following table presents the impact of SFAS 142 on net income (loss) and net income (loss) per share had the standard been in effect for the first quarter of fiscal 2001 (in millions, except per-share amounts):

	Three Months Ended	
	October 27, 2001	October 28, 2000
Reported net income (loss)	$ (268)	$ 798
Adjustments:		
Amortization of goodwill	--	144
Amortization of acquired workforce intangible previously classified as purchased intangible assets	--	2
Income tax effect	--	(20)
Net adjustments	--	126
Adjusted net income (loss)	$ (268)	$ 924
Reported net income (loss) per share--basic	$ (0.04)	$ 0.11
Adjusted net income (loss) per share--basic	$ (0.04)	$ 0.13
Reported net income (loss) per share--diluted	$ (0.04)	$ 0.11

Adjusted net income (loss) per share--diluted	$ (0.04)	$ 0.12

There was no impairment of goodwill upon adoption of SFAS 142. The Company is required to perform goodwill impairment tests on an annual basis and between annual tests in certain circumstances. There can be no assurance that future goodwill impairment tests will not result in a charge to earnings.

9

CISCO SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(UNAUDITED)

Recent Accounting Pronouncement

In October 2001, the FASB issued Statement of Financial Accounting Standard No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets" ("SFAS 144"). SFAS 144 establishes a single accounting model, based on the framework established in Statement of Financial Accounting Standard No. 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of" ("SFAS 121"), for long-lived assets to be disposed of by sale, and resolves significant implementation issues related to SFAS 121. The Company is currently assessing the impact of SFAS 144 on its operating results and financial condition. The Company is required to adopt SFAS 144 no later than the first quarter of fiscal 2003.

3. BUSINESS COMBINATIONS

During the first quarter of fiscal 2002, the Company completed the acquisitions of Allegro Systems, Inc. ("Allegro") and AuroraNetics, Inc. ("AuroraNetics"). The Company acquired Allegro to enhance its existing Virtual Private Network ("VPN") and security solutions with added performance capabilities to meet the growing security requirements of organizations connecting remote offices, employees, and customers to corporate networks and the Internet. The Company acquired AuroraNetics to enhance its development of innovative high-end routing technologies designed to address the rapid growth of data traffic in the metropolitan network environment. A summary of the purchase transactions is outlined as follows (in millions):

Acquired Company	Consideration Including Assumed Liabilities	In-Process R&D Expense	Goodwill	Purchased Intangible Assets
Allegro	$ 138	$ 28	$ 5	$ 105
AuroraNetics	51	9	16	14
Total	$ 189	$ 37	$ 21	$ 119

In connection with the above purchase acquisitions, the Company may be required to pay certain additional amounts of up to $145 million contingent upon Allegro and AuroraNetics achieving certain agreed upon milestones.

The amounts allocated to in-process research and development ("in-process R&D") were determined through established valuation techniques in the high-technology communications equipment industry and were expensed upon acquisition because technological feasibility had not been established and no future alternative uses existed. Total in-process R&D expense for

the first quarter of fiscal 2002 and 2001 was $37 million and $509 million, respectively. The in-process R&D expense that was attributable to stock consideration for the same periods was $25 million and $476 million, respectively.

The following table presents details of the purchased intangible assets acquired during the first quarter of fiscal 2002 (in millions):

	Allegro		AuroraNetics	
	Estimated Useful Life	Amount	Estimated Useful Life	Amount
Technology	4.1	$ 98	--	$ --
Patents	--	--	5.0	3
Other	2.0	7	2.0	11
	4.0	$ 105	2.6	$ 14

The remaining purchase price was primarily allocated to tangible assets and deferred stock-based compensation. At October 27, 2001 and July 28, 2001, the total unamortized deferred stock-based compensation was $266 million and $293 million, respectively, and was reflected as a debit to additional paid-in capital in the Consolidated Statements of Shareholders' Equity.

The Consolidated Financial Statements include the operating results of each business from the date of acquisition. Pro forma results of operations have not been presented because the effects of these acquisitions were not material on either an individual or aggregate basis.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(UNAUDITED)

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

October 27, 2001	Gross	Accumulated Amortization	Net
Technology	$ 1,096	$ (279)	$ 817
Technology licenses	523	(225)	298
Patents	222	(51)	171
Other	135	(55)	80
Total	$ 1,976	$ (610)	$ 1,366

July 28, 2001	Gross	Accumulated Amortization	Net
Technology	$ 1,053	$ (240)	$ 813
Technology licenses	523	(191)	332
Patents	232	(44)	188
Acquired workforce	91	(20)	71
Other	117	(51)	66
Total	$ 2,016	$ (546)	$ 1,470

The following table presents details of the amortization expense of purchased intangible assets as reported in the Consolidated Statements of Operations (in millions):

	Three Months Ended	
	October 27, 2001	October 28, 2000
Reported as:		
Cost of sales	$ 6	$ 4
Operating expenses	146	81
Total	$ 152	$ 85

CISCO SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(UNAUDITED)

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

Fiscal year	Amount
2002 (remaining nine months)	$ 410
2003	$ 416
2004	$ 291
2005	$ 199
2006	$ 49
2007	$ 1

The following table presents the changes in goodwill allocated to the reportable segments during the first quarter of fiscal 2002 (in millions):

	Balance at July 28, 2001	Acquired	Adjustments	Balance at October 27, 2001
Americas	$ 2,177	$ 11	$ 38	$ 2,226
EMEA	531	6	12	549
Asia Pacific	110	2	4	116
Japan	371	37	1	409
Total	$ 3,189	$ 56	$ 55	$ 3,300

In the first quarter of fiscal 2002, the Company purchased a portion of the minority interest of Cisco Systems, K.K. (Japan). As a result, the Company increased its ownership to 89.3% of the voting rights of Cisco Systems, K.K. (Japan) and recorded goodwill of $35 million. The adjustments during the first quarter of fiscal 2002 were due to the reclassification of acquired workforce intangible and the related deferred tax liabilities to goodwill as a result of the adoption of SFAS 142.

CISCO SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(UNAUDITED)

4. RESTRUCTURING COSTS AND OTHER SPECIAL CHARGES AND PROVISION FOR INVENTORY

On April 16, 2001, due to macroeconomic and capital spending issues affecting the networking industry, the Company announced a restructuring program to prioritize its initiatives around high-growth areas of its business, focus on profit contribution, reduce expenses, and improve efficiency. This restructuring program included a worldwide workforce reduction, consolidation of additional excess facilities, and restructuring of certain business functions.

In fiscal 2001, the Company recorded restructuring costs and other special charges classified as operating expenses and an additional excess inventory charge classified as cost of sales as a result of the restructuring program and decline in forecasted revenue. The following paragraphs provide detailed information relating to the status of the restructuring liabilities and additional excess inventory reserve during the first quarter of fiscal 2002.

Worldwide Workforce Reduction, Consolidation of Excess Facilities, and Other Special Charges

The following table summarizes the activity related to the restructuring liabilities during the first quarter of fiscal 2002 (in millions):

	Balance at July 28, 2001	Reclassification	Cash Payments	Oct
Workforce reduction	$ 61	$ (31)	$ (19)	$
Consolidation of excess facilities and other charges	325	31	(51)	
Total	$ 386	$ --	$ (70)	$

In the first quarter of fiscal 2002, due to changes in previous estimates, the Company reclassified $31 million of restructuring liabilities related to the workforce reduction charges to consolidation of excess facilities and other charges.

The following is a summary of the restructuring liabilities at October 27, 2001 (in millions):

	Total Charge	Reclassification	Non-Cash Charges	

Workforce reduction	$ 397	$ (31)	$ (71)	$
Consolidation of excess facilities and other charges	484	31	(141)	
Impairment of goodwill and purchased intangible assets	289	--	(289)	
Total	$ 1,170	$ --	$ (501)	$

The worldwide workforce reduction program started in the third quarter of fiscal 2001. As of October 27, 2001, approximately 5,300 regular employees have been terminated and paid. Amounts related to the net lease expense due to the consolidation of facilities will be paid over the respective lease terms through fiscal 2007.

Provision for Inventory

In the third quarter of fiscal 2001, the Company recorded an additional excess inventory charge of $2.2 billion. This additional excess inventory charge was subsequently reduced in the fourth quarter of fiscal 2001 by a $187 million benefit primarily related to lower settlement charges for purchase commitments. In the first quarter of fiscal 2002, this additional excess inventory charge was further reduced by a $290 million benefit primarily related to inventory used to manufacture products sold and for internal use in research and development and was credited to the provision for inventory.

The following is a summary of the additional excess inventory reserve during the first quarter of fiscal 2002 (in millions):

E

Reserve balance as of July 28, 2001
Usage:
Inventory scrapped
Sale of inventory
Inventory utilized
Settlement of purchase commitments

Remaining reserve balance as of October 27, 2001

15

CISCO SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(UNAUDITED)

The following is a summary of the additional excess inventory reserve at October 27, 2001 (in millions):

	Excess Inventory Reserve	Excess Inventory Benefit
Initial additional excess inventory charge	$ 2,249	$ --
Usage:		
Inventory scrapped	(555)	--
Sale of inventory	(121)	13
Inventory utilized	(283)	283
Settlement of purchase commitments	(447)	181
	(1,406)	$ 477
Remaining reserve balance as of October 27, 2001	$ 843	

5. BALANCE SHEET DETAILS

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

	October 27, 2001	July 28, 2001
Inventories, net:		
Raw materials	$ 521	$ 662
Work in process	100	260
Finished goods	594	669
Demonstration systems	86	93
Total	$ 1,301	$ 1,684
Other assets:		
Deferred tax assets	$ 1,220	$ 1,314
Investments in privately held companies, net	781	775
Income tax receivable	443	443
Lease deposits	393	320
Structured loans, net	112	84
Other	501	354
Total	$ 3,450	$ 3,290

(UNAUDITED)

6. LEGAL PROCEEDINGS

The Company is subject to legal proceedings, claims, and litigation arising in the ordinary course of business. While the outcome of these matters is currently not determinable, management 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.

Beginning on April 20, 2001, a number of purported shareholder class action lawsuits have been 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 are essentially identical, and purport to bring suit on behalf of those who purchased the Company's publicly traded securities between August 10, 1999 and April 16, 2001. Plaintiffs allege that defendants 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 intends to defend the actions vigorously.

In addition, beginning on April 23, 2001, a number of purported shareholder derivative lawsuits have been filed in the Superior Court of California, County of Santa Clara, against the Company (as a nominal defendant), its directors and certain officers. At least two purported derivative suits have also been filed in the United States District Court for the Northern District of California, and another has been filed in the Superior Court of California, County of San Mateo. The complaints in the various derivative actions include claims for breach of fiduciary duty, waste of corporate assets, mismanagement, unjust enrichment and violations of the California Corporations Code, seek compensatory and other damages, disgorgement and other relief, and are based on essentially the same allegations as the class actions.

7. SHAREHOLDERS' EQUITY

Stock Repurchase Program

In September 2001, the Board of Directors authorized a stock repurchase program to acquire outstanding common stock in the open market or negotiated transactions. Under the program, up to $3 billion of Cisco common stock could be reacquired over the next two years. During the first quarter of fiscal 2002, the Company repurchased and retired approximately 27 million shares of Cisco common stock for an aggregate purchase price of $350 million.

Comprehensive Income (Loss)

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

	Three Months Ended	
	October 27, 2001	October 28, 2000
Net income (loss)	$ (268)	$ 798
Other comprehensive income (loss)		
Change in unrealized gains and losses on investments, net of tax	555	(1,129)
Other	(2)	(19)
Total	$ 285	$ (350)

During the first quarter of fiscal 2002, the Company recorded a charge of $858 million related to the impairment on certain publicly traded securities in its investment portfolio in accordance with Statement of Financial Accounting Standard No. 115, "Accounting for Certain Investments in Debt and Equity Securities." The impairment charge was related to the decline in the fair value of the Company's publicly traded equity investments below the cost basis that are considered to be other-than-temporary. The change in the unrealized gains and losses on investments during the first quarter of fiscal 2002 was primarily related to this impairment charge, net of tax.

8. INCOME TAXES

The Company paid net income taxes of $390 million for the first quarter of fiscal 2002 and received net income tax refunds of $219 million for the first quarter of fiscal 2001. The Company's income taxes currently payable for federal and state purposes have been reduced by the tax benefits of employee stock option transactions. These benefits totaled $43 million and $985 million in the first quarter of fiscal 2002 and 2001, respectively, and were reflected as a credit to additional paid-in capital in the Consolidated Statements of Shareholders' Equity. In the first quarter of fiscal 2001, the Company's valuation allowance against gross deferred tax assets attributable to employee stock option transactions increased by $879 million and was reflected as a debit to additional paid-in capital in the Consolidated Statements of Shareholders' Equity.

18

CISCO SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(UNAUDITED)

9. SEGMENT INFORMATION AND MAJOR CUSTOMERS

The Company's operations involve the design, development, manufacturing, marketing, and technical support of networking products and services. The Company offers end-to-end networking solutions for its customers. Cisco products include routers, LAN and ATM switches, dial-up access servers, and network-management software. These products, integrated by the Cisco IOS(R) Software, link geographically dispersed LANs and WANs into complete end-to-end networks.

The Company conducts business globally and is managed geographically. The Company's management relies on an internal management system that provides sales and standard cost information by geographic theater. Sales are attributed to a theater based on the ordering location of the customer. The Company's management makes financial decisions and allocates resources based on the information it receives from this internal management system. The Company does not allocate research and development, sales and marketing, or general and administrative expenses to its geographic theaters in this internal management system, as management does not use the information to measure the performance of the operating segments. Management does not believe that allocating these expenses is significant in evaluating a geographic theater's performance. Based on established criteria, the Company has four reportable segments: the Americas; Europe, the Middle East, and Africa ("EMEA"); Asia Pacific; and Japan.

Summarized financial information by theater for the first quarter of fiscal 2002 and 2001, as taken from the internal management system previously discussed, is as follows (in millions):

	Three Months Ended	
	October 27, 2001	October 28, 2000
Net sales:		
Americas	$ 3,007	$ 4,632
EMEA	1,197	1,845
Asia Pacific	400	669
Japan	325	484
Revenue adjustments	(151)	(608)
Revenue deferrals	(330)	(503)
Total	$ 4,448	$ 6,519
Gross margin:		
Americas	$ 2,197	$ 3,373
EMEA	934	1,384
Asia Pacific	312	482
Japan	254	387
Standard margin	3,697	5,626
Revenue adjustments	(151)	(608)
Revenue deferrals	(330)	(503)
Deferred cost of sales	75	293
Production overhead	(191)	(154)
Manufacturing variances and other related costs	(408)	(513)
Total	$ 2,692	$ 4,141

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The net sales and standard margins by geographic theater differ from the amounts recognized under generally accepted accounting principles because the Company does not allocate certain revenue adjustments, revenue deferrals, deferred cost of sales, production overhead, and manufacturing variances and other related costs to the theaters. Revenue adjustments primarily relate to reserves for accounts receivable, leases, and structured loans which are not allocated to geographical or product categories. Revenue deferrals primarily relate to two-tier distribution, sales that contain contract terms requiring revenue deferral, and other timing differences which are not allocated to geographical or product categories. The above table reconciles the net sales and standard margins by geographic theater to net sales and gross margin as reported in the Consolidated Statements of Operations.

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

	Three Months Ended	
	October 27, 2001	October 28, 2000
Net sales:		
Routers	$ 1,607	$ 2,818
Switches	1,993	2,809
Access	316	810
Service	792	608
Other	479	642
Revenue adjustments (1)	(409)	(665)
Revenue deferrals	(330)	(503)
Total	$ 4,448	$ 6,519

Note 1: Also includes credit memos related to customer incentives and other discounts not allocated to specific product categories but allocated to geographical categories totaling $258 million and $57 million in the first quarter of fiscal 2002 and 2001, respectively.

Substantially all of the Company's assets at October 27, 2001 and July 28, 2001 were attributable to U.S. operations. In the first quarter of fiscal 2002 and 2001, no single customer accounted for 10% or more of the Company's net sales.

CISCO SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(UNAUDITED)

10. NET INCOME (LOSS) PER SHARE

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

	Three Months Ended	
	October 27, 2001	October 28, 2000
Net income (loss)	$ (268)	$ 798
Weighted-average shares -- basic	7,307	7,093
Effect of dilutive securities:		
Employee stock options	--	487
Weighted-average shares -- diluted	7,307	7,580
Net income (loss) per share -- basic	$ (0.04)	$ 0.11
Net income (loss) per share -- diluted	$ (0.04)	$ 0.11

The dilutive potential common shares that were antidilutive for the first quarter of fiscal 2002 amounted to 159 million shares.

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

Certain statements contained in this Quarterly Report on Form 10-Q, including, without limitation, statements containing the words "believes," "anticipates," "estimates," "expects," "projections," and words of similar import, constitute "forward-looking statements." You should not place undue reliance on these forward-looking statements. Our actual results could differ materially from those anticipated in these forward-looking statements for many reasons, including the risks faced by us described below and elsewhere in this Quarterly Report, and in other documents we file with the Securities and Exchange Commission.

The net sales and gross margin for the first quarter of fiscal 2002 and 2001 were as follows (in millions, except percentages):

Three Months Ended	Net Sales		Gross Margin	
	October 27, 2001	October 28, 2000	October 27, 2001	October 28, 2000
Product	$ 3,656	$ 5,911	59.0%	64.1%
Service	792	608	67.7%	57.9%
Total	$ 4,448	$ 6,519	60.5%	63.5%

Net product revenue in the first quarter of fiscal 2002 decreased by 38.1% from the first quarter of fiscal 2001. The decrease in net product revenue was primarily a result of decreased unit sales of router, switch, and access products due to the unfavorable economic conditions and capital spending environment compared to the period a year ago. Net product revenue in the first quarter of fiscal 2002 increased by 2.2% compared with net product revenue of $3.6 billion in the fourth quarter of fiscal 2001.

Product gross margin in the first quarter of fiscal 2002 decreased to 59.0% from 64.1% in the first quarter of fiscal 2001 primarily due to lower shipment volumes and related manufacturing overhead; shifts in product mix; and higher production-related costs partially offset by a benefit from the additional excess inventory reserve as discussed below. Excluding the benefit from the additional excess inventory reserve in both periods, product gross margin was 51.0% in the first quarter of fiscal 2002 compared with 49.1% in the fourth quarter of fiscal 2001.

The provision for (benefit from) inventory was ($29) million in the first quarter of fiscal 2002 compared with $143 million in the first quarter of fiscal 2001. In the third quarter of fiscal 2001, we recorded an additional excess inventory charge of $2.2 billion. This additional excess inventory charge was subsequently reduced in the fourth quarter of fiscal 2001 by a $187 million benefit primarily related to lower settlement charges for purchase commitments. In the first quarter of fiscal 2002, this additional excess inventory charge was further reduced by a $290 million benefit primarily related to inventory used to manufacture products sold and for internal use in research and development and was credited to the provision for inventory. As of October 28, 2001, the remaining additional excess inventory reserve balance was $843 million. For additional information regarding the additional excess inventory reserve, see Note 4

"Restructuring Costs and Other Special Charges and Provision for Inventory" of the Notes to Consolidated Financial Statements.

Inventory purchases and commitments are based upon future demand forecasts. Due to a sudden and significant decrease in demand for our products in the third quarter of fiscal 2001, inventory levels exceeded our estimated requirements

based on demand forecasts and the additional excess inventory charge was recorded in accordance with our accounting policy. We do not currently anticipate the additional excess inventory subject to this provision will be used significantly at a later date based on our current demand forecast.

Net service revenue in the first quarter of fiscal 2002 increased by 30.3% from the first quarter of fiscal 2001. Service revenue is generally deferred and, in most cases, recognized ratably over the service period obligations, which are typically one to three years. The increase in net service revenue was primarily related to the increased installed base of equipment needing maintenance support. Net service revenue in the first quarter of fiscal 2002 increased by 9.8% compared with net service revenue of $721 million in the fourth quarter of fiscal 2001.

Net service margin in the first quarter of fiscal 2002 increased to 67.7% from 57.9% in the first quarter of fiscal 2001. The increase in service margin was primarily due to cost efficiencies in our technical assistance centers. Service margin was 68.5% in the fourth quarter of fiscal 2001. Service margins will typically experience some variability over time due to various factors such as the changes in mix between support and professional services, as well as the timing of support contract renewals.

We manage our business based on four geographic theaters: the Americas; Europe, the Middle East, and Africa ("EMEA"); Asia Pacific; and Japan. Financial information by theater for the first quarter of fiscal 2002 and 2001 is summarized in the following table (in millions, except percentages):

	Amounts		Percentage of Net Sales	
Three Months Ended	October 27, 2001	October 28, 2000	October 27, 2001	October 28, 2000
Net sales:				
Americas	$ 3,007	$ 4,632	67.6%	71.1%
EMEA	1,197	1,845	26.9%	28.3%
Asia Pacific	400	669	9.0%	10.2%
Japan	325	484	7.3%	7.4%
Revenue adjustments	(151)	(608)	(3.4%)	(9.3%)
Revenue deferrals	(330)	(503)	(7.4%)	(7.7%)
Total	$ 4,448	$ 6,519	100.0%	100.0%

24

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

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

Amounts	Standard Margin

Years Ended	October 27, 2001	October 28, 2000	October 27, 2001	Oct
Gross margin:				
Americas	$ 2,197	$ 3,373	73.1%	
EMEA	934	1,384	78.0%	
Asia Pacific	312	482	78.0%	
Japan	254	387	78.2%	
Standard margin	3,697	5,626	75.0%	
Revenue adjustments	(151)	(608)		
Revenue deferrals	(330)	(503)		
Deferred cost of sales	75	293		
Production overhead	(191)	(154)		
Manufacturing variances and other related costs	(408)	(513)		
Total	$ 2,692	$ 4,141		

The net sales and standard margins by geographic theater differ from the amounts recognized under generally accepted accounting principles because we do not allocate certain revenue adjustments, revenue deferrals, deferred cost of sales, production overhead, and manufacturing variances and other related costs to the theaters. Standard margins vary due to a number of reasons including, but not limited to, shifts in product mix, sales discounts, and sales channels. Revenue adjustments primarily relate to reserves for accounts receivable, leases, and structured loans which are not allocated to geographical or product categories. Revenue deferrals primarily relate to two-tier distribution, sales that contain contract terms requiring revenue deferral, and other timing differences which are not allocated to geographical or product categories.

Gross margin may be adversely affected in the future by increases in material or labor costs, excess inventory, obsolescence charges, changes in shipment volume, loss of cost savings, price competition, and changes in channels of distribution or in the mix of products sold. If product or related warranty costs associated with our products are greater than we have experienced, gross margin may also be adversely affected. Gross margin may also be impacted by geographic mix, as well as the mix of configurations within each product group. We continue to expand into third-party or indirect-distribution channels, which generally results in a lower gross margin. These distribution channels are generally given privileges to return inventory. In addition, increasing third-party and indirect-distribution channels generally results in greater difficulty in forecasting the mix of our product, and to a certain degree, the timing of orders from our customers.

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

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

Three Months Ended	Amounts		Percentage of Net Sales	
	October 27, 2001	October 28, 2000	October 27, 2001	October 28, 2000
Research and development	$ 917	$ 947	20.6%	14.5%
Sales and marketing	$ 1,096	$ 1,362	24.6%	20.9%
General and administrative	$ 151	$ 196	3.4%	3.0%

In the third quarter of fiscal 2001, we announced a restructuring program to prioritize our initiatives around high-growth areas of our business, focus on profit contribution, reduce expenses, and improve efficiency. This restructuring program included a worldwide workforce reduction, consolidation of additional excess facilities, and restructuring of certain business functions. For additional information regarding the restructuring program, see Note 4 "Restructuring Costs and Other Special Charges and Provision for Inventory" of the Notes to Consolidated Financial Statements.

R&D, sales and marketing, and G&A expenses as a percentage of net sales for the first quarter of fiscal 2002 have increased compared with the first quarter of fiscal 2001 primarily due to the decline in net sales. R&D, sales and marketing, and G&A expenses decreased in absolute dollars from the first quarter of the prior year primarily due to the impact of the restructuring program and cost control measures to contain hiring and reduce discretionary spending. As a result, operating expenses have been reduced on a quarterly basis by approximately $500 million compared to the high point of fiscal 2001.

R&D expenses in the first quarter of fiscal 2002 decreased by 3.2% from the first quarter of fiscal 2001. A significant portion of the decrease was due to lower expenditures on prototypes and lab equipment and the reduction of discretionary spending. R&D includes efforts in a wide variety of areas such as data, voice, and video over IP; advanced access technologies; enterprise switching; optical transport; storage networking; content networking; security; network management; advanced routing and switching technologies; cable; and other broadband technologies, among others. We have also continued to purchase technology in order to bring a broad range of products to the 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.

Sales and marketing expenses in the first quarter of fiscal 2002 decreased by 19.5% from the first quarter of fiscal 2001. The decrease in sales and marketing expenses was principally due to the decrease in the size of our direct sales force and related commissions, reduced marketing and

advertising investments associated with existing and new product introductions, the reduction of distribution channels and markets, and reduced investments in general corporate branding. However, we have continued our efforts to invest in certain key areas, such as expansion of our end-to-end networking strategy and service provider coverage, in order to be positioned to take advantage of future

market opportunities.

G&A expenses in the first quarter of fiscal 2002 decreased by 23.0% from the first quarter of fiscal 2001. The decrease in G&A expenses was primarily related to the reduction of investments in infrastructure and discretionary spending.

We have elected to early-adopt Statement of Financial Accounting Standards No. 142, "Goodwill and Other Intangible Assets" ("SFAS 142") effective the beginning of fiscal 2002. In accordance with SFAS 142, we ceased amortizing goodwill. There was no impairment of goodwill upon adoption of SFAS 142. We are required to perform goodwill impairment tests on an annual basis and between annual tests in certain circumstances. There can be no assurance that future goodwill impairment tests will not result in a charge to earnings. For additional information regarding SFAS 142, see Note 2 "Summary of Significant Accounting Policies" of the Notes to Consolidated Financial Statements.

Amortization of purchased intangible assets included in operating expenses was $146 million in the first quarter of fiscal 2002, compared with $81 million in the first quarter of fiscal 2001. The increase in the amortization of purchased intangible assets was primarily related to the accelerated amortization for certain technology and patent intangibles due to a reduction in their useful lives. For additional information regarding purchased intangible assets, see Note 3 "Business Combinations" of the Notes to Consolidated Financial Statements.

The amount expensed to in-process research and development ("in-process R&D") arose from the purchase acquisitions (see Note 3 to the Consolidated Financial Statements). The fair values of the existing purchased technology and patents, as well as the technology currently under development, were determined using the income approach, which discounts expected future cash flows to present value. The discount rates used in the present value calculations were typically derived from a weighted-average cost of capital analysis and venture capital surveys, adjusted upward to reflect additional risks inherent in the development life cycle. We consider the pricing model for products related to these acquisitions to be standard within the high-technology communications equipment industry. However, we do not expect to achieve a material amount of expense reductions or synergies as a result of integrating the acquired in-process technology. Therefore, the valuation assumptions do not include significant anticipated cost savings.

The development of these technologies remains a significant risk due to the remaining efforts to achieve technical viability, rapidly changing customer markets, uncertain standards for new products, and significant competitive threats from numerous companies. The nature of the efforts to develop these technologies into commercially viable products consists principally 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 valuations for our significant purchase acquisitions completed in the first quarter of fiscal

2002 (in millions, except percentages):

Acquired Company	Estimated Cost to Complete Technology at Time of Acquisition	Risk-Adjusted Discount Rate for In-Process R&D
Allegro Systems, Inc.	$ 5	52.5%
AuroraNetics, Inc.	$ 2	35.0%

Regarding our purchase acquisitions, actual results to date have been consistent, in all material respects, with our assumptions at the time of acquisitions except for certain purchase acquisitions where the purchased intangible assets have been impaired and written-down as reflected in the Consolidated Statements of Operations. The assumptions primarily consist of an expected completion date for the in-process projects, estimated costs to complete the projects, and revenue and expense projections assuming the products have entered the market. 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.

Interest and other income (losses), net, were ($688) million in the first quarter of fiscal 2002, compared with $420 million in the first quarter of fiscal 2001. The decrease was primarily due to a charge of $858 million related to the impairment on certain publicly traded securities in our investment portfolio. In accordance with Statement of Financial Accounting Standard No. 115, "Accounting for Certain Investments in Debt and Equity Securities," we have recorded an impairment charge related to the declines in the fair value of our publicly traded equity investments below the cost basis that are considered to be other-than-temporary.

For the first quarter of fiscal 2002, the effective tax rate was 21.9%. The effective tax rate differs from the statutory rate primarily due to the impact of nondeductible in-process R&D, acquisition-related costs, research and experimentation tax credits, and the tax impact of foreign operations. Our future effective tax rates could be adversely affected if earnings are lower than anticipated in countries where we have lower effective rates or by unfavorable changes in tax laws and regulations.

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

LIQUIDITY AND CAPITAL RESOURCES

Cash and cash equivalents and total investments were $19.1 billion at October 27, 2001, an increase of $563 million from July 28, 2001. The increase was primarily a result of cash provided by operating activities of $1.4 billion and cash provided by the issuance of common stock of $171 million. This increase was partially offset by cash used in capital expenditures of $292 million, cash used for the repurchase of common stock of $350 million, and a net decrease of $151 million in the fair value of investments.

Accounts receivable decreased 19.4% from July 28, 2001 to October 27, 2001. Days

sales outstanding in receivables decreased to 24 days at October 27, 2001 from 31 days at July 28, 2001. The decrease in accounts receivable and days sales outstanding were primarily due to shipment linearity and process improvements surrounding billing and collections.

Inventories decreased 22.7% from July 28, 2001 to October 27, 2001. Inventory turns, excluding the additional excess inventory benefit previously discussed were 5.5 for the first quarter of fiscal 2002 and 4.6 for the fourth quarter of fiscal 2001. The inventory levels and inventory turns reflected the improvement in shipment linearity. Inventory management remains an area of focus as we balance the need to maintain strategic inventory levels to ensure competitive lead times versus the risk of inventory obsolescence because of rapidly changing technology and customer requirements.

We have entered into several agreements to lease sites in San Jose, California (where our headquarters are established) and surrounding areas; Boxborough, Massachusetts; Salem, New Hampshire; Richardson, Texas; and Research Triangle Park, North Carolina where we have pledged $1.1 billion of our investments as collateral for certain obligations of the leases. We anticipate that we may occupy more leased property in the future that will require similar pledged securities; however, we do not expect the impact of this activity to be material to our liquidity position. We also lease office space in other U.S. locations, as well as locations in the Americas, EMEA, Asia Pacific, and Japan.

In September 2001, the Board of Directors authorized a stock repurchase program to acquire outstanding common stock in the open market or negotiated transactions. Under the program, up to $3 billion of Cisco common stock could be reacquired over the next two years. During the first quarter of fiscal 2002, we repurchased and retired approximately 27 million shares of Cisco common stock for an aggregate purchase price of $350 million.

We believe that our current cash and cash equivalents, short-term investments, and cash generated from operations will satisfy our expected working capital needs, capital expenditures, investment requirements, stock repurchases, and commitments through at least the next 12 months. Amounts related to the net lease expense due to the consolidation of facilities will be paid over the respective lease terms through fiscal 2007.

29

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

PRO FORMA CONSOLIDATED DATA

We provide pro forma net income and pro forma net income per share data as an alternative for understanding our operating results. These measures are not in accordance with, or an alternative for, generally accepted accounting principles and may be different from pro forma measures used by other companies. Pro forma net income and pro forma net income per share -- diluted are calculated as follows (in millions, except per-share amounts):

	Three Months Ended	
	October 27, 2001	October 28, 2000

Net income (loss)	$ (268)	$ 798
In-process research and development	37	509
Payroll tax on stock option exercises (1)	3	22
Amortization of deferred stock-based compensation (2)	50	6
Amortization of goodwill	--	144
Amortization of purchased intangible assets	146	81
Net (gains) losses on investments	858	(190)
Excess inventory benefit	(290)	--
Income tax effect	(204)	(7)
Pro forma net income	$ 332	$ 1,363
Pro forma net income per share -- diluted	$ 0.04	$ 0.18
Shares used in per-share calculation -- diluted (3)	7,466	7,580

Note 1: Payroll tax on stock option exercises of $3 million for the first quarter of fiscal 2002 was allocated to R&D ($1 million) and sales and marketing ($2 million) expenses in the Consolidated Statements of Operations. Payroll tax on stock option exercises of $22 million for the first quarter of fiscal 2001 was allocated to R&D ($8 million), sales and marketing ($12 million), and G&A ($2 million) expenses in the Consolidated Statements of Operations.

Note 2: Amortization of deferred stock-based compensation related to purchase acquisitions of $50 million for the first quarter of fiscal 2002 was allocated to R&D ($41 million), sales and marketing ($8 million), and G&A ($1 million) expenses in the Consolidated Statements of Operations. Amortization of deferred stock-based compensation related to purchase acquisitions of $6 million for the first quarter of fiscal 2001 was allocated to R&D ($5 million) and G&A ($1 million) expenses in the Consolidated Statements of Operations.

Note 3: Diluted net income per share is computed using the weighted-average number of common shares and dilutive potential common shares outstanding during the period. Diluted net loss per share is computed using the weighted-average number of common shares and excludes dilutive potential common shares, as their effect is antidilutive. The dilutive potential common shares that were antidilutive for the first quarter of fiscal 2002 amounted to 159 million shares.

RISK FACTORS

Set forth below and elsewhere in this Quarterly Report and in the other documents we file with the SEC are risks and uncertainties that could cause

actual results to differ materially from the results contemplated by the forward-looking statements contained in this Quarterly Report.

YOU SHOULD EXPECT THAT OUR OPERATING RESULTS MAY FLUCTUATE IN FUTURE PERIODS

The results of operations for any quarter or fiscal year are not necessarily indicative of results to be expected in future periods. Our operating results have in the past been, and will continue to be, subject to quarterly and annual fluctuations as a result of a number of factors. These factors include:

- Overall information technology spending
- Changes in general economic conditions and specific market conditions in the communications and networking industries
- Fluctuations in demand for our products and services
- The effects of terrorist activity and armed conflict, such as disruptions in general economic activity, changes in logistics and security arrangements, and reduced customer demand for our products and services
- The long sales and implementation cycle for our products and the reduced visibility into our customers' spending plans and associated revenue
- Inventory levels exceeding our requirements based upon future demand forecasts
- Existing network capacity, sharing of existing network capacity, and network capacity utilization rates of our customers
- Price and product competition in the networking industry
- The overall trend toward industry consolidation
- The introduction and market acceptance of new technologies and products, as well as the adoption of new networking standards
- Variations in sales channels, product costs, or mix of products sold
- The timing of orders, timing of shipments, and the ability to satisfy all contractual obligations in customer contracts
- Manufacturing lead times
- The impact of acquired businesses and technologies
- The geographical mix of our revenue and the associated impact on gross margin
- Our ability to achieve targeted cost reductions
- Adverse changes in the public and private equity and debt markets
- The ability of our customers and suppliers to obtain financing or to fund capital expenditures
- The trend toward sales of integrated network solutions
- The timing and amount of employer payroll tax to be paid on employees' gains on stock options exercised

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

RISK FACTORS

As a consequence, operating results for a particular future period are difficult to predict, especially in recent 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.

In response to changes in industry and market conditions, we may strategically realign our resources and consider restructuring, disposing of, or otherwise exiting businesses. Any decision to limit investment in or to dispose of or otherwise exit businesses may result in the recording of accrued liabilities for special one-time charges, such as workforce reduction costs. Additionally, estimates with respect to the useful life or ultimate recoverability of our carrying basis of assets, including goodwill and purchased intangible assets, could change as a result of such assessments and decisions.

WE ARE EXPOSED TO GENERAL ECONOMIC AND MARKET CONDITIONS

Our business is subject to the effects of general economic conditions in the United States and globally, and, in particular, market conditions in the communications and networking industries. In recent quarters, our operating results have been adversely affected as a result of unfavorable economic conditions and reduced capital spending in the United States, Europe, and Asia. In particular, sales to service providers, e-commerce and Internet businesses, and the manufacturing industry in the United States has been adversely affected. If the economic conditions in the United States and globally do not improve, or if we experience a worsening in the global economic slowdown, we may continue to experience material adverse impacts on our business, operating results, and financial condition.

OPERATING RESULTS FOR A PARTICULAR QUARTER ARE DIFFICULT TO PREDICT

As a result of a variety of factors discussed herein, operating results for a particular quarter are extremely difficult to predict. Our net sales may grow at a slower rate than experienced in previous periods and, in particular periods, may decline. Our ability to meet financial expectations could also be adversely affected if the nonlinear sales pattern seen in certain of our recent quarters recurs in future periods. We generally have had at least one quarter of the fiscal year when backlog has been reduced. Although such reductions have not occurred consistently in recent years, they are difficult to predict and may occur in the future. In addition, in response to customer demand, we continue to attempt to reduce our product manufacturing lead times, which may result in corresponding reductions in order backlog. A decline in backlog levels could result in more variability and less predictability in our quarter-to-quarter net sales and operating results going forward. On the other hand, for certain products, lead times are longer than our goal. If we cannot reduce manufacturing lead times for such products, our customers may place the same orders within our various sales channels, cancel orders, or not place further orders if shorter lead times are available from other manufacturers.

33

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

OF OPERATIONS

RISK FACTORS

As a result of our growth in past periods, our fixed costs have increased. With increased levels of spending and the impact of long-term commitments, an inability to meet expected revenue levels in a particular quarter could have a material adverse impact on our operating results for that period as we may not be able to quickly reduce these fixed expenses in response to short-term business changes.

Any of the above factors could have a material adverse impact on our operations and financial results. For example, from time to time, we have made acquisitions that result in in-process research and development expenses being charged in an individual quarter. These charges may occur in any particular quarter resulting in variability in our quarterly earnings. Additionally, the operating results for a quarter could be materially adversely affected if a number of large orders are either not received or are delayed, for example, due to cancellations, delays, or deferrals by customers.

WE EXPECT GROSS MARGIN VARIABILITY OVER TIME

We expect gross margin may be adversely affected in the future by increases in material or labor costs, excess inventory, obsolescence charges, changes in shipment volume, loss of cost savings, price competition, and changes in channels of distribution or in the mix of products sold. If product or related warranty costs associated with our products are greater than we have experienced, gross margin may also be adversely affected. Gross margin may also be impacted by geographic mix, as well as the mix of configurations within each product group. We continue to expand into third-party or indirect-distribution channels, which generally results in a lower gross margin. These distribution channels are generally given privileges to return inventory. In addition, increasing third-party and indirect-distribution channels generally results in greater difficulty in forecasting the mix of our products, and to a certain degree, the timing of orders from our customers.

We plan our operating expense levels primarily based on forecasted revenue levels. Because these expenses are relatively fixed in the short-term, a shortfall in revenue could lead to operating results being below expectations.

WE ARE DEPENDENT UPON ADEQUATE COMPONENT SUPPLY AND MANUFACTURING CAPACITY

Our growth and ability to meet customer demands also depend in part on our capability to obtain timely deliveries of parts from our suppliers. We have experienced component shortages in the past that have adversely affected our operations. Although we work closely with our suppliers to avoid these types of shortages, there can be no assurance that we will not encounter these problems in the future. Although we generally use standard parts and components for our products, certain components are presently available only from a single source or limited sources.

While our suppliers have performed effectively and have been relatively flexible to date, we believe that we may be faced with the following challenges going

forward:

- New markets that we participate in may grow quickly and thus, consume significant component capacity

- As we continue to acquire companies and new technologies, we are 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 could be significant issues for us. We use several supply partners to manufacture our products. During the normal course of business, in order to reduce manufacturing lead times and ensure adequate component supply, we enter into agreements with certain supply partners which allow these partners to procure inventory based upon criteria as defined by us. For additional information regarding our purchase commitments, see Note 9, "Commitments and Contingencies" on pages 36 to 38 of our 2001 Annual Report to Shareholders. A reduction or interruption in supply, a significant increase in the price of one or more components, or a decrease in demand of products could materially adversely affect our business, operating results and financial condition and could materially damage customer relationships.

WE COMPETE IN THE HIGHLY COMPETITIVE TELECOMMUNICATIONS EQUIPMENT MARKET

We compete in the Internet infrastructure market, providing solutions for transporting data, voice, and video traffic across intranets, extranets, and the Internet. The market is characterized by rapid change, converging technologies, and a conversion to New World 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 competitors providing niche product solutions may increase due to the market's long-term attractive growth. On the other hand, we expect the number of vendors supplying end-to-end networking solutions will decrease, due to consolidations in and accompanying economic pressure upon the industry. We believe our primary competition comes from nimble start-ups and young companies offering innovative niche solutions.

Our competitors include Alcatel, Ciena, Ericsson, Extreme Networks, Foundry Networks, Juniper, Lucent, Nortel Networks, Redback Networks, Siemens AG, and Sycamore Networks, among others. Some of our competitors compete across many of our product lines, while others do not offer as wide a breadth of solutions. Several of our current and potential competitors have greater resources, including technical and engineering resources, than we do.

35

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

RISK FACTORS

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

- The ability to provide end-to-end networking solutions and support

- Performance

- Price
- The ability to provide new technologies and products
- 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 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 these companies. Our inability to effectively manage these complicated relationships with customers and suppliers, or the uncontrollable and unpredictable acts of others, could have a material adverse effect on our business, operating results, and financial condition.

WE HAVE INVESTED IN AND WILL CONTINUE TO INVEST IN NEW AND EXISTING MARKET OPPORTUNITIES

We have made investments in headcount, inventory, manufacturing capacity, and product development through internal efforts and acquisitions, as a result of growth in existing opportunities and new or emerging opportunities in our target markets over the past years. We will continue to invest in these markets either through additional investments or through re-alignment of existing resources. If we are unable to meet expected revenue levels in a particular quarter, it could have a material, negative impact on our operating results for that period as we will not be able to react quickly enough to scale back expenses.

WE DEPEND UPON THE DEVELOPMENT OF NEW PRODUCTS AND ENHANCEMENTS TO EXISTING PRODUCTS AND ARE SUBJECT TO RAPID CHANGES IN TECHNOLOGY AND THE MARKET

Our operating results may depend on our ability to develop and introduce new products into existing and emerging markets and to reduce the costs to produce existing products. The success of new products is dependent on several factors, including proper new product definition, product cost, timely completion and introduction of new products, differentiation of new products from those of our competitors, and market acceptance of these products. 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. There can

be no assurance that we will successfully identify new product opportunities, develop and bring new products to market in a timely manner, and achieve market acceptance of our products, or that products and technologies developed by others will not render our products or technologies obsolete or noncompetitive.

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 the continued growth of the Internet and on the deployment of our products by customers that depend on the growth of the Internet. As a result of the economic slowdown and the reduction in capital spending, spending on Internet infrastructure has declined, which has had a material adverse effect on our business. To the extent that the economic slowdown and reduction in capital spending continue to adversely affect spending on Internet infrastructure, we could continue to experience material adverse effects on our business, operating results, and financial condition.

We believe that there will be certain performance problems with Internet communications in the future, which could receive a high degree of publicity and visibility. As we are a large supplier of networking products, we may be materially adversely affected, regardless of whether or not these problems are due to the performance of our products. Such an event could also result in a material adverse effect on the market price of our common stock and could materially adversely affect our business, operating results, and financial condition.

WE EXPECT TO MAKE FUTURE ACQUISITIONS WHERE ADVISABLE AND ACQUISITIONS INVOLVE NUMEROUS RISKS

The networking business is highly competitive, and as such, our growth is dependent upon market growth, our ability to enhance our existing products, and our ability to introduce new products on a timely basis. One of the ways we have addressed and will continue to address the need to develop new products is through acquisitions of other companies and technologies. Acquisitions involve numerous risks, including the following:

- Difficulties in integrating the operations, technologies, and products of the acquired companies

- The risk of diverting management's attention from normal daily operations of the business

- Potential difficulties in completing projects associated with in-process research and development

- Risks of entering markets in which we have no or limited direct prior experience and where competitors in such markets have stronger market positions

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

- Insufficient revenues to offset increased expenses associated with acquisitions

- The potential loss of key employees of the acquired companies

Mergers and acquisitions of high-technology companies are inherently risky, and no assurance can be given that our previous or future acquisitions will be successful and will not materially adversely affect our business, operating results, or financial condition. We must also manage any growth effectively. Failure to manage growth effectively and successfully integrate acquisitions we make could harm our business and operating results in a material way.

THE ENTRANCE INTO NEW OR DEVELOPING MARKETS EXPOSES OUR BUSINESS AND OPERATIONS TO RISKS

As we focus on new market opportunities, such as transporting data, voice, and video traffic across the same network, we will increasingly compete with large telecommunications equipment suppliers such as Alcatel, Ericsson, Lucent, Nortel, and Siemens AG, among others, and several startup companies. Several of our current and potential 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 experienced in the past. We have not entered into a material amount of labor-intensive service contracts, which require significant production or customization. However, we expect that demand for these types of service 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 less favorable timing of revenue recognition than we have historically experienced.

SALES TO THE SERVICE PROVIDER MARKET ARE SUBJECT TO VARIATION

Sales to the service provider market have been characterized by large and often sporadic purchases. Sales activity in this industry depends upon the stage of completion of expanding network infrastructures, the availability of funding, and the extent that service providers are affected by regulatory, economic, and business conditions in the country of operations. A decline or delay in sales orders from this industry could have a material adverse effect on our business, operating results, and financial condition. The slowdown in the general economy, changes in the service provider market, and the constraints on capital availability have had a material adverse effect on many of our service provider customers, with a number of such customers going out of business or substantially reducing their expansion plans. These conditions have had a material adverse effect on our business and operating results, and we expect that these conditions may continue for the foreseeable future.

THE INDUSTRY IN WHICH WE COMPETE IS SUBJECT TO CONSOLIDATION

There has been a trend toward industry consolidation for several years. We expect this trend toward industry consolidation to continue as companies attempt to strengthen or hold their market positions in an evolving industry. We believe that industry consolidation may result in stronger competitors that are better able to compete as sole-source vendors for customers. This

could lead to more variability in operating results as we compete to be a single vendor solution and could have a material adverse effect on our business, operating results, and financial condition.

OUR BUSINESS IS SUBJECT TO RISKS FROM INTERNATIONAL OPERATIONS

We conduct business globally. Accordingly, our future results could be materially adversely affected by a variety of uncontrollable and changing factors including, among others, foreign currency exchange rates; regulatory, political, or economic conditions in a specific country or region; trade protection measures and other regulatory requirements; service provider and government spending patterns; and natural disasters. Any or all of these factors could have a material adverse impact on our future international business.

WE ARE EXPOSED TO FLUCTUATIONS IN THE EXCHANGE RATES OF FOREIGN CURRENCY

As a global concern, we face exposure to adverse movements in foreign currency exchange rates. These exposures may change over time as business practices evolve and could have a material adverse impact on our financial results. Historically, our primary exposures have related to nondollar-denominated sales in Japan, Canada, and Australia and 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. We will continue to monitor our exposures and may hedge against these or any other emerging market currencies as necessary.

The increasing use of the euro as a common currency for members of the European Union could impact our foreign exchange exposure. We are currently hedging against fluctuations with the euro and will continue to evaluate the impact of the euro on our future foreign exchange exposure as well as on our internal systems. At the present time, we hedge only those currency exposures associated with certain assets and liabilities denominated in nonfunctional currencies and periodically will hedge anticipated foreign currency cash flows. The hedging activity undertaken by us is intended to offset the impact of currency fluctuations on certain nonfunctional currency assets and liabilities.

WE ARE EXPOSED TO THE CREDIT RISK OF SOME OF OUR CUSTOMERS AND TO CREDIT EXPOSURES IN WEAKENED MARKETS

A portion of our sales is derived through our resellers in two-tier distribution channels. These resellers/customers are generally given privileges to return inventory, receive credits for changes in selling prices, and participate in cooperative marketing programs. We maintain estimated accruals and allowances for such exposures. However, such resellers tend to have access to more limited financial resources than other resellers and end-user customers and therefore represent potential sources of increased credit risk. We have experienced increased demands for

customer financing, including loan financing and leasing solutions. We expect demands for customer financing may 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 but also providing additional funds for soft costs associated with network installation and integration of our products and for working capital purposes. Due to the current slowdown in the economy, the credit risks relating to these

resellers/customers have increased. Although we have programs in place to monitor and mitigate the associated risk, there can be no assurance that such programs will be effective in reducing our credit risks. We also continue to monitor credit exposures from weakened financial conditions in certain geographic regions, and the impact that such conditions may have on the worldwide economy. We have experienced losses due to customers failing to meet their obligations. Although these losses have not been significant, future losses, if incurred, could harm our business and have a material adverse effect on our operating results and financial condition.

OUR BUSINESS DEPENDS UPON OUR PROPRIETARY RIGHTS AND THERE IS A RISK OF INFRINGEMENT

Our success is dependent upon our proprietary technology. We generally rely upon patents, copyrights, trademarks, and trade secret laws to establish and maintain our proprietary rights in our technology and products. We have a program to file applications for and obtain patents in the United States and in selected foreign countries where a potential market for our products exists. We have been issued a number of patents; other patent applications are currently pending. There can be no assurance that any of these patents will not be challenged, invalidated, or circumvented, or that any rights granted thereunder will provide competitive advantages to us. In addition, there can be no assurance that patents will be issued from pending applications, or that claims allowed on any future patents will be sufficiently broad to protect our technology. Furthermore, the laws of some foreign countries may not permit the protection of our proprietary rights to the same extent as do the laws of the United States. Although we believe the protection afforded by our patents, patent applications, copyrights, and trademarks has value, the rapidly changing technology in the networking industry makes our future success dependent primarily on the innovative skills, technological expertise, and management abilities of our employees rather than on patent, copyright, and trademark protection.

The industry in which we compete is characterized by the existence of a large number of patents and frequent claims and related litigation regarding patent and other intellectual property rights. From time to time, third parties have asserted exclusive patent, copyright, trademark and other intellectual property rights to technologies and related standards that are important to us. These claims have increased recently as a result of our acquisitions of businesses and technologies. Such parties have pursued and may in the future assert claims or initiate litigation against us or our manufacturers, suppliers, or customers alleging infringement of their proprietary rights with respect to our existing or future products. Regardless of the merit of these claims, they could be time-consuming, result in costly litigation and diversion of technical management personnel, or

require us to develop a non-infringing technology or enter into royalty or license agreements. 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, our business could be materially and adversely affected.

Many of our products are designed to include software or other intellectual property licensed from third parties. While it may be necessary in the future to

seek or renew licenses relating to various aspects of our products, we believe that based upon past experience and standard industry practice, such licenses generally could be obtained on commercially reasonable terms. Because of the existence of a large number of patents in the networking field and the rapid rate of issuance of new patents, it is not economically practical to determine in advance whether a product or any of our components infringe patent rights of others. From time to time, we receive notices from or are sued by third parties regarding patent infringement claims. If infringement claims are found to have merit, we believe that, based upon industry practice, any necessary license or rights under such patents may be obtained on terms that would not have a material adverse effect on our financial condition. Nevertheless, 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.

WE FACE RISKS FROM THE UNCERTAINTIES OF REGULATION OF THE INTERNET

There are currently few laws or regulations that 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 on technology such as voice over the Internet, encryption technology, and access charges for Internet service providers. Our business could be materially adversely affected by the changes in the regulations surrounding the telecommunications industry. 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.

OUR SUCCESS LARGELY DEPENDS ON OUR ABILITY TO RETAIN AND RECRUIT KEY PERSONNEL

Our success has always depended in large part on our ability to attract and retain highly skilled technical, managerial, sales, and marketing personnel. In spite of the economic slowdown, competition for these personnel is intense, especially in the Silicon Valley area of Northern California. Volatility or lack of positive performance in our stock price may also adversely affect our ability to retain key employees, all of whom have been granted stock options. The loss of services of any of our key personnel, the inability to retain and attract qualified personnel in

the future, or delays in hiring required personnel, particularly engineers and sales personnel, could make it difficult to meet key objectives, such as timely 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.

WE FACE CERTAIN LITIGATION RISKS

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, results of operations, or financial condition. For additional information regarding certain of the lawsuits in which we are involved, see Note 6, "Legal Proceedings" of the Notes to Consolidated Financial Statements.

OUR BUSINESS IS SUBJECT TO THE RISKS OF EARTHQUAKES, FLOODS, AND OTHER 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, certain of our facilities, which include one of our manufacturing facilities, are located near rivers that have experienced flooding in the past. A significant natural disaster, such as an earthquake or a flood, could have a material adverse impact on our business, operating results, and financial condition. In addition, despite our implementation of network security measures, our servers are vulnerable to computer viruses, break-ins, and similar disruptions from unauthorized tampering with our computer systems. Any such event could have a material adverse effect on our business, operating results, and financial condition. In addition, the effects of war or acts of terrorism could have a material adverse effect on our business, operating results, and financial condition. The recent terrorist attacks in New York and Washington, D.C. on September 11, 2001 disrupted commerce throughout the world and intensified the uncertainty of the U.S. economy and other economies around the world. 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 these economies and create further uncertainties. 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.

THE ENERGY CRISIS IN CALIFORNIA COULD DISRUPT OUR BUSINESS AND THE BUSINESSES OF OUR SUPPLIERS AND SUPPLY PARTNERS AND COULD INCREASE OUR EXPENSES

The western United States (and California in particular) has experienced repeated episodes of diminished electrical power supply, and we anticipate that this situation could continue or

worsen in the near future. As a result of these episodes, certain of our operations or facilities have been and may continue to be subject to "rolling blackouts" or other unscheduled interruptions of electrical power. The prospect of such unscheduled interruptions may continue for the foreseeable future, and we are unable to predict their occurrence or duration. Certain of our suppliers and supply partners are also located in this area and their operations may also be materially and adversely affected by such interruptions. These suppliers and manufacturers may be unable to manufacture sufficient quantities of our products to meet our demands, or they may increase the costs of such products, which in turn could have a material adverse effect on our business or results of operations.

WE ARE EXPOSED TO FLUCTUATIONS IN THE MARKET VALUES OF OUR PORTFOLIO INVESTMENTS

AND IN INTEREST RATES

We maintain an investment portfolio of various holdings, types, and maturities. These securities are generally classified as available for sale and, consequently, are recorded on the balance sheet at fair value with unrealized gains or losses reported as a separate component of accumulated other comprehensive income (loss), net of tax. Part of this portfolio includes equity investments in several publicly traded companies, the values of which are subject to market price volatility. Recent events have adversely affected the public equities market and general economic conditions may continue to worsen. As a result, we may recognize in earnings declines in fair value of our publicly traded equity investments below the cost basis that are considered to be other-than-temporary. For information regarding the sensitivity of and risks associated with the market value of portfolio investments and interest rates, see the section titled "Quantitative and Qualitative Disclosures About Market Risk" contained in this Quarterly Report.

WE CANNOT PREDICT THE IMPACT OF RECENT ACTIONS AND COMMENTS BY THE SEC

The SEC has been reviewing registrants' valuation methodologies of in-process research and development related to business combinations. We believe we are in compliance with all of the existing rules and related guidance as applicable to our business operations. However, the SEC may change these rules or issue new guidance applicable to our business in the future. There can be no assurance that the SEC will not seek to reduce the amount of in-process research and development previously expensed by us. This would result in the restatement of our previously filed financial statements and could have a material adverse effect on our operating results and financial condition for periods subsequent to the acquisitions.

WE ARE SUBJECT TO RISKS ASSOCIATED WITH STRATEGIC ALLIANCES

We have a number of strategic alliances with large and complex organizations and our ecosystem partners. These arrangements are generally limited to specific projects, the goal of which is generally to facilitate product compatibility and adoption of industry standards. If successful, these relationships may be mutually beneficial and result in industry growth. However, these

alliances carry an element of risk because, in most cases, we must compete in some business areas with a company with which we have a strategic alliance and, at the same time, cooperate with that company in other business areas. Also, if these companies fail to perform or if these relationships fail to materialize as expected, we could suffer delays in product development or other operational difficulties.

WE FACE RISKS ASSOCIATED WITH CHANGES IN TELECOMMUNICATIONS REGULATION AND TARIFFS

Changes in domestic and international telecommunications requirements could affect the sales of our products. In particular, we believe it is possible that there may be changes in domestic telecommunications regulation in the near future 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.

OUR STOCK PRICE MAY BE VOLATILE

Our common stock has experienced substantial price volatility, particularly as a result of variations between our actual and anticipated financial results, the published expectations of analysts, and as a result of announcements by our competitors and us. In addition, the stock market has experienced extreme price and volume fluctuations that have affected the market price of many technology companies, in particular, and that have often been unrelated to the operating performance of these companies. These factors, as well as general economic and political conditions, may materially adversely affect the market price of our common stock in the future. Additionally, volatility or a lack of positive performance in our stock price may adversely affect our ability to retain key employees, all of whom have been granted stock options.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

We maintain an investment portfolio of various holdings, types, and maturities. These securities are generally classified as available for sale and, consequently, are recorded on the balance sheet at fair value with unrealized gains or losses reported as a separate component of accumulated other comprehensive income (loss), net of tax. Part of this portfolio includes equity investments in several publicly traded companies, the values of which are subject to market price volatility. During the first quarter of fiscal 2002, we recorded a charge of $858 million related to the impairment on certain publicly traded securities in our investment portfolio, in accordance with Statement of Financial Accounting Standard No. 115, "Accounting for Certain Investments in Debt and Equity Securities." The impairment charge was related to the declines in the fair value of our publicly traded equity investments below the cost basis that are considered to be other-than-temporary. We have also invested in numerous privately held companies, many of which can still be considered in the start-up or development stages. These investments are inherently risky as the market for the technologies or products they have under development are typically in the early stages and may never materialize. We could lose our entire initial investment in these companies. We also have certain real estate lease commitments with payments tied to short-term interest rates. At any time, a sharp rise in interest rates could have a material adverse impact on the fair value of our investment portfolio while increasing the costs associated with our lease commitments. Conversely, declines in interest rates could have a material impact on interest earnings for our investment portfolio. We do not currently hedge these interest rate exposures.

Readers are referred to pages 21 to 22 of the fiscal 2001 Annual Report to Shareholders for a more detailed discussion of quantitative and qualitative disclosures about market risk.

The following analysis presents the hypothetical changes in fair values of public equity investments that are sensitive to changes in the stock market (in

millions):

	Valuation of Securities Given X% Decrease in Each Stock's Price			Fair Value as of Oct. 27, 2001	Valu in
	(75%)	(50%)	(25%)		25%
Corporate equities	$ 295	$ 591	$ 886	$ 1,182	$ 1,477

These equity securities are held for purposes other than trading. The modeling technique used measures the hypothetical change in fair values arising from selected hypothetical changes in each stock's price. Stock price fluctuations of plus or minus 25%, 50%, and 75% were selected based on the probability of their occurrence. Our equity portfolio consists of securities with characteristics that most closely match the S&P Index or companies traded on the NASDAQ National Market. The NASDAQ Composite Index has shown a 25% and 50% movement in each of the last three years and a 75% movement in at least one of the last three years.

45

PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

The Company is subject to legal proceedings, claims, and litigation arising in the ordinary course of business. While the outcome of these matters is currently not determinable, management 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.

Beginning on April 20, 2001, a number of purported shareholder class action lawsuits have been 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 are essentially identical, and purport to bring suit on behalf of those who purchased the Company's publicly traded securities between August 10, 1999 and April 16, 2001. Plaintiffs allege that defendants 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 intends to defend the actions vigorously.

In addition, beginning on April 23, 2001, a number of purported shareholder derivative lawsuits have been filed in the Superior Court of California, County of Santa Clara, against the Company (as a nominal defendant), its directors and certain officers. At least two purported derivative suits have also been filed in the United States District Court for the Northern District of California, and another has been filed in the Superior Court of California, County of San Mateo. The complaints in the various derivative actions include claims for breach of fiduciary duty, waste of corporate assets, mismanagement, unjust enrichment and violations of the California Corporations Code, seek compensatory and other damages, disgorgement and other relief, and are based on essentially the same allegations as the class actions.

ITEM 2. CHANGES IN SECURITIES AND USE OF PROCEEDS

(c) During the quarter ended October 27, 2001, the Company issued an aggregate of eight million shares of its common stock in connection with the purchase of the capital stock of Allegro Systems, Inc. and AuroraNetics, Inc. The shares were issued pursuant to exemptions under Section 3(a)(10), where an appropriate governmental authority approved the terms of the issuance following a fairness hearing.

46

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

The Company held its Annual Meeting of Shareholders on November 13, 2001. At such meeting, the following actions were voted upon:

(a) Election of Directors:

	FOR	AGAINST	WITHHELD	ABSTENTIO
Carol A. Bartz	5,969,818,259	-	60,971,607	
Larry R. Carter	5,962,266,097	-	68,523,769	
John T. Chambers	5,375,788,083	-	655,001,783	
Carleton S. Fiorina	5,967,574,173	-	63,215,693	
Dr. James F. Gibbons	5,970,662,836	-	60,127,030	
James C. Morgan	5,972,318,209	-	58,471,657	
John P. Morgridge	5,969,896,140	-	60,893,726	
Arun Sarin	5,971,893,257	-	58,896,609	
Donald T. Valentine	5,971,019,032	-	59,770,834	
Steven M. West	5,972,232,142	-	58,557,724	
Jerry Yang	5,970,963,415	-	59,826,451	

(b) Ratification of the appointment of PricewaterhouseCoopers LLP as the Company's independent accountants for the fiscal year ending July 27, 2002:

FOR	AGAINST	WITHHELD	ABSTENTIO
5,893,680,315	96,742,854	-	40,11

47

ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

(a) Exhibit 4.1 Second Amendment to the Rights Agreement and Certification of Compliance with Section 27 Thereof by and among Cisco Systems, Inc., Fleet National Bank (f/k/a Bank Boston, N.A.), and EquiServe Trust Company, N.A.

(b) Reports on Form 8-K

The Company filed four reports on Form 8-K during the quarter ended October 27, 2001. Information regarding the items reported on is as follows:

Date	Item Reported On
July 30, 2001	The Company announced the acquisition of Allegro Systems, Inc., which was completed on September 27, 2001.
August 24, 2001	The Company announced the completion of the acquisition of AuroraNetics, Inc.
September 14, 2001	The Company announced a stock repurchase program.
September 28, 2001	The Company announced the completion of the acquisition of Allegro Systems, Inc.

48

SIGNATURE

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

Cisco Systems, Inc.

Date: December 7, 2001

By /s/ Larry R. Carter

Larry R. Carter, Senior Vice President, Finance and Administration, Chief Financial Officer and Secretary

49

Exhibit Index

Exhibit 4.1	Second Amendment to the Rights Agreement and Certification of Compliance with Section 27 Thereof by and among Cisco Systems, Inc., Fleet National Bank (f/k/a Bank Boston, N.A.), and EquiServe Trust Company, N.A.