

F5 NETWORKS INC
Form 10-K
December 14, 2006

Table of Contents

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

Form 10-K

**ANNUAL REPORT PURSUANT TO SECTIONS 13 OR 15(d)
OF THE SECURITIES EXCHANGE ACT OF 1934**

(Mark One)

- ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES
EXCHANGE ACT OF 1934**
For the fiscal year ended September 30, 2006
- or**
- TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES
EXCHANGE ACT OF 1934**
For the transition period from to .

Commission File Number 000-26041

F5 Networks, Inc.

(Exact name of Registrant as specified in its charter)

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

91-1714307
*(I.R.S. Employer)
Identification No.*

**401 Elliott Ave West
Seattle, Washington 98119**
(Address of principal executive offices)

(206) 272-5555
(Registrant's telephone number, including area code)

**Securities registered pursuant to Section 12(b) of the Act:
Common Stock, no par value**

**Securities registered pursuant to Section 12(g) of the Act:
None**

Edgar Filing: F5 NETWORKS INC - Form 10-K

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes No

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of the Registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act.
Large accelerated filer Accelerated filer Non-accelerated filer

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

As of March 31, 2006, the aggregate market value of the Registrant's Common Stock held by non-affiliates of the Registrant was \$2,926,898,719 based on the closing sales price of the Registrant's Common Stock on the Nasdaq Global Market on that date.

As of December 6, 2006, the number of shares of the Registrant's common stock outstanding was 41,098,236.

DOCUMENTS INCORPORATED BY REFERENCE

Information required in response to Part III of this Form 10-K (Items 10, 11, 12, 13 and 14) is hereby incorporated by reference to the specified portions of the Registrant's Definitive Proxy Statement for the Annual Shareholders Meeting for fiscal year 2006, which Definitive Proxy Statement shall be filed with the Securities and Exchange Commission pursuant to Regulation 14A within 120 days of the end of the fiscal year to which this Report relates.

F5 NETWORKS, INC.

**ANNUAL REPORT ON FORM 10-K
For the Fiscal Year Ended September 30, 2006**

Table of Contents

	Page
PART I	
<u>Item 1.</u> <u>Business</u>	2
<u>Item 1A.</u> <u>Risk Factors</u>	15
<u>Item 1B.</u> <u>Unresolved Staff Comments</u>	21
<u>Item 2.</u> <u>Properties</u>	21
<u>Item 3.</u> <u>Legal Proceedings</u>	22
<u>Item 4.</u> <u>Submission of Matters to a Vote of Securities Holders</u>	23
PART II	
<u>Item 5.</u> <u>Market For Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities</u>	23
<u>Item 6.</u> <u>Selected Financial Data</u>	24
<u>Item 7.</u> <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	26
<u>Item 7A.</u> <u>Quantitative and Qualitative Disclosure About Market Risk</u>	34
<u>Item 8.</u> <u>Financial Statements and Supplementary Data</u>	36
<u>Item 9.</u> <u>Changes in and Disagreements with Accountants on Accounting and Financial Disclosure</u>	68
<u>Item 9A.</u> <u>Controls and Procedures</u>	68
<u>Item 9B.</u> <u>Other Information</u>	69
PART III	
<u>Item 10.</u> <u>Directors and Executive Officers of the Registrant</u>	70
<u>Item 11.</u> <u>Executive Compensation</u>	70
<u>Item 12.</u> <u>Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters</u>	70
<u>Item 13.</u> <u>Certain Relationships and Related Transactions</u>	70
<u>Item 14.</u> <u>Principal Accountant Fees and Services</u>	70
PART IV	
<u>Item 15.</u> <u>Exhibits and Financial Statement Schedules</u>	70
<u>SIGNATURES</u>	71
<u>EXHIBIT 10.28</u>	
<u>EXHIBIT 10.29</u>	
<u>EXHIBIT 10.30</u>	
<u>EXHIBIT 21.1</u>	
<u>EXHIBIT 23.1</u>	
<u>EXHIBIT 31.1</u>	
<u>EXHIBIT 31.2</u>	
<u>EXHIBIT 32.1</u>	

Table of Contents

Forward-Looking Statements

The statements contained in this report that are not purely historical are forward-looking statements within the meaning of Section 21E of the Securities Exchange Act of 1934 and Section 27A of the Securities Act of 1933. These statements include, but are not limited to, statements about our plans, objectives, expectations, strategies, intentions or other characterizations of future events or circumstances and are generally identified by the words expects, anticipates, intends, plans, believes, seeks, estimates, and similar expressions. Because these forward-looking statements are subject to a number of risks and uncertainties, our actual results could differ materially from those expressed or implied by these forward-looking statements. Factors that could cause or contribute to such differences include, but are not limited to, those discussed under the heading Risk Factors below and in other documents we file from time to time with the Securities and Exchange Commission. All forward-looking statements included in this report are based on information available to us on the date hereof. Our business and the associated risks may have changed since the date this report was originally filed with the SEC. We assume no obligation to update any such forward-looking statements.

Item 1. Business

General

F5 Networks, Inc. is a leading provider of application delivery networking products that improve the performance, availability and security of applications running on networks that use the Internet Protocol (IP). IP traffic between servers running applications and clients using those applications passes through our products where the content is inspected and modified to ensure that it is delivered securely and in a way that optimizes the performance and availability of both the network and the applications.

Our BIG-IP products help manage IP traffic between network servers, clients and other devices in a way that maximizes the availability, scalability and throughput of those network components and the applications that run on them. Our complementary FirePass SSL VPN products let enterprises provide authorized users connected to the Internet with secure remote access to their corporate networks and applications by leveraging standard Web browser technology. Our Application Security Manager (formerly called TrafficShield) application firewall provides content-based, application-level security against malicious attacks that network firewalls and other security devices can't prevent. Our WANJet and WebAccelerator products optimize the flow of traffic over Wide Area Networks, or WANs, to enhance the performance and availability of applications for remote users. Our BIG-IP products share a common full-proxy operating system, TMOS, or Traffic Management Operating System, that enables them to inspect and modify traffic flows to and from servers and has built-in functionality to secure, optimize and ensure the availability of application traffic. iRules, a unique feature of TMOS, is a scripting language based on TCL (Tools Command Language), that enables customers and third parties to write customized rules to inspect and modify traffic. Our application delivery networking products that are integrated on the TMOS platform also share a common software interface called iControl, which enables them to communicate with one another and allows them to be integrated with third party products, including custom and commercial enterprise applications.

During the past year, we have continued to execute on our strategy to migrate all of our products onto the TMOS platform. Early in calendar 2006, we introduced new versions of our legacy Link Controller and Global Traffic Management products on TMOS and a TMOS-based version of TrafficShield, called Application Security Manager. In July, we announced that the WebAccelerator product would also be available as a module on TMOS as part of our 9.4 release.

The flexibility of our software-based technology, the powerful capabilities of iRules and iControl, the breadth of features and functions available on our products, and the integration of those features and functions on TMOS are

characteristics that we believe differentiate our products from other application delivery networking products. These characteristics enable us to provide comprehensive solutions that address the core requirements of IP-based networks and business applications, including high availability, high performance, intelligent traffic management, streamlined manageability, bandwidth optimization, remote access to corporate

Table of Contents

networks, and network and application security. In connection with our products, we offer a broad range of services including consulting, training, installation, maintenance and other technical support services.

F5 Networks was incorporated on February 26, 1996 in the State of Washington. Our headquarters is in Seattle, Washington and our mailing address is 401 Elliott Avenue West, Seattle, Washington 98119. The telephone number at our executive offices is (206) 272-5555. We have subsidiaries or branch offices in Australia, Canada, China, France, Germany, Hong Kong, Israel, Japan, Malaysia, Northern Ireland, Russia, Singapore, South Korea, Taiwan, Thailand and the United Kingdom. Our annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and all amendments to those reports are available free of charge on our website, www.f5.com, as soon as reasonably practicable after such material is electronically filed with the Securities and Exchange Commission.

Unless the context otherwise requires, in this Annual Report on Form 10-K, the terms F5 Networks, the Company, we, us, and our refer to F5 Networks, Inc. and its subsidiaries. Our fiscal year ends on September 30 and fiscal years are referred to by the calendar year in which they end. For example, fiscal year 2005 and fiscal 2005 refer to the fiscal year ended September 30, 2005.

Industry Background

Internet Protocol (IP) is a communications language used to transmit data over the Internet. Since the late 1990s, businesses have responded to the power, flexibility and economy of the Internet by deploying new IP-based applications, upgrading their client-server applications to new IP-enabled versions, and enabling existing or legacy applications for use over the Internet. Over the next several years, we believe this process will accelerate as more and more organizations discover the benefits of deploying IP-enabled applications and new technologies continue to enhance the performance, reliability and security of both applications and IP networks. In addition, we believe the growth of Internet usage will continue to be driven by new applications such as Web Services and Voice over IP, the growth of broadband Internet access, remote use of applications, and the increasing popularity of mobile Internet access through wireless devices such as cellular telephones, PDAs and notebook computers.

Internet Architecture

IP requires all data transmitted across the Internet to be divided into packets at the source and reassembled at the destination. The Open Systems Interconnect (OSI) Reference Model is the framework that divides network functions into seven layers and specifies how the layers should interact to enable all of a network's different hardware and software components to work together to accomplish this process. Prior to transmission, each packet of data is automatically given a header that identifies the source and destination of the packet. This header information is used in the OSI Model for the purposes of identifying, routing and sequencing data packets, and is stripped from the data upon arrival at its destination. Layers 2-4 of the OSI Model perform standardized, repetitive tasks such as ensuring that packets of information sent over the Internet arrive at the destination to which they are addressed and are reassembled in the correct sequence. Consequently, most Layer 2-4 switches are hardware-based devices that use application-specific integrated circuits (ASICs) and are optimized for speed. Unlike Layers 2-4, Layer 7, which in practice includes the functions ascribed to Layers 5 and 6 in the OSI model, is complex and variable and must support end-user applications and processes on a wide variety of platforms and devices. While most Layer 4 switches rely on hardware-based architectures to maximize throughput, the demands of processing data at Layer 7 increasingly require flexibility and adaptability that can be achieved only through a software-based solution. The challenge in building highly flexible, function-rich, software-based switches for application delivery networking is to deliver these capabilities at speeds that do not slow the speed of network traffic.

Application Delivery Networking

As more applications are IP-enabled, there is growing demand for Layer 7 technology that can read the entire contents or flow of data in a packetized transmission and make intelligent decisions based on a dynamic set of business rules about how to handle the transmission to make the applications, network, and servers

Table of Contents

always secure, fast, and available. Basic Layer 7 functions include load-balancing (distributing traffic across multiple servers while making them appear to be a single server), and health-checking (monitoring the performance of servers and applications to ensure that they are working properly before routing traffic to them). In addition, Layer 7 processing encompasses a growing number of functions that have typically been performed by the server or the application itself, or by point solutions running on separate devices. This category includes a growing number of functions, such as the following:

SSL Acceleration using Secure Socket Layer (SSL) encryption to secure traffic between the server and the browser on an end user's client device;

Rate Shaping prioritizing transmissions according to preset rules that give precedence to different types of traffic;

Compression reducing the volume of data transmitted to take maximum advantage of available bandwidth;

TCP Optimization improving server efficiency by maintaining an open connection with a server during interactive sessions;

IPv6 Translation enabling communication and interoperability between networked devices using IPv6, the newest version of the Internet Protocol, and those using the older version IPv4;

Application Security protecting critical web applications from attacks such as Google hacking, cross-site scripting, and parameter tampering;

Web Acceleration enhancing the performance of web applications over wide area networks by reducing latency, eliminating errors, and resolving other issues that slow delivery;

WAN Optimization improving the performance of applications accessed over wide area network links by reducing the number of round trips required and ensuring maximum use of available bandwidth.

Global Traffic Management ensuring high availability, maximum performance and global management for applications running across multiple, globally-dispersed data centers;

Link Load Balancing monitoring availability and performance of multiple WAN connections and intelligently managing bi-directional traffic flows to ensure uninterrupted, optimized Internet access.

In addition to optimizing the performance and availability of their networks and applications, enterprises face the increasingly complex challenge of providing security for applications and data that are accessible over their IP networks. Layer 7 or application level security includes three basic components: providing employees, partners and customers with secure access to corporate applications; ensuring that access is limited to those applications for which a user is specifically authorized; and protecting the integrity of applications and data.

Currently, the most widespread solution for secure remote access is technology that uses the IP Security (IPSec) Protocol to establish a secure virtual private network (VPN) between a remote device, such as a user's home PC or a laptop, and the corporate network. Although an IPSec VPN tunnel is very secure, it has a number of drawbacks. One is that IPSec requires the remote device to have special software installed on it, and maintaining the most current version of this software on all user devices is time-consuming and costly. A more serious issue is that once IPSec establishes a connection between a user and the corporate network, the user has full access to any application in the network, and the only way to prevent unauthorized use is to secure each application or physically segment the

network. As an alternative to using IPsec VPNs for remote access, technology that employs SSL encryption to establish a secure VPN has emerged and is making inroads in the market. Because this technology relies on the SSL capabilities resident in any standard Web browser, it is not necessary to install additional software on the remote device. This makes it possible to access the network from a cell phone, PDA, kiosk, laptop, PC, or any other device with a standard browser. In addition, SSL VPN technology supports the creation of separate VPN tunnels to each application for which a user is authorized. This allows enterprises to exercise more control over who can gain access to various parts of the network and to specific applications.

Table of Contents

Along with the need to provide secure connectivity between users and applications, enterprises face an immediate and growing need to protect applications and other data center resources from application-level security threats that pass through conventional firewalls and slip past intrusion detection and prevention (IDS and IPS) devices. The solution to this problem requires a positive security model that contrasts with the negative security model used by IDS and IPS devices. In a negative security model, incoming traffic is checked against a list of signatures for known worms, viruses and other security threats, and if no match is found the traffic is allowed to pass. In a positive security model, incoming traffic is checked against a set of rules that define what specific elements are permissible in traffic headed for a particular application and rejects traffic containing anything that does not conform to the rules.

Although products that incorporate a positive security model have been around for many years, they have been inherently slow and this has limited their use to enterprises that have historically placed a high priority on security. Now that application-level attacks threaten to paralyze global business, there is growing demand among enterprises for application security that can ward off these attacks. The challenge is to deliver products that apply a positive security model to application traffic without slowing network performance.

Within the past several years, the challenge of delivering optimum application performance has grown in scope and complexity with the increasing deployment of applications over wide area networks. This trend has been fueled by the availability of cheap bandwidth which has enabled enterprises to consolidate information technology resources in centralized data centers. Since the majority of applications are optimized for delivery over local area networks, enterprises face enormous and increasing difficulties in delivering those applications to remote sites in disparate and often far-flung locations. Regardless how much bandwidth is available, application performance over WANs is affected by many factors, associated with both network and application logic, that must be addressed in order to achieve satisfactory application performance. At the network level, application performance is limited by high latency (the effect of physical distance), jitter, packet loss, and congestion. At the application level, performance is further limited by natural behavior of application protocols (especially when faced with latency, jitter, packet loss, and congestion at the network level), application protocols that engage in excessive handshaking across the network links (often referred to as chattiness), and the serialization of the applications themselves. To overcome these problems, WAN optimization solutions combine a number of functions including compression, caching and other specialized techniques to reduce the amount of data transmitted, eliminate protocol chattiness, and streamline application performance across WANs.

Since most large enterprises have hundreds if not thousands of servers and applications, it is not practical to build functions that optimize the performance, availability and security of applications into the applications themselves. Even if it were, maintenance costs would be prohibitive and the net result would be a negative impact on the overall performance of servers and applications. Deploying point solutions in the network eliminates those problems but creates a new set of challenges. Using point solutions from multiple vendors can create interoperability issues, and problems that do occur can be difficult to troubleshoot. From a security standpoint, it is also much more difficult to audit traffic passing through multiple devices. As a result, enterprise customers are demanding products that integrate the growing number of Layer 7 application traffic management and security functions on a single platform. In the past, we have referred to these functions collectively as application traffic management. However, as the scope and complexity of functions performed at Layer 7 has increased, we believe the term application delivery networking is more apt to describe the components of our addressable market, which include application security, application optimization and application availability.

The F5 Solution

We are a leading provider of application delivery networking products that ensure the security, optimization and availability of applications for any user, anywhere. We believe our products offer the most intelligent architecture and advanced functionality in the marketplace along with performance, flexibility and usability features that help

organizations improve the way they serve their employees, customers, and partners while lowering operational costs.

Table of Contents

Software Based Products. From inception, we have been committed to the belief that the complexity of Layer 7 application delivery networking requires a software-based rather than a hardware-based solution. We believe our modular software architecture enables us to deliver the broadest range of integrated functionality in the market and facilitates the addition and integration of new functionality. We also believe that integrating our software with commodity hardware components enables us to build products that deliver superior performance, functionality and flexibility at competitive prices.

Full Proxy Architecture. The core of our software technology is the Traffic Management Operating System (TMOS) introduced in September 2004 as part of BIG-IP version 9. We believe this is a major enhancement of our previous technology that enables our products to deliver functionality that is superior on many levels to any other application delivery networking product in the market. With TMOS, our products can inspect, modify and direct both inbound and outbound traffic flows across multiple packets. This ability to manage application traffic to and from servers adds value to applications that pass through our devices in ways that are not possible with other application delivery networking solutions.

Modular Functionality. In addition to its full proxy architecture, TMOS is specifically designed to facilitate the development and integration of application delivery networking functions as modules that can be added to BIG-IP's core functionality to keep pace with rapidly evolving customer needs. Add-on modules currently available with BIG-IP version 9 include: Intelligent Compression; SSL Acceleration; Layer 7 Rate Shaping; Advanced Client Authentication; IPv6 Gateway; Caching; and others. Within the past year, we also began shipping Application Security Manager (ASM), Global Traffic Manager, Link Controller, and WebAccelerator as software modules on BIG-IP.

Application Awareness. The open architecture of TMOS includes an application programming interface (API) called iControl that allows our products to communicate with one another and with third-party software and devices. Through this unique feature, third-party applications and network devices can take an active role in shaping IP network traffic, directing traffic based on exact business requirements defined by our customers and solutions partners and tailored to specific applications. This application awareness capability is one of the most important features of our software-based products and further differentiates our solutions from those of our competitors.

Adaptive Intelligence. The full-proxy capabilities of TMOS enable it to inspect or read the entire contents of a transmission across multiple packets and identify specific elements of that transmission, including items such as names, dates, and any type of number or label. Using our industry standard Tool Command Language (TCL) scripting capability, customers can use those elements as variables to create iRules that modify the content and direct the flow of traffic in ways tailored to the dynamic needs of their applications. iRules is a unique feature of TMOS that gives our products flexibility unmatched by competing products.

Integrated Layer 7 Solutions. The combination of our full proxy architecture and enhanced iRules enables BIG-IP to intercept, inspect and act on the contents of traffic from virtually every type of IP-enabled application. In addition, the modularity of the TMOS architecture allows us to deliver tightly integrated solutions that secure, optimize and ensure the availability of applications and the networks they run on.

Strategy

Our objective is to lead the industry in delivering the enabling architecture that integrates the network with the applications. This allows organizations to significantly improve costly and time consuming business processes and provide new sources of revenue through highly differentiated offerings. Key components of our strategy include:

Offering a complete, integrated application delivery product suite that includes application security and WAN optimization. In line with this strategy, we have already introduced TMOS-based versions of our own legacy products (GTM and Link Controller) and products we acquired (Application Security Manager and WebAccelerator). We are currently developing TMOS-based versions of WANJet and FirePass, and within the next year we expect to begin offering TMOS-based versions of third-party products. We believe this approach

Table of Contents

will continue to differentiate our products and provide customers with the broadest possible set of integrated application delivery networking solutions.

Investing in technology to continue to meet customer needs. We will continue to invest in research and development to provide our customers with comprehensive, integrated application delivery networking solutions. Our product development efforts will continue to leverage the unique attributes of our software-based platforms to deliver new features and functions that address the complex and changing needs of our customers. We will continue to use commodity hardware in order to ensure performance and cost competitiveness.

Enhancing the existing channel model. We are investing significant resources in order to further develop our indirect sales channels. We plan to expand our indirect sales channels through leading industry resellers, systems integrators, Internet service providers and other channel partners. We are also recruiting new channel partners and leveraging our existing channels to sell our security and WAN optimization products.

Continuing to build and expand relationships with strategic iControl partners. We plan to capitalize on our strategic relationships with enterprise software vendors who have created interfaces to our products through our iControl application programming interface. These vendors provide us significant leverage in the selling process, because they recommend our products to their customers. In order to differentiate ourselves further from our competitors we plan to explore opportunities to further embed iControl into existing and new third party products and to jointly market and sell our solutions to enterprise customers with these key partners.

Leveraging DevCentral, our online community of network architects and developers, to promote the use of iRules among customers and third-party developers. Customization of our products using iRules enhances their stickiness by allowing customers to solve problems in both their applications and their networks that would be difficult if not impossible to solve by other means.

Enhancing our brand. We plan to continue building brand awareness that positions us as one of the leading providers of application delivery networking solutions. Our goal is to make the F5 brand synonymous with superior technology, high-quality customer service and ease of use.

Products

Our core technology is software for application delivery networking, including application security, secure remote access, and WAN optimization. Our products are systems that integrate our software with hardware that is built using a combination of commodity components and our own custom ASIC for Layer 4 processing. Our flagship product is BIG-IP, which comprises a family of systems that support a growing number of features and functions including GTM, Link Controller, ASM (TrafficShield) and WebAccelerator as software modules. We also sell FirePass, ASM (TrafficShield), WANJet and WebAccelerator as separate, stand-alone appliances.

BIG-IP

Products in our family of BIG-IP application switches differ primarily in the hardware configurations that make up each system. Our current BIG-IP systems include five hardware platforms: high-end (BIG-IP 8400, 6800 and 6400), mid-range (BIG-IP 3400), and an entry-level (BIG-IP 1500). Each system uses one or more CPUs for Layer 7 processing, and all but the entry-level systems come equipped with our own proprietary Packet Velocity ASIC for high-performance Layer 4 processing, a commodity Layer 2-3 switch for connectivity, and commodity ASICs for SSL encryption and decryption and for compression. In addition to local area traffic management, which is standard on every system, BIG-IP supports a growing number of add-on software products and features. Software products currently available on BIG-IP include GTM, Link Controller, ASM, and WebAccelerator. Available features include

intelligent compression, L7 rate shaping, IPv6 gateway, advanced client authentication, SSL acceleration, advanced routing and fast caching.

Table of Contents

FirePass

FirePass appliances provide SSL VPN access for remote users of IP networks and any applications connected to those networks from any standard Web browser on any device. The components of FirePass include a dynamic policy engine, which manages user authentication and authorization privileges, and special components that enable corporations to give remote users controlled access to the full array of applications and resources within the network.

Currently, we sell two FirePass products. The FirePass 1200 Controller is a 1U rack-mount server, designed for small to medium enterprise locations, that supports up to 100 concurrent users. The FirePass 4100 Controller is a 2U rack-mount server, designed for large enterprise locations, that supports up to 2,000 concurrent users.

Application Security Manager (TrafficShield)

Application Security Manager is a Web application firewall that provides comprehensive, proactive, application-layer protection against both generalized and targeted attacks. ASM employs a positive security model (deny all unless allowed) to permit only valid and authorized application transactions. As a result, ASM can prevent day-zero attacks and other types of security threats that pass through traditional firewalls and signature-based devices such as intrusion detection and intrusion prevention systems. ASM is available as both a stand-alone system and as an add-on software module for our BIG-IP product family.

WANJet

WANJet combines WAN optimization and traffic-shaping in a single device to accelerate file transfers, email, data replication, and other applications over IP networks. It provides LAN-like performance on any WAN, ensuring predictable application performance for all users, and encrypts and secures all transfers without performance penalties. WANJet is deployed as a dual-sided (symmetric) solution that optimizes application traffic to and from data centers and branch offices.

The WANJet 400 for data centers features fault tolerance and scalability for up to 14,000 optimized connections. For branch offices, the WANJet 200 combines fault tolerant features, silent operation and performance for up to 1,000 optimized connections.

WebAccelerator

WebAccelerator speeds web transactions by optimizing individual network object requests, connections, and end-to-end transactions from the browser through to databases. WebAccelerator enhances web application performance from any location, speeding up interactive performance, improving download times, utilizing bandwidth more efficiently, and dramatically reducing the cost and response time of delivering Web-enabled applications to distributed users where it is not possible to deploy an end point device like WANJet.

The WebAccelerator software, acquired with our purchase of Swan Labs, Inc. (Swan Labs) has been ported to TMOS and is available on stand-alone systems or as a software module on BIG-IP.

Enabling Technologies

iControl is an application programming interface that allows customers and independent software vendors to modify their programs to communicate with our products, eliminating the need for human involvement, lowering the cost of performing basic network functions and reducing the likelihood of error. Although we do not derive revenue from iControl itself, the sale of iControl-enabled applications by independent software vendors such as Microsoft and

Oracle helps promote and often leads directly to the sale of our other products.

Enterprise Manager, which is designed to facilitate the broader use of our products, takes advantage of iControl to provide a single, centralized management and operational interface for our devices. This feature allows customers with dozens or hundreds of our products to upgrade or modify the software on those products simultaneously from a single console. This lowers the cost and simplifies the task of deploying,

Table of Contents

managing and maintaining our products and reduces the likelihood of error when blanket changes are implemented.

Product Development

We believe our future success depends on our ability to maintain technology leadership by constantly improving our products and by developing new products to meet the changing needs of our customers. Our product development group employs a standard process for the development, documentation and quality control of software and systems that is designed to meet these goals. This process includes working with management, product management, customers and partners to identify new or improved solutions that meet the evolving needs of our addressable markets.

Our principal software engineering group is located in our headquarters in Seattle, Washington. Our core product development teams for FirePass, WANJet and WebAccelerator are located in San Jose, California. There is also a smaller development facility for WANJet and WebAccelerator in Belfast, Northern Ireland. Our core Application Security Manager (TrafficShield) product development team is located in Tel Aviv, Israel. Our hardware engineering group is located in Spokane, Washington. In addition, we maintain a dedicated facility for product testing and quality control in Tomsk, Russia. Members of all these teams collaborate closely with one another to ensure the interoperability and performance of our hardware and software systems.

During the fiscal years ended September 30, 2006, 2005 and 2004, we had research and product development expenses of \$49.2 million, \$31.5 million and \$24.4 million, respectively.

Customers

Our customers include a wide variety of enterprise customers (Fortune 1000 or Business Week Global 1000 companies) including those in telecommunications, financial services, technology, manufacturing, transportation and government. In fiscal year 2006, international sales represented 42.6% of our net revenues. Refer to Note 9 of our consolidated financial statements included in this Annual Report on Form 10-K for additional information regarding our revenues by geographic area.

Sales and Marketing

Sales

We sell our products and services to large enterprise customers and service providers through a variety of channels, including distributors, value-added resellers and systems integrators. A substantial amount of our revenue for fiscal year 2006 was derived from these channel sales. Our sales teams work closely with our channel partners and sell our products and services directly to a limited number of major accounts.

F5 sales teams. Our inside sales team generates and qualifies leads for regional sales managers and helps manage accounts by serving as a liaison between the field and internal corporate resources. Our field sales personnel are located in major cities in four sales regions: the Americas; Europe, the Middle East, and Africa (EMEA); Japan; and the Asia Pacific region (APAC). Field sales personnel work closely with our channel partners to assist them, as necessary, in the sale of our products and services to their customers. We also sell our products and services directly to a limited group of customers, primarily large enterprises, whose accounts are managed by our major account services team. Field systems engineers support our regional sales managers and channel partners by participating in joint sales calls and providing pre-sale technical resources as needed.

Distributors and value-added resellers. Consistent with our goal of building a strong channel sales model, we have established relationships with large national and international distributors, local and specialized distributors and

value-added resellers from which we derive the majority of our sales. The distributors sell our products, and the value-added resellers not only sell our products, but also assist their customers in network design, installation and testing. Our agreements with our channel partners are not exclusive and do not prevent them from selling competitive products. These agreements typically have terms

Table of Contents

of one year with no obligation to renew, and typically do not provide for exclusive sales territories or minimum purchase requirements.

For fiscal year 2006, sales to two of our distributors, Ingram Micro, Inc., and GE Access, represented 13.59% and 11.57% of our total revenues respectively. Our agreements with these distributors are standard, non-exclusive distribution agreements that renew automatically on an annual basis and are terminable by either party with 30 days prior written notice. The agreements grant Ingram Micro and GE Access the right to distribute our products to resellers in North America and certain other territories internationally, with no minimum purchase requirements.

Systems integrators. We also market our products through strategic relationships with systems integrators, who include our products as core components of application or network-based solutions they deploy for their customers. In most cases, systems integrators do not directly purchase our products for resale to their customers. Instead they typically recommend our products as part of broader solutions, such as enterprise resource platform (ERP) or customer relationship management (CRM) solutions, that incorporate our products for high availability and enhanced performance.

Marketing

There are three primary aspects to our marketing strategy. First, we believe our future success depends on our ability to understand and anticipate the dynamic needs of our addressable markets and to develop valuable solutions that address those needs. Our marketing organization works directly with customers, partners and our product development teams to identify and create innovative solutions to further enhance our leadership position. The second aspect is to continue to build upon our iControl strategy. We have established relationships with various independent software vendors who have adapted their applications to interact with our products via the iControl interface. iControl enhances the functionality of third party applications by enabling them to control the network in an automated way, based on business policies and rules associated with the application. As a result, customers who purchase iControl-enabled applications have an incentive to purchase our products in order to take advantage of the enhanced functionality made possible through our technical cooperation. Third, we offer an on-line community website called DevCentral that provides technical resources to customers, prospects and partners wanting to extend and optimize F5 solutions using iRules. A key aspect of DevCentral is an on-line forum where developers as well as application and network architects discuss and share solutions they have written with iRules. At the end of fiscal 2006, DevCentral had more than 11,500 registered members.

We also engage in a number of marketing programs and initiatives aimed at promoting our brand and creating market awareness of our technology and products. These include actively participating in industry trade shows and briefing industry analysts and members of the trade press on our latest products, and on new business and technology partnerships. In addition, we market our products to chief information officers and other information technology professionals through targeted advertising, direct mail and high-profile Web events.

Backlog

At the end of fiscal years 2006 and 2005, we had product backlog of approximately \$12.3 million and \$11.7 million, respectively. Backlog represents orders confirmed with a purchase order for products to be shipped generally within 90 days to customers with approved credit status. Orders are subject to cancellation, rescheduling by customers or product specification changes by the customers. Although we believe that the backlog orders are firm, purchase orders may be cancelled by the customer prior to shipment without significant penalty. For this reason, we believe that our product backlog at any given date is not a reliable indicator of future revenues.

Customer Service and Technical Support

We believe that our ability to provide consistent, high-quality customer service and technical support is a key factor in attracting and retaining large enterprise customers. Accordingly we offer a broad range of support

Table of Contents

services that include installation, phone support, hardware repair and replacement, software updates, consulting and training services. We deliver these services directly to end users and also utilize a multi-tiered support model, leveraging the capabilities of our channel partners when applicable. Our technical support staff is strategically located in regional service centers to support our global customer base.

Prior to the installation of our products, our services personnel work with customers to analyze their network needs and determine the best way to deploy our products and configure product features and functions to meet those needs. Our services personnel also provide on-site installation and training services to help customers make optimal use of product features and functions.

Our customers typically purchase a one-year maintenance contract which entitles them to an array of services provided by our technical support team. Maintenance services provided under the contract include online updates, software error correction releases, hardware repair and replacement, and remote support through a 24 hours a day, 7 days a week help desk, although not all service contracts entitle a customer to round-the-clock call center support. Updates to our software are only available to customers with a current maintenance contract. Our technical support team also offers seminars and training classes for customers on the configuration and use of products, including local and wide area network system administration and management. In addition, we have a professional services team able to provide a full range of fee-based consulting services, including comprehensive network management, documentation and performance analysis, and capacity planning to assist in predicting future network requirements.

We also offer, as part of our maintenance service, an online, automated, self-help customer support function called Ask F5 that allows customers to answer many commonly asked questions without having to call our support desk. This allows the customer to rapidly address issues and questions, while significantly reducing the number of calls to our support desk. This enables us to provide comprehensive customer support while keeping our support-related expenses at a manageable, consistent level.

Manufacturing

We outsource the manufacturing of our pre-configured hardware platforms to contract manufacturer Solectron Corporation for assembly according to our specifications. Solectron installs our software onto the hardware platforms and conducts functionality testing, quality assurance and documentation control prior to shipping our products. Our agreement with Solectron allows them to procure component inventory on our behalf based upon a rolling production forecast. Subcontractors supply Solectron with standard parts and components for our products based on our production forecast. We are contractually obligated to purchase component inventory that our contract manufacturer procures in accordance with the forecast, unless we give notice of order cancellation in advance of applicable lead times. As protection against component shortages and to provide replacement parts for our service teams, we also stock limited supplies of certain key components for our products.

Hardware platforms for our products consist primarily of commodity parts and certain custom components designed and approved by our hardware engineering group. Most of our components are purchased from sources which we believe are readily available from other suppliers. However, several components used in the assembly of our products are purchased from single or limited sources such as our proprietary Packet Velocity ASIC for Layer 4 processing that is manufactured for us by a third-party contract semiconductor foundry.

Competition

The increasing breadth of our product offerings has enabled us to address a growing array of opportunities, many of which are outside the bounds of the traditional Layer 4-7 market. Within what Gartner Group calls the Application Acceleration market, we compete in the Application Delivery Controller (ADC) market, which encompasses the

traditional Layer 4-7 market, and the WAN Optimization Controller market. Over the next year or two, we believe these two market segments will merge as WANJet is ported to TMOS and WAN optimization effectively becomes a feature of Application Delivery. With ASM available as a software module on BIG-IP and our intention to port FirePass to TMOS within the next 12 months, these products will also

Table of Contents

become and be viewed as components of our overall Application Delivery solution. For the immediate future, however, these market segments will continue to be viewed as discrete markets.

In 2006, approximately 90 percent of our products and services were sold into the Application Delivery market where our primary competitor is Cisco Systems, Inc. Other competitors in this market include Nortel Networks Corporation, Juniper Networks, Inc., Citrix Systems, Inc., Foundry Networks, Inc. and Radware Ltd.

In the adjacent WAN Optimization market, WANJet competes mainly with Riverbed Technology, Inc., Juniper, Packeteer, Inc., and to a lesser extent Cisco and Citrix. None of our competitors offer an integrated product with advanced features comparable to WebAccelerator.

In the SSL VPN market, we compete with Juniper, Citrix, Aventail Corporation, Nokia, Nortel, and Symantec and a number of smaller players. Because SSL VPNs are a potential replacement for IPSec VPNs, the most widely deployed solution for secure remote access today, we also compete with Check Point Software Technologies, Ltd. Which, along with Juniper, are the market leaders in IPSec VPNs.

Application firewalls represent an emerging market that is populated mainly by private, early-development-stage companies. Other companies that have acquired products similar to Application Security Manager (TrafficShield) include Citrix Systems. None of our competitors offers a high-performance product similar to our Application Security Module, which is tightly integrated with our application delivery products.

Some of our competitors have a longer operating history and greater financial, technical, marketing and other resources than we do. These larger competitors also have a more extensive customer base and broader customer relationships, including relationships with many of our current and potential customers. In addition, many have large, well-established, worldwide customer support and professional services organizations and a more extensive direct sales force and sales channels. Because of our relatively smaller size, market presence and resources, our larger competitors may be able to respond more quickly than we can to new or emerging technologies and changes in customer requirements. There is also the possibility that these companies may adopt aggressive pricing policies to gain market share. As a result, our competitors could undermine our ability to win new customers and maintain our existing customer base.

Intellectual Property

We rely on a combination of patent, copyright, trademark and trade secret laws and restrictions on disclosure to protect our intellectual property rights. We have obtained three patents in the United States and have applications pending for various aspects of our technology. Our future success depends in part on our ability to protect our proprietary rights to the technologies used in our principal products. Despite our efforts to protect our proprietary rights, unauthorized parties may attempt to copy aspects of our products or to obtain and use trade secrets or other information that we regard as proprietary. In addition, the laws of some foreign countries do not protect our proprietary rights as fully as do the laws of the United States. We cannot assure you that any issued patent will preserve our proprietary position, or that competitors or others will not develop technologies similar to or superior to our technology. Our failure to enforce and protect our intellectual property rights could harm our business, operating results and financial condition.

In addition to our own proprietary software, we incorporate software licensed from several third-party sources into our products. These licenses generally renew automatically on an annual basis. We believe that alternative technologies for this licensed software are available both domestically and internationally.

Employees

As of September 30, 2006, we employed 1,068 full-time persons, including 287 in product development, 442 in sales and marketing, 205 in professional services and technical support and 134 in finance, administration and operations. None of our employees are represented by a labor union. We have experienced no work stoppages and believe that our employee relations are good.

Table of Contents**Directors and Executive Officers of the Registrant**

The following table sets forth certain information with respect to our executive officers and directors as of November 30, 2006:

Name	Age	Position
John McAdam	55	President, Chief Executive Officer and Director
Edward J. Eames	48	Senior Vice President of Business Operations
M. Thomas Hull	47	Senior Vice President of Worldwide Sales
Dan Matte	40	Senior Vice President of Marketing
Andy Reinland	42	Senior Vice President and Chief Finance Officer
John Rodriguez	46	Senior Vice President and Chief Accounting Officer
Karl Triebes	39	Senior Vice President of Product Development and Chief Technology Officer
A. Gary Ames(2)(3)(4)	62	Director
Deborah L. Bevier(4)	55	Director
Keith D. Grinstein(1)(2)(3)	46	Director
Karl D. Guelich(1)(2)(3)	64	Director
Alan J. Higginson(1)(3)	59	Chairman of the Board of Directors
Rich Malone(3)	58	Director

- (1) Member of the Audit Committee.
- (2) Member of the Compensation Committee.
- (3) Member of the Governance and Nominating Committee.
- (4) Member of the Special Committee.

John McAdam has served as our President, Chief Executive Officer and a director since July 2000. Prior to joining us, Mr. McAdam served as General Manager of the Web server sales business at International Business Machines Corporation from September 1999 to July 2000. From January 1995 until August 1999, Mr. McAdam served as the President and Chief Operating Officer of Sequent Computer Systems, Inc., a manufacturer of high-end open systems, which was sold to International Business Machines Corporation in September 1999. Mr. McAdam holds a B.S. in Computer Science from the University of Glasgow, Scotland.

Edward J. Eames has served as our Senior Vice President of Business Operations since January 2001 and as our Vice President of Professional Services from October 2000 to January 2001. From September 1999 to October 2000, Mr. Eames served as Vice President of e-Business Services for International Business Machines Corporation. From June 1992 to September 1999, Mr. Eames served as the European Services Director and the Worldwide Vice President of Customer Service for Sequent Computer Systems, Inc., a manufacturer of high-end open systems. Mr. Eames holds a Higher National Diploma in Business Studies from Bristol Polytechnic and in 1994 completed the Senior Executive Program at the London Business School.

M. Thomas Hull has served as our Senior Vice President of Worldwide Sales since October 2003. Prior to joining us, Mr. Hull served as President and Chief Executive Officer of Picture IQ Corporation from April 2001 to October 2003.

From September 1998 through April 1999, he served as Vice President of Corporate Sales for Visio Corporation. From April 1999 to January 2000, he served as Senior Vice President of Worldwide Sales for Visio Corporation through its acquisition by Microsoft Corporation in January 2000. From January 2000 through July 2000, Mr. Hull continued to oversee sales of the Visio product set for Microsoft Corporation. He holds a B.S. in Electrical Engineering from the University of Washington.

Dan Matte has served as our Senior Vice President of Marketing since June 2004, and as Vice President of Product Marketing and Management from March 2002 through May 2004. He has served as our Senior Director of Product Marketing and Management from February 2001 through February 2002. From March

Table of Contents

1999 to February 2001, Mr. Matte served as our Director of Product Management. He holds a Bachelor of Commerce from Queens's University and an MBA from the University of British Columbia.

Andy Reinland was promoted to Senior Vice President and Chief Finance Officer effective October 25, 2005. Reinland joined F5 in 1998, serving as a senior financial analyst and, most recently, Vice President of Finance. Prior to joining F5, Reinland was Chief Financial Officer for RTIME, Inc., a developer of real-time 3D software for Internet applications, which was acquired by Sony. Mr. Reinland started his career in public accounting. Mr. Reinland holds a B.A. in Business from Washington State University.

John Rodriguez was promoted to Senior Vice President and Chief Accounting Officer effective October 25, 2005. For SEC reporting purposes, Mr. Rodriguez is the principal financial officer. Rodriguez joined F5 in 2001 as Corporate Controller. His most recent position held was Vice President and Corporate Controller. Prior to F5, Rodriguez was Vice President and Chief Financial Officer of CyberSafe, a security solutions company, and Senior Director of Finance and Operations at Mosaix, which was acquired by Lucent Technologies. Mr. Rodriguez started his career in public accounting. Mr. Rodriguez holds a B.A. in Business from the University of Washington.

Karl Triebes has served as our Senior Vice President of Product Development and Chief Technology Officer since August 2004. Prior to joining us, Mr. Triebes served as Chief Technology Officer and Vice President of Engineering of Foundry Networks, Inc. from January 2003 to August 2004. From June 2001 to January 2003, he served as Foundry's Vice President of Hardware Engineering. From May 2000 to June 2001, Mr. Triebes was Vice President of Engineering at Alcatel U.S.A., a telecommunications company. From December 1999 to May 2000, he was Assistant Vice President of Newbridge Networks Corp., a networking company subsequently acquired by Alcatel. Mr. Triebes holds a B.S. in Electrical Engineering from San Diego State University.

A. Gary Ames was appointed as one of our directors in July 2004. Mr. Ames served as President and Chief Executive Officer of MediaOne International, a provider of broadband and wireless communications from July 1995 until his retirement in June of 2000. From January 1990 to July 1995, he served as President and Chief Executive Officer of U S West Communications, a regional provider of residential and business telephone services, and operator and carrier services. Mr. Ames also serves as director of Albertsons, Inc., Tektronix, Inc., Pac-West Telecomm, Inc. and iPass, Inc.

Deborah L. Bevier was appointed as one of our directors in July 2006. Ms. Bevier is a principal of D.L. Bevier Consulting LLC, an organizational and management consulting firm, and has been president of Waldron Consulting, a division of Waldron & Co., an organizational and management consulting firm, since July 2004. Prior to that time, from 1996 until 2003, Ms. Bevier served as a director, president and chief executive officer of Laird Norton Financial Group and its predecessor companies, an independent financial advisory services firm. From 1973 to 1996, Ms. Bevier held numerous leadership positions with Key Bank of Washington, including chairman and chief executive officer. Ms. Bevier currently serves on the board of directors of Fisher Communications, Inc., a media and communications company, Coinstar, Inc., and Puget Sound Bank. Ms. Bevier holds a B.S. in Economics from State University of New York and a graduate degree from Stonier Graduate School of Banking at Rutgers University.

Keith D. Grinstein has served as one of our directors since December 1999. He also serves as board chair for Coinstar, Inc., a coin counting machine company, and as lead outside director for Nextera, Inc. an economics-consulting firm. Mr. Grinstein is a partner of Second Avenue Partners, LLC, a venture capital fund. Mr. Grinstein's past experience includes serving as President, Chief Executive Officer and Vice Chair of Nextel International Inc., and as President and Chief Executive Officer of the Aviation Communications Division of AT&T Wireless Services Inc. Mr. Grinstein holds a B.A. from Yale University and a J.D. from Georgetown University.

Karl D. Guelich has served as one of our directors since June 1999 and as board chair from January 2003 through April 2004. Mr. Guelich has been in private practice as a certified public accountant since his retirement from Ernst & Young LLP in 1993, where he served as the Area Managing Partner for the Pacific

Table of Contents

Northwest offices headquartered in Seattle from October 1986 to November 1992. Mr. Guelich holds a B.S. in Accounting from Arizona State University.

Alan J. Higginson has served as board chair since April 2004, and as one of our directors since May 1996. Mr. Higginson has been the President and Chief Executive Officer of Hubspan, Inc., an e-business infrastructure provider, since August 2001. From November 1995 to November 1998, Mr. Higginson served as President of Atrieva Corporation, a provider of advanced data backup and retrieval technology. Mr. Higginson holds a B.S. in Commerce and an M.B.A. from the University of Santa Clara.

Rich Malone has served as one of our directors since August 2003. Mr. Malone has been the Chief Information Officer of Edward Jones Investments Inc. since 1979, when he joined Edward Jones Investments as a General Principal. In 1985, he became a member of the management committee of Edward Jones Investments. Mr. Malone is currently a member of the BITS Advisory Group, the Xerox Executive Advisory Forum and serves on the Technology Advisory Committee at Arizona State University.

Item 1A. Risk Factors

In addition to the other information in this report, the following risk factors should be carefully considered in evaluating our company and its business.

Our success depends on our timely development of new products and features, market acceptance of new product offerings and proper management of the timing of the life cycle of our products

We expect the application delivery networking market to be characterized by rapid technological change, frequent new product introductions, changes in customer requirements and evolving industry standards. Our continued success depends on our ability to identify and develop new products and new features for our existing products to meet the demands of these changes, and for those products and features to be accepted by our existing and target customers. If we are unable to identify, develop, and deploy new products and new product features on a timely basis, our business and results of operations may be harmed.

In September 2004, we announced the release of our next-generation BIG-IP product featuring the Traffic Management Operating System, or TMOS. This major new version of BIG-IP represented the culmination of over two years of research and development efforts. TMOS is specifically designed to facilitate the development and integration of application delivery functions as modules that can be added to BIG-IP's core functionality to keep pace with rapidly evolving customer needs. We currently offer software modules as add-ons for this product and our continued success depends significantly on our ability to integrate new modules and functionality onto this platform and the acceptance of the new hardware and software platforms associated with this release by our existing and target customers.

The current life cycle of our products is typically 12 to 24 months. The introduction of new products or product enhancements may shorten the life cycle of our existing products, or replace sales of some of our current products, thereby offsetting the benefit of even a successful product introduction, and may cause customers to defer purchasing our existing products in anticipation of the new products. This could harm our operating results by decreasing sales, increasing our inventory levels of older products, and exposing us to greater risk of product obsolescence. We have also experienced, and may in the future experience, delays in developing and releasing new products and product enhancements. This has led to, and may in the future lead to, delayed sales, increased expenses and lower quarterly revenue than anticipated. Also, in the development of our products, we have experienced delays in the prototyping of our products, which in turn has led to delays in product introductions. In addition, complexity and difficulties in managing product transitions at the end-of-life stage of a product can create excess inventory of components

associated with the outgoing product that can lead to increased expenses. Any or all of the above problems could materially harm our business and operating results.

Table of Contents

Our success depends on sales and continued innovation of our BIG-IP product lines

For the fiscal year ended September 30, 2006, we derived 89.4% of our product revenues from sales of our BIG-IP family of application delivery networking product lines. We expect to derive a significant portion of our net revenues from sales of our BIG-IP products in the future. Implementation of our strategy depends upon BIG-IP being able to solve critical network availability and performance problems of our customers. If BIG-IP is unable to solve these problems for our customers or if we are unable to sustain the high levels of innovation in BIG-IP's product feature set needed to maintain leadership in what will continue to be a competitive market environment, our business and results of operations will be harmed.

We may not be able to compete effectively in the emerging application delivery networking market

The markets we serve are new, rapidly evolving and highly competitive, and we expect competition to persist and intensify in the future. Our principal competitors in the application delivery networking market include Cisco Systems, Inc., Nortel Networks Corporation, Foundry Networks, Inc., Citrix Systems, Inc., Radware Ltd. and Juniper Networks, Inc. We expect to continue to face additional competition as new participants enter our market. In addition, larger companies with significant resources, brand recognition, and sales channels may form alliances with or acquire competing application delivery networking solutions and emerge as significant competitors. Potential competitors may bundle their products or incorporate an Internet traffic management or security component into existing products in a manner that discourages users from purchasing our products.

Our quarterly and annual operating results are volatile and may cause our stock price to fluctuate

Our quarterly and annual operating results have varied significantly in the past and will vary significantly in the future, which makes it difficult for us to predict our future operating results. In particular, we anticipate that the size of customer orders may increase as we continue to focus on larger business accounts. A delay in the recognition of revenue, even from just one account, may have a significant negative impact on our results of operations for a given period. In the past, a majority of our sales have been realized near the end of a quarter. Accordingly, a delay in an anticipated sale past the end of a particular quarter may negatively impact our results of operations for that quarter, or in some cases, that year. Additionally, we have exposure to the credit risks of some of our customers and sub-tenants. Although we have programs in place that are designed to monitor and mitigate the associated risk, there can be no assurance that such programs will be effective in reducing our credit risks adequately. We monitor individual payment capability in granting credit arrangements, seek to limit the total credit to amounts we believe our customers can pay, and maintain reserves we believe are adequate to cover exposure for potential losses. If there is a deterioration of a sub-tenant's or major customer's creditworthiness or actual defaults are higher than expected future resulting losses, if incurred, could harm our business and have a material adverse effect on our operating results.

Further, our operating results may be below the expectations of securities analysts and investors in future quarters or years. Our failure to meet these expectations will likely harm the market price of our common stock.

The average selling price of our products may decrease and our costs may increase, which may negatively impact gross profits

It is possible that the average selling prices of our products will decrease in the future in response to competitive pricing pressures, increased sales discounts, new product introductions by us or our competitors or other factors. Therefore, in order to maintain our gross profits, we must develop and introduce new products and product enhancements on a timely basis and continually reduce our product costs. Our failure to do so will cause our net revenue and gross profits to decline, which will harm our business and results of operations. In addition, we may experience substantial period-to-period fluctuations in future operating results due to the erosion of our average selling

prices.

Table of Contents

It is difficult to predict our future operating results because we have an unpredictable sales cycle

Our products have a lengthy sales cycle, which is difficult to predict. Historically, our sales cycle has ranged from approximately two to three months and has tended to lengthen as we have increasingly focused our sales efforts on the enterprise market. Also, as our distribution strategy has evolved into more of a channel model, utilizing value-added resellers, distributors and systems integrators, the level of variability in the length of sales cycle across transactions has increased and made it more difficult to predict the timing of many of our sales transactions. Sales of our products require us to educate potential customers in their use and benefits. Sales of our products are subject to delays from the lengthy internal budgeting, approval and competitive evaluation processes that large corporations and governmental entities may require. For example, customers frequently begin by evaluating our products on a limited basis and devote time and resources to testing our products before they decide whether or not to purchase. Customers may also defer orders as a result of anticipated releases of new products or enhancements by our competitors or us. As a result, our products have an unpredictable sales cycle that contributes to the uncertainty of our future operating results.

Our business may be harmed if our contract manufacturers are not able to provide us with adequate supplies of our products or if a single source of hardware assembly is lost or impaired

We rely on third party contract manufacturers to assemble our products. We outsource the manufacturing of our hardware platforms to contract manufacturers who assemble these hardware platforms to our specifications. We have experienced minor delays in shipments from contract manufacturers in the past. However, if we experience major delays in the future or other problems, such as inferior quality and insufficient quantity of product, any one or a combination of these factors may harm our business and results of operations. The inability of our contract manufacturers to provide us with adequate supplies of our products or the loss of our contract manufacturer may cause a delay in our ability to fulfill orders while we obtain a replacement manufacturer and may harm our business and results of operations. In particular, because we subcontract substantially all of our manufacturing to a single contract manufacturer, with whom we do not have a long-term contract, any termination, loss or impairment in our arrangement with this single source of hardware assembly, or any impairment of their facilities or operations, would harm our business, financial condition and results of operation.

If the demand for our products grows, we will need to increase our raw material and component purchases, contract manufacturing capacity and internal test and quality control functions. Any disruptions in product flow may limit our revenue, may harm our competitive position and may result in additional costs or cancellation of orders by our customers.

Our business could suffer if there are any interruptions or delays in the supply of hardware components from our third-party sources

We currently purchase several hardware components used in the assembly of our products from a number of single or limited sources. Lead times for these components vary significantly. The unavailability of suitable components, any interruption or delay in the supply of any of these hardware components, or the inability to procure a similar component from alternate sources at acceptable prices within a reasonable time, may delay assembly and sales of our products and, hence, our revenues, and may harm our business and results of operations.

We may not adequately protect our intellectual property and our products may infringe on the intellectual property rights of third parties

We rely on a combination of patent, copyright, trademark and trade secret laws, and restrictions on disclosure of confidential and proprietary information to protect our intellectual property rights. Despite our efforts to protect our proprietary rights, unauthorized parties may attempt to copy or otherwise obtain and use our products or technology.

Monitoring unauthorized use of our products is difficult, and we cannot be certain that the steps we have taken will prevent misappropriation of our technology, particularly in foreign countries where the laws may not protect our proprietary rights as fully as in the United States.

Table of Contents

Our industry is characterized by the existence of a large number of patents and frequent claims and related litigation regarding patent and other intellectual property rights. In the ordinary course of our business, we are involved in disputes and licensing discussions with others regarding their claimed proprietary rights and cannot assure you that we will always successfully defend ourselves against such claims. If we are found to infringe the proprietary rights of others, or if we otherwise settle such claims, we could be compelled to pay damages or royalties and either obtain a license to those intellectual property rights or alter our products so that they no longer infringe upon such proprietary rights. Any license could be very expensive to obtain or may not be available at all. Similarly, changing our products or processes to avoid infringing upon the rights of others may be costly or impractical. In addition, we have initiated, and may in the future initiate, claims or litigation against third parties for infringement of our proprietary rights, to determine the scope and validity of our proprietary rights or those of our competitors. Any of these claims, whether claims that we are infringing the proprietary rights of others, or vice versa, with or without merit, may be time-consuming, result in costly litigation and diversion of technical and management personnel or require us to cease using infringing technology, develop non-infringing technology or enter into royalty or licensing agreements. Further, our license agreements typically require us to indemnify our customers, distributors and resellers for infringement actions related to our technology, which could cause us to become involved in infringement claims made against our customers, distributors, or resellers. Any of the above-described circumstances relating to intellectual property rights disputes could result in our business and results of operations being harmed.

Many of our products include intellectual property licensed from third parties. In the future, it may be necessary to renew licenses for third party intellectual property or obtain new licenses for other technology. These third party licenses may not be available to us on acceptable terms, if at all. The inability to obtain certain licenses, or litigation regarding the interpretation or enforcement of license rights and related intellectual property issues, could have a material adverse effect on our business, operating results and financial condition. Furthermore, we license some third party intellectual property on a non-exclusive basis and this may limit our ability to protect our intellectual property rights in our products.

We may not be able to sustain or develop new distribution relationships and a reduction or delay in sales to a significant distribution partner could hurt our business

Our sales strategy requires that we establish and maintain multiple distribution channels in the United States and internationally through leading industry resellers, systems integrators, Internet service providers and other channel partners. We have a limited number of agreements with companies in these channels, and we may not be able to increase our number of distribution relationships or maintain our existing relationships. If we are unable to establish or maintain our indirect sales channels, our business and results of operations will be harmed. In addition, one domestic distributor of our products accounted for 13.6% and 18.6% of our total net revenue for the fiscal years 2006 and 2005, respectively. A substantial reduction or delay in sales of our products to this or any other key distribution partner could harm our business, operating results and financial condition.

Undetected software errors may harm our business and results of operations

Software products frequently contain undetected errors when first introduced or as new versions are released. We have experienced these errors in the past in connection with new products and product upgrades. We expect that these errors will be found from time to time in new or enhanced products after commencement of commercial shipments. These problems may cause us to incur significant warranty and repair costs, divert the attention of our engineering personnel from our product development efforts and cause significant customer relations problems. We may also be subject to liability claims for damages related to product errors. While we carry insurance policies covering this type of liability, these policies may not provide sufficient protection should a claim be asserted. A material product liability claim may harm our business and results of operations.

Our products must successfully operate with products from other vendors. As a result, when problems occur in a network, it may be difficult to identify the source of the problem. The occurrence of software errors, whether caused by our products or another vendor's products, may result in the delay or loss of market

Table of Contents

acceptance of our products. The occurrence of any of these problems may harm our business and results of operations.

Our operating results are exposed to risks associated with international commerce

As our international sales increase, our operating results become more exposed to international operating risks. These risks include risks related to potential recessions in economies outside the United States, foreign currency exchange rates, managing foreign sales offices, regulatory, political, or economic conditions in specific countries, military conflict or terrorist activities, changes in laws and tariffs, inadequate protection of intellectual property rights in foreign countries, foreign regulatory requirements, and natural disasters. All of these factors could have a material adverse effect on our business. We intend to continue expanding into international markets. International sales represented 42.6% and 40.5% of our net revenues for the fiscal years ended September 30, 2006 and 2005, respectively. In particular, in fiscal year 2006, we derived 13.1% of our total revenue from the Japanese market. This revenue is dependent on a number of factors outside our control, including the viability and success of our resellers and the strength of the Japanese economy.

Changes in governmental regulations could negatively affect our revenues

Our products are subject to various regulations promulgated by the United States and various foreign governments including, but not limited to, environmental regulations and regulations implementing export license requirements and restrictions on the import or export of some technologies, especially encryption technology. Changes in governmental regulation and our inability or failure to obtain required approvals, permits, or registrations could harm our international and domestic sales and adversely affect our revenues, business and operations.

Acquisitions, including our recent acquisition of Swan Labs, present many risks and we may not realize the financial and strategic goals that are contemplated at the time of the transaction

With respect to our acquisitions, as well as any other future acquisitions we may undertake, we may find that the acquired assets do not further our business strategy as expected, or that we paid more than what the assets are later worth, or that economic conditions change, all of which may generate future impairment charges. There may be difficulty integrating the operations and personnel of the acquired business, and we may have difficulty retaining the key personnel of the acquired business. We may have difficulty in incorporating the acquired technologies or products with our existing product lines. Our ongoing business and management's attention may be disrupted or diverted by transition or integration issues and the complexity of managing geographically and culturally diverse locations. We may have difficulty maintaining uniform standards, controls, procedures and policies across locations. We may experience significant problems or liabilities associated with the product quality, technology and other matters.

Our inability to successfully operate and integrate newly-acquired businesses appropriately, effectively and in a timely manner, or to retain key personnel of any acquired business, could have a material adverse effect on our ability to take advantage of further growth in demand for integrated traffic management and security solutions and other advances in technology, as well as on our revenues, gross margins and expenses.

Our success depends on our key personnel and our ability to attract and retain qualified sales and marketing, operations, product development and professional services personnel

Our success depends to a significant degree upon the continued contributions of our key management, product development, sales, marketing and finance personnel, many of whom may be difficult to replace. The complexity of our application delivery networking products and their integration into existing networks and ongoing support, as well as the sophistication of our sales and marketing effort, requires us to retain highly trained professional services, customer support and sales personnel. Competition for qualified professional services, customer support and sales

personnel in our industry is intense because of the limited number of people available with the necessary technical skills and understanding of our products. Our ability to retain and hire these personnel may be adversely affected by volatility or reductions in the price of our common

Table of Contents

stock, since these employees are generally granted stock options. The loss of services of any of our key personnel, the inability to retain and attract qualified personnel in the future or delays in hiring qualified personnel, may harm our business and results of operations.

We face litigation risks

We are a party to lawsuits in the normal course of our business. Litigation in general, and intellectual property and securities litigation in particular, can be expensive, lengthy and disruptive to normal business operations. Moreover, the results of complex legal proceedings are difficult to predict. Responding to the allegations has been, and will likely continue to be, expensive and time-consuming for us. An unfavorable resolution of the lawsuits could adversely affect our business, results of operations, or financial condition.

Our historical stock option practices and the restatement of our prior financial statements have exposed us to greater risks associated with litigation. In May 2006 several derivative actions were filed against certain current and former directors and officers based on allegations relating to our historical stock option practices. We cannot assure you that this current litigation will result in the same conclusions reached by the special committee of outside directors formed by our Board of Directors to conduct a review of our stock option practices (the Special Committee).

We may in the future be subject to additional litigation arising in relation to our historical stock option practices and the restatement of our prior financial statements. Litigation may be time consuming, expensive and distracting for management from the conduct of our business. The adverse resolution of any lawsuit could have a material adverse effect on our business, financial condition and results of operations. We cannot assure you that any future litigation relating to our historical stock option practices will result in the same conclusions reached by the Special Committee. Furthermore, if we are subject to adverse findings in any of these matters, we could be required to pay damages or penalties or have other remedies imposed upon us which could adversely affect our business, results of operations, or financial condition.

The matters relating to the Special Committee's review of our historical stock option practices and the restatement of our consolidated financial statements has resulted in regulatory proceedings against us and may result in future regulatory proceedings, which could have a material adverse impact on our financial condition

On November 8, 2006, we announced that the Special Committee had completed its review of our historical stock option practices. Upon completion of its review, the Special Committee found that the recorded grant dates for certain stock options granted during fiscal years 1999 to 2004 should be adjusted as the measurement date for accounting purposes and the accounting treatment used for the vesting of certain stock options was incorrect. Based on the Special Committee's review, to correct the accounting treatment, we have amended our Annual Report on Form 10-K/A (as amended) for the year ended September 30, 2005 and our Quarterly Reports on Form 10-Q for the three months ended December 31, 2005 and March 31, 2006 to restate the consolidated financial statements contained in those reports.

We have received notice from both the Securities and Exchange Commission (SEC) and the United States Attorney's Office for the Eastern District of New York (the Department of Justice) that they are conducting informal inquiries into our historical stock option practices, and we have continually cooperated with both agencies. Considerable legal and accounting expenses related to our historical stock option practices have already been incurred to date and significant expenditures may continue to be incurred in the future. We may in the future be subject to additional regulatory proceedings or actions arising in relation to our historical stock option practices and the restatement of our prior period financial statements. Any potential regulatory proceeding or action may be time consuming, expensive and distracting for management from the conduct of our business. The adverse resolution of any potential regulatory proceeding or action could adversely affect our business, results of operations, or financial condition. We cannot

assure you that the SEC and Department of Justice inquiries, or any future regulatory action relating to our historical stock option practices, will result in the same conclusions reached by the Special Committee. Furthermore, if we are subject to adverse findings in any of these matters, we could be required to pay damages or penalties or have other remedies imposed

Table of Contents

upon us, including criminal penalties, which could adversely affect our business, results of operations, or financial condition.

As a result of our delayed filing of our Form 10-Q for the quarter ended June 30, 2006, our inability to maintain our Form S-3 eligibility may adversely affect our ability to raise future capital

As a result of our delayed filing of our Form 10-Q for the quarter ended June 30, 2006, we will be ineligible to register our securities on Form S-3 for sale by us or resale by other security holders until we have timely filed all periodic reports under the Securities Exchange Act of 1934 for one year from the date the Form 10-Q for the quarter ended June 30, 2006 was due. In the meantime, we have the ability to use Form S-1 to raise capital or complete acquisitions, which could increase the transaction costs and adversely affect our ability to raise capital or complete acquisitions of other companies during this period.

Anti-takeover provisions could make it more difficult for a third party to acquire us

Our Board of Directors has the authority to issue up to 10,000,000 shares of preferred stock and to determine the price, rights, preferences, privileges and restrictions, including voting rights, of those shares without any further vote or action by the stockholders. The rights of the holders of common stock may be subject to, and may be adversely affected by, the rights of the holders of any preferred stock that may be issued in the future. The issuance of preferred stock may have the effect of delaying, deferring or preventing a change of control of our company without further action by our stockholders and may adversely affect the voting and other rights of the holders of common stock. Further, certain provisions of our bylaws, including a provision limiting the ability of stockholders to raise matters at a meeting of stockholders without giving advance notice, may have the effect of delaying or preventing changes in control or management of our company, which could have an adverse effect on the market price of our common stock. In addition, our articles of incorporation provide for a staggered board, which may make it more difficult for a third party to gain control of our board of directors. Similarly, state anti-takeover laws in the State of Washington related to corporate takeovers may prevent or delay a change of control of our company.

Item 1B. *Unresolved Staff Comments*

Not applicable.

Item 2. *Properties*

Our principal administrative, sales, marketing, research and development facilities are located in Seattle, Washington and consist of approximately 195,000 square feet. In April 2000, we amended and restated the lease agreement on two buildings for our corporate headquarters. The lease commenced in July 2000 on the first building; and the lease on the second building commenced in September 2000. The lease for both buildings expires in 2012 with an option for renewal. The lease for the second building has been fully subleased through 2012. We believe that our existing properties are in good condition and suitable for the conduct of our business. We also lease office space for our product development personnel in Spokane, Washington, San Jose, California, Israel, Northern Ireland, and Russia and for our sales and support personnel in Washington D.C., New York, Hong Kong, Singapore, China, Taiwan, Malaysia, South Korea, Japan, Australia, Germany, France, and the United Kingdom. We believe that our future growth can be accommodated by current facilities or by leasing additional space if necessary.

On October 31, 2006 we entered into an office lease agreement to lease a total of approximately 137,000 square feet of office space in the building known as 333 Elliott West, which is next to the three buildings that currently serve as our corporate headquarters. The lease term is 10 years with an option for renewal. We plan to occupy this new building during the second quarter of fiscal 2008 after construction is completed.

Table of Contents

Item 3. Legal Proceedings

Regulatory proceedings

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

Derivative Suits. On May 24, 2006, a shareholder action captioned Adams v. Amdahl et al. was filed against certain of our current and former officers and directors in the King County Superior Court in Washington. The complaint generally alleges that the defendants breached their fiduciary duties to us in connection with the granting of certain stock options. Five additional shareholder derivative complaints, based on substantially the same allegations, were subsequently filed in the Washington federal and state courts. Although litigation is subject to inherent uncertainties, we do not believe the results of these pending actions will, individually or in the aggregate, have a material adverse impact on our consolidated financial position or results of operations.

Nasdaq Delisting. On July 20, 2006 we announced that it would be unlikely that the Special Committee's review would be completed in time for us to file our Form 10-Q for the quarter ended June 30, 2006, by the SEC's deadline of August 14, 2006. In August 2006, we failed to timely file our Form 10-Q for the period ended June 30, 2006 as a result of the ongoing Special Committee investigation. On August 14, 2006, we received a written Staff Determination Notice from Nasdaq stating that we are not in compliance with Nasdaq's Marketplace Rule 4310(c)(14) because we had not timely filed our Quarterly Report on Form 10-Q for the quarter ended June 30, 2006, and that, therefore, our securities were subject to delisting. On August 18, 2006, we appealed Nasdaq's Staff's delisting determination to the Panel and requested an oral hearing before the Panel. On August 23, 2006, Nasdaq's Staff stayed the delisting action pending a final written decision on our appeal by the Panel. A hearing before the Panel occurred on September 22, 2006. On November 28, 2006, we received notice that the Panel had granted our request for continued listing on the Nasdaq Global Market, subject to certain conditions we expect to satisfy within the time period requested by the Panel.

There is no assurance that we will not be subject to inquiries related to our stock option grant practices by other federal, state or foreign regulatory agencies.

2001 Securities Suits. In July and August 2001, a series of putative securities class action lawsuits were filed in United States District Court, Southern District of New York against certain investment banking firms that underwrote the Company's initial and secondary public offerings, the Company and some of the Company's officers and directors. These cases, which have been consolidated under *In re F5 Networks, Inc. Initial Public Offering Securities Litigation*, No. 01 CV 7055, assert that the registration statements for the Company's June 4, 1999 initial public offering and September 30, 1999 secondary offering failed to disclose certain alleged improper actions by the underwriters for the offerings. The consolidated, amended complaint alleges claims against the Company and those of our officers and directors named in the complaint under Sections 11 and 15 of the Securities Act of 1933, and under Sections 10(b) and 20(a) of the Securities Exchange Act of 1934. Other lawsuits have been filed making similar allegations regarding the public offerings of more than 300 other companies. All of these various consolidated cases have been coordinated for pretrial purposes as *In re Initial Public Offering Securities Litigation*, Civil Action No. 21-MC-92. In October 2002, the directors and officers were dismissed without prejudice. The issuer defendants filed a coordinated motion to dismiss these lawsuits in July 2002, which the Court granted in part and denied in part in an order dated February 19,

2003. The Court declined to dismiss the Section 11 and Section 10(b) and Rule 10b-5 claims against the Company. In June 2004, a stipulation of settlement for the claims against the issuer defendants, including the Company, was submitted to the Court. On August 31, 2005, the Court granted preliminary approval of the settlement. The settlement is subject to a number of conditions, including final approval by the Court. If the settlement does not occur, and litigation against us continues, we believe we have meritorious defenses and intend to defend the case vigorously. Securities class action litigation could result in

Table of Contents

substantial costs and divert our management's attention and resources. Due to the inherent uncertainties of litigation, we cannot accurately predict the ultimate outcome of the litigation, and any unfavorable outcome could have a material adverse impact on our business, financial condition and operating results.

We are not aware of any additional pending legal proceedings that, individually or in the aggregate, would have a material adverse effect on the Company's business, operating results, or financial condition. We may in the future be party to litigation arising in the ordinary course of business, including claims that we allegedly infringe upon third-party trademarks or other intellectual property rights. Such claims, even if not meritorious, could result in the expenditure of significant financial and managerial resources.

Item 4. *Submission of Matters to a Vote of Securities Holders*

No matters were submitted to a vote of the shareholders during the fourth quarter of fiscal 2006.

PART II**Item 5. *Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities*****Market Prices of Common Stock**

Our common stock is traded on the Nasdaq Global Market under the symbol FFIV. The following table sets forth the high and low sales prices of our common stock as reported on the Nasdaq Global Market.

	Fiscal Year 2006		Fiscal Year 2005	
	High	Low	High	Low
First Quarter	\$ 58.50	\$ 39.50	\$ 49.79	\$ 30.47
Second Quarter	\$ 74.00	\$ 56.20	\$ 59.12	\$ 41.25
Third Quarter	\$ 72.93	\$ 42.22	\$ 54.01	\$ 41.30
Fourth Quarter	\$ 60.85	\$ 40.55	\$ 51.25	\$ 35.34

The last reported sales price of our common stock on the Nasdaq Global Market on December 6, 2006 was \$73.41.

As of December 6, 2006, there were 96 holders of record of our common stock. As many of our shares of common stock are held by brokers and other institutions on behalf of stockholders, we are unable to estimate the total number of beneficial holders of our common stock represented by these record holders.

Dividend Policy

Our policy has been to retain cash to fund future growth. Accordingly, we have not paid dividends and do not anticipate declaring dividends on our common stock in the foreseeable future.

Unregistered Securities Sold in 2006

We did not sell any unregistered shares of our common stock during the fiscal year 2006.

Table of Contents**Item 6. Selected Financial Data**

The consolidated balance sheet data as of September 30, 2006 and 2005 and the consolidated statement of operations data for the years ended September 30, 2006, 2005 and 2004 are derived from our audited financial statements and related notes that are included elsewhere in this report. The consolidated balance sheet data as of September 30, 2004 is derived from our audited financial statements and related notes which are not included in this report. The consolidated balance sheet data as of September 30, 2003 and 2002 are derived from our unaudited financial statements which are not included in this report. The consolidated statement of operations data as of September 30, 2003 is derived from our audited financial statements and related notes which are not included in this report. The consolidated statement of operations as of September 30, 2002 are derived from our unaudited financial statements which are not included in this report. The information set forth below should be read in conjunction with our historical financial statements, including the notes thereto, and Management's Discussion and Analysis of Financial Condition and Results of Operations, included elsewhere in this report.

	Years Ended September 30,				
	2006	2005	2004	2003	2002
	(In thousands, except per share data)				
Consolidated Statement of Operations Data(4)					
Net revenues					
Products	\$ 304,878	\$ 219,603	\$ 126,169	\$ 84,197	\$ 82,566
Services	89,171	61,807	45,021	31,698	25,700
Total	394,049	281,410	171,190	115,895	108,266
Cost of net revenues					
Products	63,619	48,990	28,406	17,843	20,557
Services	24,534	16,194	10,993	9,132	10,238
Total	88,153	65,184	39,399	26,975	30,795
Gross profit	305,896	216,226	131,791	88,920	77,471
Operating expenses(1)					
Sales and marketing	127,478	89,866	66,446	54,897	53,673
Research and development	49,171	31,516	24,438	19,455	19,110
General and administrative	39,109	25,486	15,761	12,210	16,203
Restructuring charges					3,274
Total	215,758	146,868	106,645	86,562	92,260
Income (loss) from operations	90,138	69,358	25,146	2,358	(14,789)
Other income, net	17,431	8,076	2,731	751	1,420
Income (loss) before income taxes	107,569	77,434	27,877	3,109	(13,369)

Edgar Filing: F5 NETWORKS INC - Form 10-K

Provision (benefit) for income taxes	41,564	30,532	(8,451)	853	489
Net income (loss)	\$ 66,005	\$ 46,902	\$ 36,328	\$ 2,256	\$ (13,858)
Net income (loss) per share basic	\$ 1.64	\$ 1.26	\$ 1.09	\$ 0.09	\$ (0.55)
Weighted average shares basic	40,139	37,220	33,221	26,453	25,323
Net income (loss) per share diluted	\$ 1.59	\$ 1.21	\$ 1.01	\$ 0.08	\$ (0.55)
Weighted average shares diluted	41,510	38,761	35,961	27,175	25,323

Consolidated Balance Sheet Data(4)

Cash, cash equivalents, and short-term investments(2)	\$ 374,173	\$ 236,181	\$ 140,501	\$ 44,878	\$ 80,333
Restricted cash(3)	3,929	3,871	6,243	6,000	6,000
Long-term investments(2)	118,003	128,834	81,792	34,132	1,346
Total assets	729,511	537,739	360,593	148,173	126,289
Long-term liabilities	13,416	9,964	6,228	1,735	1,315
Total shareholders equity	616,458	460,167	307,745	110,429	93,685

Table of Contents

- (1) Amortization of unearned compensation reported in fiscal years 2001 through fiscal 2004 has been reclassified to conform to the current year's presentation. Specifically, amounts have been attributed to the respective categories within operating expenses.
- (2) The combined overall increase in cash, cash equivalents, short-term and long-term investments in fiscal 2004 was primarily due to the net proceeds of \$113.6 million received from the sale of our common stock in a public offering in November 2003.
- (3) Restricted cash represents escrow accounts established in connection with lease agreements for our facilities.
- (4) In our Form 10-K/A No. 2 (filed on December 12, 2006), we restated our consolidated financial statements for the years ended September 30, 2005, 2004 and 2003, and the selected consolidated financial data as of and for the years ended September 30, 2005, 2004, 2003, 2002 and 2001. In addition, we restated our consolidated financial statements for the quarters ended December 31, 2005 and March 31, 2006 in our Quarterly Reports on Form 10-Q/A for the quarters ended December 31, 2005 and March 31, 2006, each of which was filed on December 13, 2006. All financial information included in this Annual Report on Form 10-K reflects our restatement.

Table of Contents

Item 7. *Management's Discussion and Analysis of Financial Condition and Results of Operations*

The statements contained below that are not purely historical are forward-looking statements within the meaning of Section 21E of the Securities Exchange Act of 1934 and Section 27A of the Securities Act of 1933. These statements include, but are not limited to, statements about our plans, objectives, expectations, strategies, intentions or other characterizations of future events or circumstances and are generally identified by the words expects, anticipates, intends, plans, believes, seeks, estimates, and similar expressions. Because these forward-looking statements are subject to a number of risks and uncertainties, our actual results could differ materially from those expressed or implied by these forward-looking statements. Factors that could cause or contribute to such differences include, but are not limited to, those discussed under the heading Risk Factors herein and in other documents we file from time to time with the Securities and Exchange Commission. All forward-looking statements set forth below are based on information available to us on the date hereof. Our business and the associated risks may have changed since the date this report was originally filed with the SEC. We assume no obligation to update any such forward-looking statements.

Restatement of Consolidated Financial Statements

In our Annual Report on Form 10-K/A No. 2 for the fiscal year ended September 30, 2005 (filed on December 12, 2006), we restated our consolidated financial statements for the years ended September 30, 2005, 2004 and 2003, and the selected consolidated financial data as of and for the years ended September 30, 2005, 2004, 2003, 2002 and 2001. In addition, we restated our consolidated financial statements for the quarters ended December 31, 2005 and March 31, 2006 in our Quarterly Reports on Form 10-Q/A for the quarters ended December 31, 2005 and March 31, 2006, each of which was filed on December 13, 2006. All financial information included in this Annual Report on Form 10-K reflects our restatement.

Overview

We are a global provider of software and hardware products and services that help companies efficiently and securely manage their Internet traffic. Our products enhance the delivery, optimization and security of application traffic on Internet-based networks. We market and sell our products primarily through indirect sales channels in the Americas (primarily the United States); Europe, the Middle East, and Africa (EMEA); Japan and the Asia Pacific region. Enterprise customers (Fortune 1000 or Business Week Global 1000 companies) in financial services, transportation, government and telecommunications industries continue to make up the largest percentage of our customer base.

Our management monitors and analyzes a number of key performance indicators in order to manage our business and evaluate our financial and operating performance. Those indicators include:

Revenues. The majority of our revenues are derived from sales of our core products; BIG-IP Local Traffic Manager; BIG-IP Global Traffic Manager; BIG-IP ISP Traffic Manager; TrafficShield Application Firewall, and FirePass SSL VPN servers. We also derive revenues from the sales of services including annual maintenance contracts, installation, training and consulting services. We carefully monitor the sales mix of our revenues within each reporting period. We believe customer acceptance rates of our new products and feature enhancements are key indicators of future trends. We also consider overall revenue concentration by customer and by geographic region as additional indicators of current and future trends.

Cost of revenues and gross margins. We strive to control our cost of revenues and thereby maintain our gross margins. Significant items impacting cost of revenues are hardware costs paid to our contract manufacturers,

third-party software license fees, and amortization of developed technology, personnel and overhead expenses. Our margins have remained relatively stable over the past two years; however factors such as sales price, product mix, inventory obsolescence, returns, component price increases, and warranty costs could significantly impact our gross margins from quarter to quarter and represent the significant indicators we monitor on a regular basis.

Table of Contents

Operating expenses. Operating expenses are substantially driven by personnel and related overhead expenses. Existing headcount and future hiring plans are the predominant factors in analyzing and forecasting future operating expense trends. Other significant operating expenses that we monitor include marketing and promotions, travel, professional fees, computer costs related to the development of new products, facilities and depreciation expenses.

Liquidity and cash flows. Our financial condition remains strong with significant cash and investments and no long term debt. The increase in cash and investments during the fiscal year 2006 was primarily due to net income from operations, with operating activities providing cash of \$125.4 million. Capital expenditures during the fiscal year 2006 were comprised primarily of tenant improvements and information technology infrastructure and equipment to support the growth of our core business activities.

Balance sheet. We view cash, short-term and long-term investments, deferred revenue, accounts receivable balances and day's sales outstanding as important indicators of our financial health. Deferred revenues continued to increase due to the growth in the amount of annual maintenance contracts purchased on new products and maintenance renewal contracts related to our existing product installation base. Our day's sales outstanding for the fourth quarter of fiscal 2006 was 51. We expect to maintain this metric going forward.

Critical Accounting Policies

Our consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities. We base our estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances. Actual results may differ from these estimates under different assumptions or conditions.

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

Revenue Recognition. We recognize revenue in accordance with the guidance provided under Statement of Position (SOP) No. 97-2, *Software Revenue Recognition*, and SOP No. 98-9 *Modification of SOP No. 97-2, Software Revenue Recognition, with Respect to Certain Transactions*, Statement of Financial Accounting Standards (SFAS) No. 48, *Revenue Recognition When Right of Return Exists*, and SEC Staff Accounting Bulletin (SAB) No. 101, *Revenue Recognition in Financial Statements*, and SAB No. 104, *Revenue Recognition*.

We sell products through distributors, resellers, and directly to end users. We recognize product revenue upon shipment, net of estimated returns, provided that collection is determined to be probable and no significant obligations remain. In certain regions where we do not have the ability to reasonably estimate returns, revenue is recognized upon sale to the end user. In this situation, we receive a sales report from the channel partner to determine when the sales transaction to the end user has occurred. Payment terms to domestic customers are generally net 30 days to net 45 days. Payment terms to international customers range from net 30 to 90 days based on normal and customary trade practices in the individual markets. We have offered extended payment terms ranging from three to six months to certain customers, in which case, revenue is recognized when payments are made.

Whenever a software license, hardware, installation and post-contract customer support (PCS) elements are combined into a package with a single bundled price, a portion of the sales price is allocated to each element of the bundled package based on their respective fair values as determined when the individual elements are sold separately.

Revenues from the license of software are recognized when the software has been shipped and the customer is obligated to pay for the software. When rights of return are present and we cannot estimate returns, we recognize revenue when such rights of return lapse. Revenues for PCS are recognized on a straight-line basis over the service contract term. PCS includes rights to upgrades, when and if

Table of Contents

available, a limited period of telephone support, updates, and bug fixes. Installation revenue is recognized when the product has been installed at the customer's site. Consulting services are customarily billed at fixed rates, plus out-of-pocket expenses, and revenues are recognized when the consulting has been completed. Training revenue is recognized when the training has been completed.

Reserve for Doubtful Accounts. Estimates are used in determining our allowance for doubtful accounts and are based upon an assessment of selected accounts and as a percentage of our remaining accounts receivable by aging category. In determining these percentages, we evaluate historical write-offs, current trends in the credit quality of our customer base, as well as changes in the credit policies. We perform ongoing credit evaluations of our customers' financial condition and do not require any collateral. If there is deterioration of a major customer's credit worthiness or actual defaults are higher than our historical experience, our allowance for doubtful accounts may not be sufficient.

Reserve for Product Returns. In some instances, product revenue from distributors is subject to agreements allowing rights of return. Product returns are estimated based on historical experience and are recorded at the time revenues are recognized. Accordingly, we reduce recognized revenue for estimated future returns at the time revenue is recorded. When rights of return are present and we cannot estimate returns, revenue is recognized when such rights lapse. The estimates for returns are adjusted periodically based upon changes in historical rates of returns and other related factors. It is possible that these estimates will change in the future or that the actual amounts could vary from our estimates.

Reserve for Warranties. A warranty reserve is established based on our historical experience and an estimate of the amounts necessary to settle future and existing claims on products sold as of the balance sheet date. While we believe that our warranty reserve is adequate and that the judgment applied is appropriate, such amounts estimated to be due and payable could differ materially from what will actually transpire in the future.

Accounting for Income Taxes. We utilize the liability method of accounting for income taxes as set forth SFAS No. 109, *Accounting for Income Taxes* (SFAS 109). Accordingly, we are required to estimate our income taxes in each of the jurisdictions in which we operate as part of the process of preparing our consolidated financial statements. This process involves estimating our actual current tax exposure, including assessing the risks associated with tax audits, together with assessing temporary differences resulting from the different treatment of items for tax and accounting purposes. These differences result in deferred tax assets and liabilities. Due to the evolving nature and complexity of tax rules combined with the large number of jurisdictions in which we operate, it is possible that our estimates of our tax liability could change in the future, which may result in additional tax liabilities and adversely affect our results of operations, financial condition and cash flows.

Stock-based compensation. We adopted the fair value recognition provisions of Financial Accounting Standards Board (FASB) Statement No. 123(R), *Share-Based Payment* (FAS 123R), on July 1, 2005. Prior to July 1, 2005, we accounted for share-based payments under the recognition and measurement provisions of Accounting Principles Board (APB) Opinion No. 25, *Accounting for Stock Issued to Employees* (APB 25), and related Interpretations, as permitted by FASB Statement No. 123, *Accounting for Stock-Based Compensation* (FAS 123). In accordance with APB 25, no compensation cost was required to be recognized for options granted that had an exercise price equal to the market value of the underlying common stock on the date of grant.

We adopted FAS 123R using the modified-prospective-transition method. Under that transition method, compensation cost recognized in the fiscal year 2005 includes: a) compensation cost for all share-based payments granted prior to, but not yet vested as of July 1, 2005, based on the grant-date fair value estimated in accordance with the original provisions of FAS 123, and b) compensation cost for all share-based payments granted subsequent to July 1, 2005, based on the grant-date fair value estimated in accordance with the provisions of FAS 123R. The results for the prior periods have not been restated.

Effective July 1, 2005, we adopted the straight-line attribution method for recognizing compensation expense. Previously under the disclosure-only provisions of SFAS 123, the Company used the accelerated method of expense recognition pursuant to FASB Interpretation No. 28, *Accounting for Stock Appreciation Rights and Other Variable Stock Option or Award Plans* (FIN 28). For all unvested options outstanding as of

Table of Contents

July 1, 2005, the previously measured but unrecognized compensation expense, based on the fair value at the original grant date, will be recognized on an accelerated basis over the remaining vesting period. For share-based payments granted subsequent to July 1, 2005, compensation expense, based on the fair value on the date of grant, will be recognized on a straight-line basis over the vesting period.

In addition, in 2005, we modified the method in which we issue incentive awards to our employees through stock-based compensation. In prior years, stock-based compensation consisted only of stock options. Beginning in the fourth quarter of fiscal 2005, we began to grant restricted stock unit awards instead of stock options. The value of restricted stock units is determined using the intrinsic value method, which in this case, is based on the number of shares granted and the quoted price of our common stock on the date of grant. Alternatively, in determining the fair value of stock options, we use the Black-Scholes option pricing model that employs the following key assumptions. Expected volatility is based on the annualized daily historical volatility of our stock price, over the expected life of the option. Expected term of the option is based on historical employee stock option exercise behavior, the vesting terms of the respective option and a contractual life of ten years. Our stock price volatility and option lives involve management's best estimates at that time, both of which impact the fair value of the option calculated under the Black-Scholes methodology and, ultimately, the expense that will be recognized over the life of the option.

SFAS 123R also requires that we recognize compensation expense for only the portion of options or stock units that are expected to vest. Therefore, we apply estimated forfeiture rates that are derived from historical employee termination behavior. Our estimated forfeiture rate in the fourth quarter of fiscal 2006 is 5%. If the actual number of forfeitures differs from those estimated by management, additional adjustments to compensation expense may be required in future periods.

Results of Operations

The following discussion and analysis should be read in conjunction with our consolidated financial statements and related notes included elsewhere in this Annual Report on Form 10-K.

	Years Ended September 30,		
	2006	2005	2004
	(In thousands, except for percentages)		
Net Revenues			
Products	\$ 304,878	\$ 219,603	\$ 126,169
Services	89,171	61,807	45,021
Total	\$ 394,049	\$ 281,410	\$ 171,190
Percentage of net revenues			
Products	77.4%	78.0%	73.7%
Services	22.6	22.0	26.3
Total	100.0%	100.0%	100.0%

Net Revenues. Total net revenues increased 40.0% in fiscal year 2006 from fiscal year 2005, compared to an increase of 64.4% in fiscal year 2005 from fiscal year 2004. The continued revenue growth was due to increased demand for our Application Traffic Management (ATM) products and higher services revenues resulting from our increased

installed base of products. During fiscal year 2006, each of our primary geographic regions reported higher revenues compared to the prior year period. International revenues represented 42.6%, 40.5% and 39.4% of net revenues in fiscal years 2006, 2005 and 2004, respectively. We expect international sales will continue to represent a significant portion of net revenues, although we cannot provide assurance that international revenues as a percentage of net revenues will remain at current levels.

Net product revenues increased 38.8% in fiscal year 2006 and 74.1% in fiscal year 2005 as compared to the previous fiscal year, respectively. The increase in fiscal 2006 was primarily due to absolute growth in the volume of product sales of our BIG-IP product line as well as incremental revenues derived from sales of our TrafficShield and WAN Optimization product lines. Sales of our BIG-IP family of application delivery

Table of Contents

networking products represented 89.4%, 89.1% and 90.3% of total product revenues in fiscal years 2006, 2005 and 2004, respectively.

Net service revenues increased 44.3% in fiscal year 2006 compared to a 37.3% increase for fiscal year 2005 from the prior year, respectively. The increase of services revenues in absolute dollars was the result of increased purchases and renewals of maintenance contracts as our installed base of products increased.

Ingram Micro Inc., one of our domestic distributors, accounted for 13.6%, 18.6%, and 19.1% of our total net revenues in fiscal years 2006, 2005 and 2004, respectively. GE Access, one of our domestic distributors, which began selling our products in fiscal year 2006 accounted for 11.6% of our total net revenue in fiscal 2006. Ingram Micro accounted for 8.5%, 26.2% and 26.9% of our accounts receivable as of September 30, 2006, 2005 and 2004, respectively.

	Years Ended September 30,		
	2006	2005	2004
	(In thousands, except for percentages)		
Cost of net revenues and Gross margin			
Products	\$ 63,619	\$ 48,990	\$ 28,406
Services	24,534	16,194	10,993
Total	88,153	65,184	39,399
Gross margin	\$ 305,896	\$ 216,226	\$ 131,791
Cost of net revenues and Gross margin (as a percentage of related net revenue)			
Products	20.9%	22.3%	22.5%
Services	27.5	26.2	24.4
Total	22.4	23.2	23.0
Gross margin	77.6%	76.8%	77.0%

Cost of Net Product Revenues. Cost of net product revenues consist of finished products purchased from our contract manufacturers, manufacturing overhead, freight, warranty, provisions for excess and obsolete inventory, and amortization expenses in connection with developed technology from acquisitions. In absolute dollars, product cost increased to \$63.6 million in fiscal year 2006 as compared to \$49.0 million and \$28.4 million in fiscal years 2005 and 2004, respectively. The increases were primarily due to the higher volume of units shipped. Higher indirect product costs including amortization charges of our acquired technology contributed to the percentage increase as compared to fiscal year 2005.

Cost of Net Service Revenues. Cost of net service revenues consist of the salaries and related benefits of our professional services staff, travel, facilities, and depreciation expenses. Cost of net service revenues as a percentage of net service revenues increased slightly to 27.5% in fiscal year 2006 as compared to 26.2% and 24.4% in fiscal years 2005 and 2004, respectively. The increase in fiscal year 2006 is primarily due to increased salary and benefits attributed to growth in headcount. Professional services headcount at the end of fiscal year 2006 increased to 205 from 147 at the end of fiscal year 2005. In addition, stock compensation expense increased to \$1.5 million in fiscal year

2006 from \$288,000 in fiscal year 2005. Going forward, we

Table of Contents

expect to continue to increase our cost of service revenues to support our expanded product lines and growing customer base.

	Years Ended September 30,		
	2006	2005	2004
	(In thousands, except for percentages)		
Operating expenses			
Sales and marketing	\$ 127,478	\$ 89,866	\$ 66,446
Research and development	49,171	31,516	24,438
General and administrative	39,109	25,486	15,761
Total	\$ 215,758	\$ 146,868	\$ 106,645
Operating expenses (as a percentage of net revenue)			
Sales and marketing	32.4%	31.9%	38.8%
Research and development	12.5	11.2	14.3
General and administrative	9.9	9.1	9.2
Total	54.8%	52.2%	62.3%

Sales and Marketing. Sales and marketing expenses consist of salaries, commissions and related benefits of our sales and marketing staff, the costs of our marketing programs, including public relations, advertising and trade shows, travel, facilities and depreciation expenses. In absolute dollars, sales and marketing expense increased 41.9% in fiscal year 2006 as compared to 35.2% and 21.0% in fiscal years 2005 and 2004, respectively. The increase in sales and marketing is primarily due to higher commission and personnel costs, consistent with the increased revenue and headcount for the corresponding period. Sales and marketing headcount at the end of fiscal 2006 increased to 442 from 331 at the end of fiscal 2005 and 229 at the end of fiscal 2004. Stock-based compensation charges of \$10.1 million contributed to the overall increase in fiscal year 2006. We expect to continue to increase sales and marketing expenses in absolute dollars in order to grow revenues and increase our market share.

Research and Development. Research and development expenses consist of the salaries and related benefits for our product development personnel, prototype materials and expenses related to the development of new and improved products, facilities and depreciation expenses. In absolute dollars, research and development expenses increased 56.0% in fiscal year 2006 and 29.0% in fiscal year 2005 as compared to the previous fiscal year, respectively. The increases in fiscal years 2006 and 2005 were primarily due to higher salary and benefits costs attributed to an increase in headcount to 287 in fiscal year 2006 from 217 in fiscal year 2005 and 185 in fiscal 2004. The growth in employee headcount was primarily related to enhancement of our current products and the development of new advanced products. Stock-based compensation charges of \$6.9 million contributed to the overall increase in fiscal year 2006 compared to \$1.5 million in fiscal year 2005. We expect to continue to increase research and development expenses as our future success is dependent on the continued development of our products.

General and Administrative. General and administrative expenses consist of the salaries, benefits and related costs of our executive, finance, information technology, human resource and legal personnel, third-party professional service fees, bad debt charges, facilities, and depreciation expenses. In absolute dollars, general and administrative expenses increased 53.5% in fiscal year 2006 and increased 61.7% in fiscal year 2005 as compared to the previous fiscal year, respectively. The increase in fiscal year 2006 is due primarily to expenses incurred by third parties for legal,

accounting, tax and other professional services in connection with the Special Committee investigation of \$7.0 million, an increase in stock-based compensation charges of \$5.1 million and, increased salary and benefit expenses of \$2.7 million. The increase in personnel costs is consistent with the growth in headcount. General and administrative headcount at the end of fiscal 2006 increased to 134 from 97 at the end of fiscal 2005. These increases were partially offset by a decrease in bad debt expense of approximately \$1.5 million. The increase in general and administrative expenses is expected

Table of Contents

to remain at these increased levels as the Company continues to build its infrastructure to support the worldwide growth of our business.

	Years Ended September 30,		
	2006	2005	2004
	(In thousands, except for percentages)		
Other Income and Income Taxes			
Income from operations	\$ 90,138	\$ 69,358	\$ 25,146
Other income, net	17,431	8,076	2,731
Income before income taxes	107,569	77,434	27,877
Provision (benefit) for income taxes	41,564	30,532	(8,451)
Net income	\$ 66,005	\$ 46,902	\$ 36,328
Other Income and Income Taxes (as percentage of net revenue)			
Income from operations	22.9%	24.6%	14.7%
Other income, net	4.4	2.9	1.6
Income before income taxes	27.3	27.5	16.3
Provision (benefit) for income taxes	10.5	10.8	(4.9)
Net income	16.8%	16.7%	21.2%

Other Income, Net. Other income, net, consists of interest income and foreign currency transaction gains and losses. Other income, net, increased 115.8% in fiscal year 2006 and increased 195.7% in fiscal year 2005 as compared to the previous fiscal year, respectively. The significant increase was due to a combination of higher yields and increased investment balances. The increased investment balances are the result of cash provided from operating and financing activities during the fiscal years 2005 and fiscal year 2004. Net proceeds of \$113.6 million received from the sale of common stock in a public offering completed in November of 2003 was the most significant addition to our investment balances.

Provision for Income Taxes. We recorded a 38.64% provision for income taxes for the fiscal year 2006. As of fiscal year-end 2006 we do not have a valuation allowance on any of our deferred tax assets in any of the jurisdictions in which we operate because we believe that the assets are more likely than not to be realized. In making this determination we have considered projected future taxable income and ongoing prudent and feasible tax planning strategies in assessing the appropriateness of a valuation allowance. Our net deferred tax assets as of fiscal year end 2006, 2005 and 2004 were \$23.3 million, \$40.4 million and \$31.6 million, respectively. Our world wide effective tax rate may fluctuate based on a number of factors including variations in projected taxable income in our various geographic locations in which we operate, changes in the valuation of our net deferred tax assets, resolution of potential exposures, tax positions taken on tax returns filed in the various geographic locations in which we operate, introduction of new accounting standards or changes in tax laws or interpretations thereof in the various geographic locations in which we operate. We have recorded liabilities to address potential tax exposures related to business and income tax positions we have taken that could be challenged by taxing authorities. The ultimate resolution of these potential exposures may be greater or less than the liabilities recorded which could result in an adjustment to our future tax expense.

In fiscal year 2004, the primary difference between the statutory tax rate and the effective tax rate was due to previously unrecognized deferred tax assets which were recognized. SFAS 109, provides for the recognition of deferred tax assets if realization is more likely than not. Based on available evidence, which includes our historical operating performance and the reported cumulative net losses in all prior years, we had provided for a full valuation allowance against our deferred tax assets at the end of fiscal year 2003. Based upon our operating performance in fiscal year 2004 and projected future taxable income, we determined that our U.S. deferred tax assets were more likely than not to be realizable. Therefore, the valuation allowance was reversed and as a result we realized an income tax benefit of \$11.9 million. The credit from the release of the

Table of Contents

valuation allowance was partially offset by actual U.S. and international tax expenses resulting in a net benefit for income taxes of \$8.5 million in fiscal year 2004.

Liquidity and Capital Resources

We have funded our operations with our cash balances, cash generated from operations and proceeds from public offerings.

	Years Ended September 30,		
	2006	2005	2004
	(In thousands)		
Liquidity and Capital Resources			
Cash and cash equivalents and investments	\$ 492,176	\$ 365,015	\$ 222,293
Cash provided by operating activities	125,378	84,987	40,590
Cash used in investing activities	(204,409)	(126,760)	(164,713)
Cash provided by financing activities	65,145	68,867	138,468

Cash and cash equivalents, short-term investments and long-term investments totaled \$492.2 million as of September 30, 2006 compared to \$365.0 million as of September 30, 2005, representing an increase of \$127.2 million. The increase was due to the cash flow from operations and cash from employee stock option exercises. In fiscal year 2005, overall cash and investments increased \$142.7 million compared to the fiscal year 2004. The increase was primarily due to the net proceeds of \$113.6 million from the sale of 5,175,000 shares of common stock in a public offering completed in November 2003.

Cash provided by operating activities during fiscal year 2006 was \$125.4 million compared to \$85.0 million in fiscal year 2005 and \$40.6 million in fiscal year 2004. Cash provided by operating activities resulted primarily from cash generated from net income, after adjusting for non-cash charges and changes in operating assets and liabilities as adjusted for various non-cash items including stock-based compensation, depreciation and amortization charges.

Cash used in investing activities was \$204.4 million for the fiscal year 2006, \$126.8 million for fiscal year 2005 and \$164.7 million for fiscal year 2004. The cash used in fiscal year 2006 was primarily the result of the purchase of investments partially offset by the sale of investments and \$42.8 million of cash payments, net of cash acquired, to shareholders of Swan Labs, which was acquired in October 2005. The cash used in the fiscal year 2005 was primarily due to the purchase of investments and property and equipment partially offset by the sale of investments. The cash used in fiscal year 2004 was due to the purchase of investments, primarily made possible by the proceeds of our public offering, the purchase of property and equipment and the acquisition of MagniFire, partially offset by the sale of investments.

Cash provided by financing activities was \$65.1 million for fiscal year 2006 compared to \$68.9 million and \$138.5 million in fiscal years 2005 and 2004, respectively. During the fiscal years 2006 and 2005, our financing activities consisted of cash proceeds received from the exercise of stock options and purchases under our employee stock purchase plan. During the fiscal year 2004, our financing activities included \$113.6 million of net proceeds received from a public stock offering as well as cash received from the exercise of employee stock options and purchases under our employee stock purchase plan.

We expect that our existing cash and investment balances and cash from operations will be sufficient to meet our anticipated working capital and capital expenditures for the foreseeable future.

Table of Contents**Obligations and Commitments**

The following table summarizes our contractual payment obligations and commitments as of September 30, 2006:

	2007	2008	Payment Obligations by Year			Thereafter	Total
			2009	2010	2011		
			(In thousands)				
Operating leases	\$ 10,934	\$ 11,509	\$ 12,527	\$ 12,259	\$ 11,032	\$ 32,763	\$ 91,024
Purchase obligations	10,839						10,839
Total	\$ 21,773	\$ 11,509	\$ 12,527	\$ 12,259	\$ 11,032	\$ 32,763	\$ 101,863

We lease our facilities under operating leases that expire at various dates through 2014.

Purchase obligations are comprised of purchase commitments with our contract manufacturers. The agreement with our primary contract manufacturer allows them to procure component inventory on our behalf based on our production forecast. We are obligated to purchase component inventory that the contract manufacturer procures in accordance with the forecast, unless cancellation is given within applicable lead times.

Recent Accounting Pronouncements

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

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

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

Item 7A. Quantitative and Qualitative Disclosure About Market Risk

Interest Rate Risk. Our cash equivalents consist of high-quality securities, as specified in our investment policy guidelines. The policy limits the amount of credit exposure to any one issue or issuer to a maximum of 5% of the total portfolio with the exception of U.S. treasury securities, commercial paper and money market funds, which are exempt from size limitation. The policy requires investments in securities that mature in three years or less, with the average maturity being no greater than one and a half years. These securities are subject to interest rate risk and will decrease

in value if interest rates increase. A decrease of one percent in the average interest rate would have resulted in a decrease of approximately \$3.0 million in our interest income for the fiscal year 2006.

Table of Contents

	Three Months or Less	Three Months to One Year	Maturing in Greater Than One Year	Total	Fair Value
	(In thousands, except for percentages)				
September 30, 2006					
Included in cash and cash equivalents	\$ 7,852	\$	\$	\$ 7,852	\$ 7,852
Weighted average interest rate	4.6%				
Included in short-term investments	\$ 122,805	\$ 213,621	\$	\$ 336,426	\$ 336,426
Weighted average interest rates	4.4%	3.8%			
Included in long-term investments	\$	\$	\$ 118,003	\$ 118,003	\$ 118,003
Weighted average interest rates			4.1%		
September 30, 2005					
Included in cash and cash equivalents	\$ 298	\$	\$	\$ 298	\$ 298
Weighted average interest rate	2.5%				
Included in short-term investments	\$ 89,015	\$ 95,299	\$	\$ 184,314	\$ 184,314
Weighted average interest rates	2.6%	2.3%			
Included in long-term investments	\$	\$	\$ 128,834	\$ 128,834	\$ 128,834
Weighted average interest rates			3.1%		
September 30, 2004					
Included in cash and cash equivalents	\$ 16,363	\$	\$	\$ 16,363	\$ 16,363
Weighted average interest rate	1.1%				
Included in short-term investments	\$ 64,410	\$ 51,190	\$	\$ 115,600	\$ 115,600
Weighted average interest rates	1.3%	1.8%			
Included in long-term investments	\$	\$	\$ 81,792	\$ 81,792	\$ 81,792
Weighted average interest rates			2.0%		

Foreign Currency Risk. The majority of our sales and expenses are denominated in U.S. dollars and as a result, we have not experienced significant foreign currency transaction gains and losses to date. While we have conducted some transactions in foreign currencies during the fiscal year ended September 30, 2006 and expect to continue to do so, we do not anticipate that foreign currency transaction gains or losses will be significant at our current level of operations. However, as we continue to expand our operations internationally, transaction gains or losses may become significant in the future. We have not engaged in foreign currency hedging to date. However, we may do so in the future.

Table of Contents

Item 8. *Financial Statements and Supplementary Data*

F5 NETWORKS, INC.

INDEX TO CONSOLIDATED FINANCIAL STATEMENTS

	Page
Consolidated Financial Statements	
<u>Report of Independent Registered Public Accounting Firm</u>	37
<u>Consolidated Balance Sheets</u>	39
<u>Consolidated Income Statements</u>	40
<u>Consolidated Statements of Shareholders' Equity</u>	41
<u>Consolidated Statements of Cash Flows</u>	42
<u>Notes to Consolidated Financial Statements</u>	43
Supplementary Data	
<u>Valuation and Qualifying Accounts and Reserves</u>	67

Table of Contents

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Shareholders
of F5 Networks, Inc.:

We have completed integrated audits of F5 Networks, Inc.'s 2006 and 2005 consolidated financial statements and of its internal control over financial reporting as of September 30, 2006, and an audit of its 2004 consolidated financial statements in accordance with the standards of the Public Company Accounting Oversight Board (United States). Our opinions, based on our audits, are presented below.

Consolidated financial statements and financial statement schedule

In our opinion, the consolidated financial statements listed in the accompanying index present fairly, in all material respects, the financial position of F5 Networks, Inc. and its subsidiaries at September 30, 2006 and 2005, and the results of their operations and their cash flows for each of the three years in the period ended September 30, 2006 in conformity with accounting principles generally accepted in the United States of America. In addition, in our opinion, the financial statement schedule listed in the accompanying index presents fairly, in all material respects, the information set forth therein when read in conjunction with the related consolidated financial statements. These financial statements and financial statement schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and financial statement schedule based on our audits. We conducted our audits of these statements in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit of financial statements includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

Internal control over financial reporting

Also, in our opinion, management's assessment, included in Management's Report on Internal Control over Financial Reporting appearing under Item 9A, that the Company maintained effective internal control over financial reporting as of September 30, 2006 based on criteria established in *Internal Control - Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), is fairly stated, in all material respects, based on those criteria. Furthermore, in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of September 30, 2006, based on criteria established in *Internal Control - Integrated Framework* issued by the COSO. The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express opinions on management's assessment and on the effectiveness of the Company's internal control over financial reporting based on our audit. We conducted our audit of internal control over financial reporting in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. An audit of internal control over financial reporting includes obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we consider necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinions.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial

Table of Contents

statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

PricewaterhouseCoopers LLP
Seattle, Washington
December 8, 2006

Table of Contents**F5 NETWORKS, INC.****CONSOLIDATED BALANCE SHEETS**

	September 30,	
	2006	2005
	(In thousands)	
ASSETS		
Current assets		
Cash and cash equivalents	\$ 37,746	\$ 51,867
Short-term investments	336,427	184,314
Accounts receivable, net of allowances of \$2,858 and \$2,969	62,750	41,703
Inventories	5,763	2,699
Deferred tax assets	4,682	4,175
Other current assets	15,607	9,906
Total current assets	462,975	294,664
Restricted cash	3,929	3,871
Property and equipment, net	29,951	16,158
Long-term investments	118,003	128,834
Deferred tax assets	18,657	36,212
Goodwill	81,701	49,677
Other assets, net	14,295	8,323
Total assets	\$ 729,511	\$ 537,739
LIABILITIES AND SHAREHOLDERS EQUITY		
Current liabilities		
Accounts payable	\$ 13,174	\$ 7,668
Accrued liabilities	31,583	23,931
Deferred revenue	54,880	36,009
Total current liabilities	99,637	67,608
Other long-term liabilities	7,976	6,650
Deferred revenue, long-term	5,440	3,314
Total long-term liabilities	13,416	9,964
Commitments and contingencies		
Shareholders' equity		
Preferred stock, no par value; 10,000 shares authorized, no shares outstanding		
Common stock, no par value; 100,000 shares authorized, 40,778 and 38,593 shares issued and outstanding	521,791	431,897
Accumulated other comprehensive loss	(1,038)	(1,430)

Retained earnings	95,705	29,700
Total shareholders' equity	616,458	460,167
Total liabilities and shareholders' equity	\$ 729,511	\$ 537,739

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

Table of Contents**F5 NETWORKS, INC.****CONSOLIDATED INCOME STATEMENTS**

	Years Ended September 30,		
	2006	2005	2004
	(In thousands, except per share data)		
Net revenues			
Products	\$ 304,878	\$ 219,603	\$ 126,169
Services	89,171	61,807	45,021
Total	394,049	281,410	171,190
Cost of net revenues			
Products	63,619	48,990	28,406
Services	24,534	16,194	10,993
Total	88,153	65,184	39,399
Gross profit	305,896	216,226	131,791
Operating expenses			
Sales and marketing	127,478	89,866	66,446
Research and development	49,171	31,516	24,438
General and administrative	39,109	25,486	15,761
Total	215,758	146,868	106,645
Income from operations	90,138	69,358	25,146
Other income, net	17,431	8,076	2,731
Income before income taxes	107,569	77,434	27,877
Provision (benefit) for income taxes	41,564	30,532	(8,451)
Net income	\$ 66,005	\$ 46,902	\$ 36,328
Net income per share basic	\$ 1.64	\$ 1.26	\$ 1.09
Weighted average shares basic	40,139	37,220	33,221
Net income per share diluted	\$ 1.59	\$ 1.21	\$ 1.01
Weighted average shares diluted	41,510	38,761	35,961

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

Table of Contents**F5 NETWORKS, INC.****CONSOLIDATED STATEMENTS OF SHAREHOLDERS EQUITY**

	Common Stock		Accumulated Other Unearned Compensation		Retained Earnings (Deficit)	Total Shareholders Equity
	Shares	Amount	Income/(Loss)	(In thousands)		
Balance, September 30, 2003	27,403	\$ 165,321	\$ (1,557)	\$ 195	\$ (53,530)	\$ 110,429
Exercise of employee stock options	2,032	22,349				22,349
Issuance of stock under employee stock purchase plan	162	2,579				2,579
Issuance of common stock in a public offering (net of issuance costs of \$6,682)	5,175	113,636				113,636
Tax benefit from employee stock transactions		21,925				21,925
Unearned compensation		468	(468)			
Amortization of unearned compensation			1,192			1,192
Net income					36,328	
Foreign currency translation adjustment				144		
Unrealized loss on securities				(837)		
Comprehensive income						35,635
Balance, September 30, 2004	34,772	\$ 326,278	\$ (833)	\$ (498)	\$ (17,202)	\$ 307,745
Exercise of employee stock options	3,685	65,056				65,056
Issuance of stock under employee stock purchase plan	136	3,837				3,837
Tax benefit from employee stock transactions		32,153				32,153
Amortization of unearned compensation			833			833
Stock based compensation		4,573				4,573
Net income					46,902	
Foreign currency translation adjustment				(161)		
Unrealized gain on securities				(771)		
Comprehensive income						45,970
Balance, September 30, 2005	38,593	\$ 431,897	\$	\$ (1,430)	\$ 29,700	\$ 460,167

Exercise of employee stock options	1,747	38,701				38,701
Issuance of stock under employee stock purchase plan	136	5,488				5,488
Issuance of restricted stock	302					
Tax benefit from employee stock transactions		20,887				20,887
Stock based compensation		24,818				24,818
Net income					66,005	
Foreign currency translation adjustment				(293)		
Unrealized loss on securities				685		
Comprehensive income						66,397
Balance, September 30, 2006	40,778	\$ 521,791	\$	\$ (1,038)	\$ 95,705	\$ 616,458

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

Table of Contents**F5 NETWORKS, INC.****CONSOLIDATED STATEMENTS OF CASH FLOWS**

	Years Ended September 30,		
	2006	2005	2004
	(In thousands)		
Operating activities			
Net income	\$ 66,005	\$ 46,902	\$ 36,328
Adjustments to reconcile net income to net cash provided by operating activities:			
Realized loss (gain) on disposition of assets	446	569	21
Realized (gain) loss on sale of investments			(3)
Stock based compensation	24,818	5,406	1,192
Provision for doubtful accounts and sales returns	67	1,419	1,189
Depreciation and amortization	11,585	6,797	5,355
Deferred income taxes	18,946	(7,733)	(33,886)
Tax benefit from employee stock option plans		32,153	21,685
Changes in operating assets and liabilities, net of amounts acquired:			
Accounts receivable	(20,812)	(20,456)	(4,152)
Inventories	(2,997)	(1,002)	(928)
Other current assets	(5,578)	(3,604)	(642)
Other assets	(957)	(149)	(630)
Accounts payable and accrued liabilities	13,088	13,426	6,303
Deferred revenue	20,767	11,259	8,758
Net cash provided by operating activities	125,378	84,987	40,590
Investing activities			
Purchases of investments	(557,999)	(407,533)	(335,231)
Sales of investments	417,817	290,351	205,662
Investment of restricted cash	(49)	2,369	(168)
Acquisition of intangible assets, net		(2,259)	
Acquisition of businesses, net of cash acquired	(42,778)	(395)	(29,201)
Purchases of property and equipment	(21,400)	(9,293)	(5,775)
Net cash used in investing activities	(204,409)	(126,760)	(164,713)
Financing activities			
Proceeds from secondary offering, net of issuance costs			113,636
Tax benefit from nonqualified stock options	20,887		
Proceeds from the exercise of stock options	44,258	68,867	24,832
Net cash provided by financing activities	65,145	68,867	138,468
Net increase (decrease) in cash and cash equivalents	(13,886)	27,094	14,345
Effect of exchange rate changes on cash and cash equivalents	(235)	(128)	205

Edgar Filing: F5 NETWORKS INC - Form 10-K

Cash and cash equivalents, beginning of year	51,867	24,901	10,351
Cash and cash equivalents, end of year	\$ 37,746	\$ 51,867	\$ 24,901
Supplemental Information			
Cash paid for taxes	\$ 1,500	\$ 792	\$ 706

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

Table of Contents

F5 NETWORKS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. Summary of Significant Accounting Policies

The Company

F5 Networks, Inc. (the Company) provides products and services to help companies efficiently and securely manage their Internet traffic. The Company s products improve the performance, availability and security of applications running on Internet-based networks. Internet traffic between servers running applications and clients using these applications passes through the Company s products where the content is inspected to ensure that it is safe and modified as necessary to ensure that it is delivered securely and in a way that optimizes the performance of both the network and the applications. The Company also offers a broad range of services such as consulting, training, installation, maintenance, and other technical support services.

Accounting Principles

The Company s consolidated financial statements and accompanying notes are prepared on the accrual basis of accounting in accordance with generally accepted accounting principles in the United States of America.

Principles of Consolidation

The consolidated financial statements include the accounts of the Company and its wholly owned subsidiaries. All intercompany accounts and transactions have been eliminated in consolidation.

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, disclosures of contingent assets and liabilities as of the date of the financial statements, and the reported amounts of revenues and expenses during the reporting period. Estimates are used in accounting for revenue recognition, reserves for doubtful accounts, product returns, obsolete and excess inventory, warranties, valuation allowance on deferred tax assets and purchase price allocations. Actual results could differ from those estimates.

Cash and Cash Equivalents

The Company considers all highly liquid investments with purchased maturities of three months or less to be cash equivalents. The Company invests its cash and cash equivalents in deposits with three major financial institutions, which, at times, exceed federally insured limits. The Company has not experienced any losses on its cash and cash equivalents.

Investments

The Company classifies its investment securities as available for sale. Investment securities, consisting of corporate and municipal bonds and notes and United States government securities, are reported at fair value with the related unrealized gains and losses included as a component of accumulated other comprehensive income (loss) in shareholders equity. Realized gains and losses and declines in value of securities judged to be other than temporary are included in other income (expense). The cost of investments for purposes of computing realized and unrealized

gains and losses is based on the specific identification method. Investments in securities with maturities of less than one year or where management's intent is to use the investments to fund current operations are classified as short-term investments. Investments with maturities of greater than one year are classified as long-term investments.

Table of Contents**F5 NETWORKS, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)*****Concentration of Credit Risk***

The Company extends credit to customers and is therefore subject to credit risk. The Company performs initial and ongoing credit evaluations of its customers' financial condition and does not require collateral. An allowance for doubtful accounts is recorded to account for potential bad debts. Estimates are used in determining the allowance for doubtful accounts and are based upon an assessment of selected accounts and as a percentage of remaining accounts receivable by aging category. In determining these percentages, the Company evaluates historical write-offs, and current trends in customer credit quality, as well as changes in credit policies.

The Company maintains its cash and investment balances with high credit quality financial institutions.

Fair Value of Financial Instruments

Short-term and long-term investments are recorded at fair value as the underlying securities are classified as available for sale and marked-to-market at each reporting period. The fair value is determined using quoted market prices for the securities held.

Inventories

The Company outsources the manufacturing of its pre-configured hardware platforms to contract manufacturers, who assemble each product to the Company's specifications. As protection against component shortages and to provide replacement parts for its service teams, the Company also stocks limited supplies of certain key product components. The Company reduces inventory to net realizable value based on excess and obsolete inventories determined primarily by historical usage and forecasted demand. Inventories consist of hardware and related component parts and are recorded at the lower of cost or market (as determined by the first-in, first-out method).

Inventories consist of the following (in thousands):

	Years Ended September 30,	
	2006	2005
Finished goods	\$ 2,610	\$ 2,486
Raw materials	3,153	213
	\$ 5,763	\$ 2,699

Restricted Cash

Restricted cash represents escrow accounts established in connection with lease agreements for the Company's corporate headquarters and, to a lesser extent, our international facilities. Under the terms of the lease for our corporate headquarters, the amount required to be held in escrow reduces and eventually eliminates at various dates

throughout the duration of the lease term. During the fiscal year ended September 30, 2006, the amount required to be held in escrow was \$3.6 million as set forth in the lease agreement for our corporate headquarters.

Property and Equipment

Property and equipment is stated at cost. Depreciation of property and equipment are provided using the straight-line method over the estimated useful lives of the assets, ranging from two to five years. Leasehold improvements are amortized over the lesser of the lease term or the estimated useful life of the improvements. The cost of normal maintenance and repairs is charged to expense as incurred and expenditures for major

Table of Contents**F5 NETWORKS, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

improvements are capitalized at cost. Gains or losses on the disposition of assets are reflected in the income statements at the time of disposal.

Property and equipment consist of the following (in thousands):

	Years Ended September 30,	
	2006	2005
Computer equipment	\$ 29,802	\$ 19,344
Office furniture and equipment	7,026	5,326
Leasehold improvements	16,118	8,772
	52,946	33,442
Accumulated depreciation and amortization	(22,995)	(17,284)
	\$ 29,951	\$ 16,158

Depreciation and amortization expense totaled approximately \$7.6 million, \$4.8 million, and \$4.0 million for the fiscal years ended September 30, 2006, 2005 and 2004, respectively.

Goodwill

Goodwill represents the excess purchase price over the estimated fair value of net assets acquired as of the acquisition date. The Company has adopted the requirements of Statement of Financial Accounting Standards (SFAS) No. 142, *Goodwill and Other Intangible Assets* (SFAS No. 142). SFAS No. 142 requires goodwill to be tested for impairment on an annual basis and between annual tests in certain circumstances, and written down when impaired. Goodwill of \$32.0 million was recorded in connection with the acquisition of Swan Labs, Inc., in fiscal year 2006, goodwill of \$25.5 million was recorded in connection with the acquisition of MagniFire Websystems Inc., in fiscal year 2004 and \$24.2 million was recorded in connection with the acquisition of uRoam, Inc. in fiscal year 2003. The Company completed its annual impairment test in the second quarter of each fiscal year and concluded that there was no impairment of goodwill in fiscal year 2006, 2005 or 2004.

Other Assets

Other assets primarily consist of software development costs and acquired technology.

Software development costs are charged to research and development expense until technological feasibility is established. The Company accounts for internally-generated software development costs in accordance with SFAS No. 86, *Accounting for the Costs of Computer Software to be Sold, Leased or Otherwise Marketed*. Thereafter, until the product is released for sale, software development costs are capitalized and reported at the lower of unamortized cost or net realizable value of each product. The establishment of technological feasibility and the

ongoing assessment of recoverability of costs require considerable judgment by the Company with respect to certain internal and external factors, including, but not limited to, anticipated future gross product revenues, estimated economic life and changes in hardware and software technology. The Company did not capitalize any software development costs in fiscal year 2006 and 2005. During the fiscal year 2004, the Company capitalized \$424,000 of software development costs. Related amortization costs of \$272,000, \$317,000, and \$328,000 were recorded during the fiscal years 2006, 2005, and 2004, respectively.

Acquired technology and customer relationship assets are recorded at cost and amortized over their estimated useful lives of five years. Acquired technology of \$8.6 million in fiscal 2006, \$5.0 million in fiscal year 2004 and \$3.0 million in fiscal year 2003 was recorded in connection with the acquisitions of Swan Labs,

Table of Contents

F5 NETWORKS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Inc., MagniFire and uRoam, respectively. Related amortization expense, which is charged to cost of product revenues, totaled \$3.2 million, \$1.6 million and \$1.0 million during the fiscal years 2006, 2005 and 2004, respectively.

Impairment of Long-Lived Assets

The Company assesses the impairment of long-lived assets whenever events or changes in business circumstances indicate that the carrying amount of an asset may not be recoverable. When such events occur, management determines whether there has been an impairment by comparing the anticipated undiscounted net future cash flows to the related asset's carrying value. If an impairment exists, the asset is written down to its estimated fair value.

Revenue Recognition

The Company's products are integrated with software that is essential to the functionality of the equipment. Accordingly, the Company recognizes revenue in accordance with the guidance provided under Statement of Position (SOP) No. 97-2, *Software Revenue Recognition*, and SOP No. 98-9 *Modification of SOP No. 97-2, Software Revenue Recognition, with Respect to Certain Transactions*, SFAS No. 48, *Revenue Recognition When Right of Return Exists*, and SEC Staff SAB No. 104, *Revenue Recognition*.

The Company sells products through distributors, resellers, and directly to end users. The Company recognizes product revenue upon shipment, net of estimated returns, provided that collection is determined to be probable and no significant obligations remain. In certain regions where the Company does not have the ability to reasonably estimate returns, the Company defers revenue on sales to its distributors until the Company has received information from the channel partner indicating that the distributor has sold the product to its customer. Payment terms to domestic customers are generally net 30 to 45 days. Payment terms to international customers range from net 30 to 90 days based on normal and customary trade practices in the individual markets. The Company has offered extended payment terms ranging from three to six months to certain customers, in which case, revenue is recognized when payments are received.

Whenever a software license, hardware, installation and post-contract customer support (PCS), elements are sold together, a portion of the sales price is allocated to each element based on their respective fair values as determined when the individual elements are sold separately. Revenues from the license of software are recognized when the software has been shipped and the customer is obligated to pay for the software. When rights of return are present and the Company cannot estimate returns, the Company recognizes revenue when such rights of return lapse. Revenues for PCS are recognized on a straight-line basis over the service contract term. PCS includes rights to upgrades, when and if available, a limited period of telephone support, updates, and bug fixes. Installation revenue is recognized when the product has been installed at the customer's site. Consulting services are customarily billed at fixed rates, plus out-of-pocket expenses, and revenues are recognized when the consulting has been completed. Training revenue is recognized when the training has been completed.

Shipping and Handling

Shipping and handling fees charged to our customers are recognized as product revenue in the period shipped and the related costs for providing these services are recorded as a cost of sale.

Guarantees and Product Warranties

In the normal course of business to facilitate sales of its products, the Company indemnifies other parties, including customers, resellers, lessors, and parties to other transactions with the Company, with respect to certain matters. The Company has agreed to hold the other party harmless against losses arising from a breach

Table of Contents**F5 NETWORKS, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

of representations or covenants, or out of intellectual property infringement or other claims made against certain parties. These agreements may limit the time within which an indemnification claim can be made and the amount of the claim. The Company has entered into indemnification agreements with its officers and directors, and the Company's bylaws contain similar indemnification obligations to the Company's agents. It is not possible to determine the maximum potential amount under these indemnification agreements due to the limited history of prior indemnification claims and the unique facts and circumstances involved in each particular agreement.

The Company offers warranties of one year for hardware, with the option of purchasing additional warranty coverage in yearly increments. The Company accrues for warranty costs as part of its cost of sales based on associated material product costs and technical support labor costs. During the years ended September 30, 2006, 2005 and 2004, warranty expense was \$1.8 million, \$2.2 million and \$0.9 million, respectively.

The following table summarizes the activity related to product warranties (in thousands):

	Years Ended September 30		
	2006	2005	2004
Balance, beginning of fiscal year	\$ 1,565	\$ 1,062	\$ 827
Provision for warranties issued	1,825	2,233	923
Payments	(1,808)	(1,730)	(688)
Balance, end of fiscal year	\$ 1,582	\$ 1,565	\$ 1,062

Research and Development

Research and development expenses consist of salaries and related benefits of product development personnel, prototype materials and expenses related to the development of new and improved products, and an allocation of facilities and depreciation expense. Research and development expenses are reflected in the statements of income as incurred.

Advertising

Advertising costs are expensed as incurred. The Company incurred \$1.3 million, \$1.7 million and \$1.7 million in advertising costs during the fiscal years 2006, 2005 and 2004, respectively.

Income Taxes

The Company utilizes the liability method of accounting for income taxes as set forth by SFAS No. 109, *Accounting for Income Taxes* (SFAS 109). Deferred income tax assets and liabilities are determined based upon differences between the financial statement and income tax bases of assets and liabilities using enacted tax rates in effect for the year in which the differences are expected to reverse. The realization of deferred tax assets is based on historical tax positions and estimates of future taxable income. A valuation allowance is recorded when it is more likely than not

that some of the deferred tax assets will not be realized.

Foreign Currency

The functional currency for the Company's foreign subsidiaries is the local currency in which the respective entity is located, with the exception of F5 Networks, Ltd., in the United Kingdom that uses the U.S. dollar as its functional currency. An entity's functional currency is determined by the currency of the economic environment in which the majority of cash is generated and expended by the entity. The financial statements of all majority-owned subsidiaries and related entities, with a functional currency other than the U.S. dollar, have been translated into U.S. dollars in accordance with SFAS No. 52 *Foreign Currency*

Table of Contents

F5 NETWORKS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Translation. All assets and liabilities of the respective entities are translated at year-end exchange rates and all revenues and expenses are translated at average rates during the respective period. Translation adjustments are reported as a separate component of accumulated other comprehensive income (loss) in shareholders equity.

Foreign currency transaction gains and losses are a result of the effect of exchange rate changes on transactions denominated in currencies other than the functional currency, including U.S. dollars. Gains and losses on those foreign currency transactions are included in determining net income or loss for the period of exchange. The net effect of foreign currency gains and losses were not significant during the fiscal years ended September 30, 2006 and 2005. Net transaction losses of \$466,000 were charged to operations for the fiscal year ended September 30, 2004.

Segments

The Company complies with the requirements of SFAS No. 131, *Disclosure about Segments of an Enterprise and Related Information*, which establishes annual and interim reporting standards for an enterprise's operating segments and related disclosures about its products, services, geographic areas and major customers. Management has determined that the Company operates in one segment.

Stock-Based Compensation

On July 1, 2005, the Company adopted the fair value recognition provisions of FASB Statement No. 123(R), *Share-Based Payment* (FAS 123R). Prior to July 1, 2005, the Company accounted for share-based payments under the recognition and measurement provisions of Accounting Principles Board (APB) Opinion No. 25, *Accounting for Stock Issued to Employees* (APB 25), and related Interpretations, as permitted by FASB Statement No. 123, *Accounting for Stock-Based Compensation* (FAS 123). In accordance with APB 25, no compensation cost was required to be recognized for options granted that had an exercise price equal to the market value of the underlying common stock on the date of grant.

The Company adopted FAS 123R using the modified-prospective-transition method. Under that transition method, compensation cost recognized in the fiscal year 2005 includes: a) compensation cost for all share-based payments granted prior to, but not yet vested as of July 1, 2005, based on the grant-date fair value estimated in accordance with the original provisions of FAS 123, and b) compensation cost for all share-based payments granted subsequent to July 1, 2005, based on the grant-date fair value estimated in accordance with the provisions of FAS 123R. The results for the prior periods have not been restated.

Effective July 1, 2005 the Company adopted the straight-line attribution method for recognizing compensation expense. Previously under the disclosure-only provisions of SFAS 123, the Company used the accelerated method of expense recognition pursuant to FASB Interpretation No. 28, *Accounting for Stock Appreciation Rights and Other Variable Stock Option or Award Plans* (FIN 28). For all unvested options outstanding as of July 1, 2005, the previously measured but unrecognized compensation expense, based on the fair value at the original grant date, will be recognized on an accelerated basis over the remaining vesting period. For share-based payments granted subsequent to July 1, 2005, compensation expense, based on the fair value on the date of grant, will be recognized on a straight-line basis over the vesting period.

Table of Contents**F5 NETWORKS, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The fair value of restricted stock units is based on the price of a share of our common stock on the date of grant. However, in determining the fair value of stock options, we use the Black-Scholes option pricing model that employs the following key assumptions.

	Stock Option Plan			Employee Stock Purchase Plan		
	Years Ended September 30,			Years Ended September 30,		
	2006	2005	2004	2006	2005	2004
Risk-free interest rate	4.86%	3.53%	3.19%	4.90%	2.72%	1.14%
Expected dividend						
Expected term	6.3 years	2.7 years	2.2 years	0.5 years	0.5 years	0.5 years
Expected volatility	51.07%	68.17%	59.05%	45.35%	52.48%	50.18%

The risk-free rate is based on the U.S. Treasury yield curve in effect at the time of grant. The Company does not anticipate declaring dividends in the foreseeable future. Expected volatility is based on the annualized daily historical volatility of our stock price commensurate with the expected life of the option. Expected term of the option is based on an evaluation of the historical employee stock option exercise behavior, the vesting terms of the respective option and a contractual life of ten years. Our stock price volatility and option lives involve management's best estimates at that time, both of which impact the fair value of the option calculated under the Black-Scholes methodology and, ultimately, the expense that will be recognized over the life of the option. SFAS 123R also requires that we recognize compensation expense for only the portion of options or stock units that are expected to vest. Therefore, the Company applies estimated forfeiture rates that are derived from historical employee termination behavior. The estimated forfeiture rate in the fourth quarter of fiscal 2005 and fiscal 2006 was 5%. If the actual number of forfeitures differs from those estimated by management, additional adjustments to compensation expense may be required in future periods.

The following table shows the pro forma effect on the Company's net income (loss) and net income (loss) per share for the years ended September 30, 2005 and 2004, had compensation expense been determined based upon the fair value at the grant date for awards consistent with the methodology prescribed by SFAS 123. The Company adopted SFAS 123R on July 1, 2005, the beginning of its fourth quarter of fiscal 2005; therefore, stock-based compensation expense shown in the pro forma table relates to expense through June 30, 2005 while the Company was still under the disclosure only provisions of SFAS 123. Stock-based compensation expense for the fourth quarter of fiscal 2005 and fiscal 2006 has been included in results of operations. These pro forma effects may not be representative of expense in future periods since the estimated fair value of stock options on the date of grant is amortized to expense over the vesting period, and additional options may be granted or options may be cancelled in future years:

	Years Ended	
	September 30,	2004
	2005	2004
Net income, as reported	\$ 46,902	\$ 36,328
	833	1,192

Edgar Filing: F5 NETWORKS INC - Form 10-K

Add: Stock-based employee compensation expense under APB No. 25 included in reported net income, net of tax effect		
Deduct: Total stock-based employee compensation expense determined under the fair value methods, net of tax effect	7,161	19,356
Pro forma net income (loss)	\$ 40,574	\$ 18,164
Net income (loss) per share:		
As reported basic	\$ 1.26	\$ 1.09
Pro forma basic	\$ 1.09	\$ 0.55
As reported diluted	\$ 1.21	\$ 1.01
Pro forma diluted	\$ 1.05	\$ 0.51

Table of Contents**F5 NETWORKS, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)*****Earnings Per Share***

Basic net income per share is computed by dividing net income by the weighted average number of common shares outstanding during the period. Diluted net income per share is computed by dividing net income by the weighted average number of common and dilutive common stock equivalent shares outstanding during the period.

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

	Years Ended September 30,		
	2006	2005	2004
Numerator			
Net income	\$ 66,005	\$ 46,902	\$ 36,328
Denominator			
Weighted average shares outstanding basic	40,139	37,220	33,221
Dilutive effect of common shares from stock options and restricted stock units	1,371	1,541	2,740
Weighted average shares outstanding diluted	41,510	38,761	35,961
Basic net income per share	\$ 1.64	\$ 1.26	\$ 1.09
Diluted net income per share	\$ 1.59	\$ 1.21	\$ 1.01

Approximately 0.2 million, 0.4 million, and 1.4 million of common shares potentially issuable from stock options for the years ended September 30, 2006, 2005 and 2004 are excluded from the calculation of diluted earnings per share because the exercise price was greater than the market price.

Recent Accounting Pronouncements

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

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

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

Table of Contents**F5 NETWORKS, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****2. Short-Term and Long-Term Investments**

Short-term investments consist of the following (in thousands):

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
September 30, 2006				
Corporate bonds and notes	\$ 83,619	\$	\$ (475)	\$ 83,144
Municipal bonds and notes	67,450			67,450
U.S. government securities	186,159	43	(369)	185,833
	\$ 337,228	\$ 43	\$ (844)	\$ 336,427

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
September 30, 2005				
Corporate bonds and notes	\$ 56,352	\$	\$ (275)	\$ 56,077
Municipal bonds and notes	45,500			45,500
U.S. government securities	83,061	1	(325)	82,737
	\$ 184,913	\$ 1	\$ (600)	\$ 184,314

Long-term investments consist of the following (in thousands):

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
September 30, 2006				
Corporate bonds and notes	\$ 10,823	\$ 22	\$ (51)	\$ 10,794
U.S. government securities	107,471	76	(338)	107,209
	\$ 118,294	\$ 98	\$ (389)	\$ 118,003

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
September 30, 2005				
Corporate bonds and notes	\$ 61,932	\$	\$ (1,007)	\$ 60,925
U.S. government securities	68,497		(588)	67,909
	\$ 130,429	\$	\$ (1,595)	\$ 128,834

The amortized cost and fair value of fixed maturities at September 30, 2006, by contractual years-to-maturity, are presented below (in thousands):

	Amortized Cost	Fair Value
One year or less	\$ 337,228	\$ 336,427
Over one year through five years	118,294	118,003
	\$ 455,522	\$ 454,430

Table of Contents**F5 NETWORKS, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The Company invests in securities that are rated investment grade or better. The unrealized losses on these investments were caused by interest rate increases and not credit quality. The Company has determined the unrealized losses are temporary as the duration of the decline in value of investments has been short, the extent of the decline, in both dollars and as a percentage of costs, is not significant, and the Company has the ability and intent to hold the investments until it recovers at least substantially all of the cost of the investments.

The following table summarizes investments that have unrealized losses as of September 30, 2006 (in thousands):

	Less Than 12 Months		12 Months of Greater		Total	
	Fair	Gross	Fair	Gross	Fair	Gross
	Value	Unrealized	Value	Unrealized	Value	Unrealized
		Losses		Losses		Losses
September 30, 2006						
Corporate bonds and notes	\$ 10,771	\$ 13	\$ 57,843	\$ 522	\$ 68,613	\$ 536
U.S. government securities	106,142	119	66,913	589	173,055	708
Total	\$ 116,913	\$ 132	\$ 124,756	\$ 1,111	\$ 241,668	\$ 1,244

3. Business Combinations

The Company's acquisitions are accounted for under the purchase method of accounting in accordance with SFAS No. 141, *Business Combinations*. The total purchase price is allocated to the tangible and intangible assets acquired and the liabilities assumed based on their estimated fair values. The excess of the purchase price over those fair values is recorded as goodwill. The fair value assigned to the tangible and intangible assets acquired and liabilities assumed are based on estimates and assumptions provided by management, and other information compiled by management, including independent valuations, prepared by valuation specialists that utilize established valuation techniques appropriate for the technology industry. In accordance with SFAS No. 142, *Goodwill and other Intangible Assets*, goodwill is not amortized but instead is tested for impairment at least annually.

Fiscal Year 2006 Acquisition of Swan Labs

On October 4, 2005, the Company acquired all of the capital stock of Swan Labs, a privately held Delaware corporation headquartered in San Jose, California for \$43.0 million in cash. The Company also incurred \$3.2 million of direct transaction costs for a total purchase price of approximately \$46.2 million. As a result of the merger, the Company acquired all the assets of Swan Labs, all property, equipment and other assets that Swan Labs used in its business and assumed all the liabilities of Swan Labs. Swan Labs provides WAN (Wide Area Network) optimization and application acceleration products and services. The addition of Swan Labs is intended to allow us to quickly enter the WAN optimization market, broaden the Company's customer base, and augment the Company's existing product line. The results of operations of Swan Labs have been included in the Company's consolidated financial statements from the date of acquisition.

Table of Contents**F5 NETWORKS, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The purchase price allocation is as follows (in thousands):

Assets acquired	
Cash	\$ 3,448
Fair value of assets	1,497
Deferred tax assets, net	2,341
Developed technology and customer relationships	8,589
Goodwill	31,975
Total assets acquired	\$ 47,850
Liabilities assumed	
Accrued liabilities	\$ (1,405)
Deferred revenue	(229)
Total liabilities assumed	(1,634)
Net assets acquired	\$ 46,216

Of the total estimated purchase price, \$8.0 million and \$0.6 million was allocated to developed technology and customer relationships, respectively. To determine the value of the developed technology, a combination of cost and market approaches were used. The cost approach required an estimation of the costs required to reproduce the developed technology. The market approach measures the fair value of the technology through an analysis of recent comparable transactions. To determine the value of customer relationships, the income approach was used. The income approach estimates the fair value based on the earnings and cash flow capacity of an asset. The \$8.6 million allocated to developed technology and customer relationships will be amortized on a straight-line basis over an estimated useful life of five years.

Fiscal Year 2004 Acquisition of MagniFire Websystems, Inc.

On May 31, 2004, the Company completed its acquisition of MagniFire Websystems, Inc. a provider of web application firewall products. As a result of the merger, the Company acquired all the assets of MagniFire, including MagniFire's web application firewall product line (TrafficShield), all property, equipment and other assets that MagniFire used in its business and assumed certain of the liabilities of MagniFire. The purchase price was \$30.5 million including \$1.5 million of transactions costs. The results of operations of MagniFire have been included in the Company's consolidated financial statements since June 1, 2004.

Table of Contents**F5 NETWORKS, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The purchase price allocation is as follows (in thousands):

Assets acquired	
Cash	\$ 895
Accounts receivable, net	152
Restricted cash	76
Other assets	625
Property and equipment	81
Developed technology	5,000
Goodwill	25,488
Total assets acquired	\$ 32,317
Liabilities assumed	
Accrued liabilities	\$ (723)
Deferred tax liability	(1,069)
Deferred revenue	(25)
Total liabilities assumed	(1,817)
Net assets acquired	\$ 30,500

Of the total estimated purchase price, \$5.0 million was allocated to developed technology. To determine the value of the developed technology, a combination of cost and market approaches were used. The cost approach required an estimation of the costs required to reproduce the acquired technology. The market approach measures the fair value of the technology through an analysis of recent comparable transactions. The \$5.0 million allocated to developed technology is being amortized on a straight-line basis over an estimated useful life of five years.

At the time of the acquisition, the estimated purchase price was allocated to goodwill in the amount of \$24.8 million, including the Company's full valuation allowance on deferred taxes. During the fourth quarter of fiscal year 2004, the Company reversed the valuation allowance and therefore increased the amount allocated to goodwill by an additional \$1.1 million due to the deferred tax liability that was assumed as a result of the acquisition. During the fourth quarter of fiscal year 2005, the Company adjusted the fair value of certain other assets and as a result decreased the amount allocated to goodwill by \$0.4 million.

Pro Forma Results

The unaudited pro forma condensed combined consolidated summary financial information below, presents the combined results of operations as if the acquisition had occurred at the beginning of the previous fiscal year. For pro forma reporting purposes, the fiscal year 2005 presentation included the results of operations of Swan Labs from October 1, 2004 through September 30, 2005. The 2004 presentation includes the results of operations of MagniFire from October 1, 2003 through May 31, 2004, the date of acquisition.

Table of Contents**F5 NETWORKS, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Unaudited pro forma financial information is as follows (in thousands, except per share data):

	Year Ended September 30, 2005	Year Ended September 30, 2004
Net revenues pro forma	\$ 283,434	\$ 171,309
Net income pro forma	\$ 38,412	\$ 28,700
Net income per share basic pro forma	\$ 1.03	\$ 0.86
Net income per share diluted pro forma	\$ 0.99	\$ 0.80

The unaudited pro forma financial information does not reflect integration costs, or cost savings or other synergies anticipated as a result of the acquisition. This information is not necessarily indicative of the operating results that would have occurred if the acquisition had been consummated on the date indicated nor is it necessarily indicative of future operating results of the combined enterprise.

4. Balance Sheet Details

Other assets consist of the following (in thousands):

	Years Ended September 30, 2006 2005	
Software development costs	\$ 249	\$ 521
Acquired technology	10,159	5,367
Deposits and other	3,887	2,435
	\$ 14,295	\$ 8,323

Amortization expense related to other assets was approximately \$3.8 million, \$1.9 million, and \$1.3 million for the fiscal years ended September 30, 2006, 2005 and 2004, respectively.

Estimated amortization expense for software development costs and acquired technology for the five succeeding fiscal years is as follows (in thousands):

2007	\$ 3,447
2008	\$ 3,098
2009	\$ 2,265
2010	\$ 1,598

\$ 10,408

Accrued liabilities consist of the following (in thousands):

	Years Ended September 30,	
	2006	2005
Payroll and benefits	\$ 17,644	\$ 11,572
Sales and marketing	1,212	1,544
Restructuring	14	559
Warranty	1,582	1,564
Income taxes	4,490	4,265
Other	6,641	4,427
	\$ 31,583	\$ 23,931

Table of Contents**F5 NETWORKS, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

As of September 30, 2006, restructuring liabilities were \$0.01 million and consisted of obligations under an excess facility operating lease. The excess facility charge was initially recognized during fiscal 2002 as part of the Company's decision to discontinue its cache appliance business and exit its support facility in Washington D.C. The remaining liability approximates the full amount owed through the remainder of the lease term, expiring in 2007, and actual losses are not expected to vary from the original estimate.

The activity of the remaining restructuring liability as of September 30, 2006 and 2005 is presented below (in thousands):

	Balance at			Balance at
	September 30,	Additional	Cash	September 30,
	2005	Charges	Payments	2006
			and	
			Write-offs	
Excess facilities	\$ 559	\$	\$ (500)	\$ 59

	Balance at			Balance at
	September 30,	Additional	Cash	September 30,
	2004	Charges	Payments	2005
			and	
			Write-offs	
Excess facilities	\$ 625	\$	\$ (66)	\$ 559

Other long term liabilities consist of the following (in thousands):

	Years Ended	
	September 30,	
	2006	2005
Income taxes payable	\$ 4,201	\$ 3,880
Deferred rent and other	3,775	2,770
	\$ 7,976	\$ 6,650

5. Income Taxes

The United States and international components of income before income taxes are as follows (in thousands):

	Years Ended September 30,		
	2006	2005	2004
United States	\$ 104,167	\$ 73,797	\$ 26,533
International	3,402	3,637	1,344
	\$ 107,569	\$ 77,434	\$ 27,877

Table of Contents**F5 NETWORKS, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The provision for income taxes (benefit) consists of the following (in thousands):

	Years Ended September 30,		
	2006	2005	2004
Current			
U.S. federal	\$ 43,041	\$ 33,827	\$ 133
State	2,458	2,451	129
Foreign	68	750	923
Total	45,567	37,028	1,185
Deferred			
U.S. federal	(4,371)	(6,129)	(9,034)
State	(144)	(653)	(602)
Foreign	512	286	
Total	(4,003)	(6,496)	(9,636)
	\$ 41,564	\$ 30,532	\$ (8,451)

The effective tax rate differs from the U.S. federal statutory rate as follows (in thousands):

	Years Ended September 30,		
	2006	2005	2004
Income tax provision at statutory rate	\$ 37,649	\$ 27,102	\$ 9,757
State taxes, net of federal benefit	2,468	1,874	706
Impact of international operations	(655)	2,417	357
Research and development and other credits	(830)	(2,057)	(1,397)
Other	2,932	3,845	(1,498)
Change in valuation allowance		(2,649)	(28,062)
Impact of stock option compensation on valuation allowance			11,686
	\$ 41,564	\$ 30,532	\$ (8,451)

Table of Contents**F5 NETWORKS, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The tax effects of the temporary differences that give rise to the deferred tax assets and liabilities are as follows (in thousands):

	Years Ended September 30,		
	2006	2005	2004
Deferred tax assets			
Net operating loss carry-forwards	\$ 6,054	\$ 25,002	\$ 26,427
Allowance for doubtful accounts	860	915	810
Accrued compensation and benefits	1,442	1,140	690
Inventories and related reserves	248	417	210
Other accruals and reserves	9,113	6,097	2,248
Depreciation	1,079	462	838
Tax credit carry-forwards	8,643	7,631	5,552
	27,439	41,664	36,775
Valuation allowance			(2,649)
Deferred tax liabilities			
Purchased intangibles and other	(4,100)	(1,277)	(2,506)
Net deferred tax assets	\$ 23,339	\$ 40,387	\$ 31,620

During the fourth quarter of fiscal year 2005 the Company determined, based on an evaluation of current operating results and projected future taxable income that the valuation allowance of \$2.6 million pertaining to net operating loss carry-forwards in the United Kingdom was no longer needed and as a result the related valuation allowance was reversed. In fiscal 2004, the Company determined that the U.S. deferred tax assets were more likely than not to be realizable and reversed the related valuation allowance during the fourth quarter of fiscal 2004. If the estimates and assumptions used in our determination change in the future, we could be required to revise our estimates of the valuation allowances against our deferred tax assets and adjust our provisions for additional income taxes.

At September 30, 2006, the Company had no U.S. net operating loss carry-forwards resulting from tax benefits associated with employee stock option plans. At September 30, 2006 the Company had other U.S. net operating loss carry-forwards of approximately \$10.8 million, a portion of which begins to expire in fiscal year 2025 if not utilized. At September 30, 2006 the Company also had net operating loss carry-forwards of approximately \$6.7 million related to operations in the United Kingdom that carry-forward indefinitely and approximately \$186,982 of net operating loss carry-forwards related to operations in Israel that carry-forward indefinitely. At September 30, 2006 the Company also had federal research credit carry-forwards and other federal credit carry-forwards of approximately \$7.9 million which, if not utilized, will begin to expire in fiscal year 2021 and state research credit carry-forwards of approximately \$695,000 which, if not utilized, will begin to expire in fiscal year 2024. At September 30, 2005 the Company had approximately \$64.3 million of U.S. net operating loss carry-forwards resulting from tax benefits associated with employee stock option plans. At September 30, 2005 the Company also had net operating loss carry-forwards of approximately \$7.4 million related to operations in the United Kingdom that carry-forward indefinitely. At

September 30, 2005, the Company also had federal research credit carry-forwards of approximately \$7.2 million and state research credit carry-forwards of \$349,000.

United States income and foreign withholding taxes have not been provided on approximately \$2.8 million of undistributed earnings from the Company's international subsidiaries. The Company has not recognized a deferred tax liability for the undistributed earnings of its foreign subsidiaries because the Company currently does not expect to remit those earnings in the foreseeable future. Determination of the amount of unrecognized

Table of Contents

F5 NETWORKS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

deferred tax liability related to undistributed earnings of foreign subsidiaries is not practicable because such liability, if any, is dependent on circumstances existing if and when remittance occurs.

On October 22, 2004, the American Jobs Creation Act of 2004 (AJCA) was signed into law. The AJCA provides for a temporary 85% dividends received deduction on certain earnings repatriated during either fiscal year 2005 or fiscal year 2006. The deduction would result in an approximate 5.25% federal tax rate on the repatriated earnings. To qualify for the deduction, the earnings must be reinvested in the U.S. pursuant to a domestic reinvestment plan established by a company's chief executive officer and approved by the company's board of directors. Additionally, certain other significant criteria, as outlined in the AJCA, must also be met. The Company did not elect this provision in fiscal year 2006 or fiscal year 2005.

6. Shareholders Equity

Common Stock

In November 2003, the Company sold 5,175,000 shares, including 675,000 shares sold upon the exercise of the underwriters' over-allotment option, of its common stock in a public offering at a price of \$23.25 per share. The proceeds to the Company were \$113.6 million, net of offering costs of \$6.7 million.

Equity Incentive Plans

In fiscal 2005, the Company modified the method in which it issues incentive awards to its employees through stock-based compensation. In prior years, stock-based compensation consisted only of stock options. In 2005, the majority of awards consisted of restricted stock unit awards and to a lesser degree stock options. Employees vest in restricted stock units and stock options ratably over the corresponding service term, generally one to four years. The Company's stock options expire 10 years from the date of grant. Restricted stock units are payable in shares of the Company's common stock as the periodic vesting requirements are satisfied. The value of a restricted stock unit is based upon the fair market value of the Company's common stock on the date of grant. The value of restricted stock units is determined using the intrinsic value method and is based on the number of shares granted and the quoted price of the Company's common stock on the date of grant. Alternatively, the Company uses the Black-Scholes option pricing model to determine the fair value of its stock options. Compensation expense related to restricted stock units and stock options is recognized over the vesting period. The Company has adopted a number of stock-based compensation plans as discussed below.

1998 Equity Incentive Plan. In November 1998, the Company adopted the 1998 Equity Incentive Plan, or the 1998 Plan, which provides for discretionary grants of non-qualified and incentive stock options, stock purchase awards and stock bonuses for employees and other service providers. Upon certain changes in control of the Company, all outstanding and unvested options or stock awards under the 1998 Plan will vest at the rate of 50%, unless assumed or substituted by the acquiring entity. As of September 30, 2006, there were options to purchase 726,572 shares outstanding and 45,838 shares available for awards under the 1998 Plan.

1999 Employee Stock Purchase Plan. In May 1999, the board of directors approved the adoption of the 1999 Employee Stock Purchase Plan, or the Employee Stock Purchase Plan. A total of 2,000,000 shares of common stock have been reserved for issuance under the Employee Stock Purchase Plan. The Employee Stock Purchase Plan permits

eligible employees to acquire shares of the Company's common stock through periodic payroll deductions of up to 15% of base compensation. No employee may purchase more than \$25,000 worth of stock, determined at the fair market value of the shares at the time such option is granted, in one calendar year. The Employee Stock Purchase Plan has been implemented in a series of offering periods, each 6 months in duration. The price at which the common stock may be purchased is 85% of the lesser of the fair market value of the Company's common stock on the first day of the applicable offering period or on the last day of

Table of Contents**F5 NETWORKS, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

the respective purchase period. As of September 30, 2006 there were 876,814 shares available for awards under the Employee Stock Purchase Plan.

2000 Equity Incentive Plan. In July 2000, the Company adopted the 2000 Employee Equity Incentive Plan, or the 2000 Plan, which provides for discretionary grants of non-qualified stock options, stock purchase awards and stock bonuses for non-executive employees and other service providers. A total of 3,500,000 shares of common stock have been reserved for issuance under the 2000 Plan. Upon certain changes in control of the Company, all outstanding and unvested options or stock awards under the 2000 Plan will vest at the rate of 50%, unless assumed or substituted by the acquiring entity. As of September 30, 2006, there were options to purchase 583,218 shares outstanding and 70,504 shares available for awards under the 2000 Plan.

New Hire Incentive Plans. In October 2003, the company adopted a non-qualified stock option plan, or the Hull Plan, in connection with the hiring of Thomas Hull, the Company's Senior Vice President of Worldwide Sales. The Hull plan provided for a grant of 225,000 non-qualified stock options for Mr. Hull. As of September 30, 2006, there were options to purchase 115,000 shares outstanding and no shares available for awards under the Hull Plan. In August 2004, the Company adopted a non-qualified stock option plan, or the Triebes Plan, in connection with the hiring of Karl Triebes, the Company's Senior Vice President of Product Development and Chief Technology Officer. The Triebes Plan provided for a grant of 300,000 non-qualified stock options for Mr. Triebes. As of September 30, 2006, there were options to purchase 168,750 shares outstanding and no shares available for awards under the Triebes Plan. Upon certain changes in control of the Company, 100% of all outstanding and unvested options remaining under the Hull Plan and the Triebes Plan will vest and become immediately exercisable.

Acquisition Incentive Plans. In July 2003, the Company adopted the uRoam Acquisition Equity Incentive Plan, or the uRoam Plan, in connection with the hiring of the former employees of uRoam, Inc. A total of 250,000 shares of common stock were reserved for issuance under the uRoam Plan. The plan provided for discretionary grants of non-qualified and incentive stock options, stock purchase awards and stock bonuses. The Company has not granted any stock purchase awards or stock bonuses under this plan. As of September 30, 2006 there were options to purchase 26,236 shares outstanding and no shares available for awards under the uRoam Plan. In July 2004, the Company adopted the MagniFire Acquisition Equity Incentive Plan, or the MagniFire Plan, in connection with the hiring of the former employees of MagniFire Websystems, Inc. A total of 415,000 shares of common stock were reserved for issuance under the MagniFire Plan. The plan provides for discretionary grants of non-qualified and incentive stock options, stock purchase awards and stock bonuses. The Company has not granted any stock purchase awards or stock bonuses under this plan. As of September 30, 2006 there were options to purchase 131,792 shares outstanding and no shares available for awards under the MagniFire Plan. Options that expire under the uRoam Plan or the MagniFire Plan, whether due to termination of employment or otherwise, are not available for future grant.

2005 Equity Incentive Plan. In December 2004, the Company adopted the 2005 Equity Incentive Plan, or the 2005 Plan, which provides for discretionary grants of non-statutory stock options and stock units for employees, including officers, and other service providers. A total of 1,700,000 shares of common stock have been reserved for issuance under the 2005 Plan. Upon certain changes in control of the Company, the surviving entity will either assume or substitute all outstanding Stock Awards under the 2005 Plan. During the fiscal year 2006, the Company issued 37,500 stock options and 1,233,059 stock units under the 2005 Plan. As of September 30, 2006, there were options to purchase 37,500 shares outstanding and 504,883 shares available for awards under the 2005 Plan.

The restricted stock units granted in fiscal 2006 and 2005 vest quarterly over a two year period. The restricted stock units were granted during fiscal 2006 with a per share weighted average fair value of \$54.42. Restricted stock units were granted during the fourth quarter of fiscal year 2005 with a per share weighted

Table of Contents**F5 NETWORKS, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

average fair value of \$44.60. The fair value of restricted stock vested during fiscal year 2006 was \$17.1 million. A summary of restricted stock unit activity under the 2005 Plan is as follows:

	Outstanding Stock Units
Balance, September 30, 2004	
Units granted	721,184
Units cancelled	(3,000)
Balance, September 30, 2005	718,184
Units granted	511,875
Units vested	(302,135)
Units cancelled	(72,442)
Balance, September 30, 2006	855,482

A summary of stock option activity under all of the Company's plans is as follows:

	Options Outstanding	
	Number of Shares	Weighted Average Exercise Price per Share
Balance, September 30, 2003	7,507,829	17.92
Options granted	2,230,515	24.79
Options exercised	(2,031,552)	11.00
Options cancelled	(353,232)	26.07
Balance, September 30, 2004	7,353,560	21.52
Options granted	224,100	43.73
Options exercised	(3,684,558)	17.66
Options cancelled	(297,786)	34.08
Balance, September 30, 2005	3,595,316	\$ 25.82
Options granted	73,500	51.08
Options exercised	(1,747,237)	22.15
Options cancelled	(104,661)	40.91
Balance at September 30, 2006	1,816,918	\$ 29.50

The weighted-average fair values per share at the date of grant for options granted with exercise prices equal to market were \$28.46, \$18.68, and \$9.36 for the fiscal years 2006, 2005, and 2004, respectively. The weighted-average fair value per share at the date of grant for options granted with exercise prices less than market was \$7.41 for fiscal year 2004. For fiscal years 2006 and 2005, there were no options granted with exercise prices less than market.

The total intrinsic value of options exercised during fiscal 2006, 2005 and 2004 was \$62.1 million, \$105.2 million and \$39.3 million, respectively.

Table of Contents**F5 NETWORKS, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The total intrinsic value for options outstanding at September 30, 2006 was \$44.0 million, representing the difference between the fair value of the Company's common stock underlying these options at September 30, 2006 and the related exercise prices.

Range of Exercise Prices	Options Outstanding			Options Exercisable	
	Number of Shares	Weighted Average Remaining Contractual Life (In Years)	Weighted Average Exercise Price per Share	Number of Shares	Weighted Average Price per Share
\$ 0.25 - \$ 14.64	429,083	5.33	\$ 10.68	425,474	\$ 10.66
\$15.40 - \$ 22.81	403,695	7.53	\$ 21.48	113,593	\$ 19.75
\$22.92 - \$ 28.10	377,443	7.29	\$ 25.18	280,665	\$ 25.45
\$28.18 - \$ 50.56	368,251	6.20	\$ 38.78	215,850	\$ 38.83
\$50.68 - \$120.88	238,446	5.36	\$ 69.48	195,466	\$ 71.78
\$ 0.25 - \$120.88	1,816,918	6.41	\$ 29.50	1,231,048	\$ 29.51

The total intrinsic value for options exercisable at September 30, 2006 was \$29.8 million, representing the difference between the fair value of the Company's common stock underlying these options at September 30, 2006 and the related exercise prices.

As of September 30, 2006, equity based awards (including stock option and stock units) available for future issuance is as follows:

	Awards Available for Grant
Balance, September 30, 2003	1,178,733
Granted	(2,230,515)
Exercised	
Cancelled	353,232
Additional shares reserved (terminated), net	820,070
Balance, September 30, 2004	121,520
Granted	(945,284)
Exercised	
Cancelled	300,786

Additional shares reserved (terminated), net	1,582,081
Balance, September 30, 2005	1,059,103
Granted	(585,375)
Exercised	
Cancelled	177,103
Additional shares reserved (terminated), net	(29,606)
Balance at September 30, 2006	621,225

As of September 30, 2006, there was \$39.0 million of total unrecognized compensation cost, related to unvested stock options and restricted stock units, the majority of which will be recognized ratably over the next two years. An assumption of a five percent forfeiture rate is utilized when arriving at the amount of stock compensation expense. The Company recognized \$24.8 million of pre-tax stock compensation expense for the

Table of Contents**F5 NETWORKS, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

year-ended September 30, 2006, and \$4.6 million of pre-tax stock compensation expense following the early adoption of FAS 123R in the fourth quarter of fiscal year 2005.

7. Commitments and Contingencies***Operating Leases***

The majority of the Company's operating lease payments relate to the Company's two building corporate headquarters in Seattle, Washington. The lease on the first building commenced in July 2000; and the lease on the second building commenced in September 2000. The lease for both buildings expire in 2012. The second building has been fully subleased until 2012. The Company also leases additional office space for product development and sales and support personnel in the United States and internationally.

Future minimum operating lease payments, net of sublease income, are as follows (in thousands):

	Gross Lease Payments	Sublease Income	Net Lease Payments
2007	10,934	2,943	7,989
2008	11,509	2,867	8,643
2009	12,527	2,944	9,583
2010	12,259	3,021	9,238
2011	11,032	3,098	7,935
Thereafter	32,763	2,644	30,119
	\$ 91,024	\$ 17,517	\$ 73,507

Rent expense under non-cancelable operating leases amounted to approximately \$8.2 million, \$5.6 million, and \$4.8 million for the fiscal years ended September 30, 2006, 2005, and 2004, respectively.

Litigation

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

Derivative Suits. On May 24, 2006, a shareholder action captioned Adams v. Amdahl et al. was filed against certain of the Company's current and former officers and directors in the King County Superior Court in Washington. The complaint generally alleges that the defendants breached their fiduciary duties to the Company in connection with the

granting of certain stock options. Five additional shareholder derivative complaints, based on substantially the same allegations, were subsequently filed in the Washington federal and state courts. Although litigation is subject to inherent uncertainties, the Company does not believe the results of these pending actions will, individually or in the aggregate, have a material adverse impact on our consolidated financial position or results of operations.

Nasdaq Delisting. On July 20, 2006 the Company announced that it would be unlikely that the Special Committee's review would be completed in time for the Company to file its Form 10-Q for the quarter ended June 30, 2006, by the SEC's deadline of August 14, 2006. In August 2006, the Company failed to timely file its Form 10-Q for the period ended June 30, 2006 as a result of the ongoing Special Committee investigation. On August 14, 2006, the Company received a written Staff Determination Notice from Nasdaq stating that the Company was not in compliance with Nasdaq's Marketplace Rule 4310(c)(14) because it has not timely filed

Table of Contents**F5 NETWORKS, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

its Quarterly Report on Form 10-Q for the quarter ended June 30, 2006, and that, therefore, the Company's securities are subject to delisting. On August 18, 2006, the Company appealed Nasdaq's Staff's delisting determination to the Panel and requested an oral hearing before the Panel. On August 23, 2006, Nasdaq's Staff stayed the delisting action pending a final written decision on the Company's appeal by the Panel. A hearing before the Panel occurred on September 22, 2006. On November 28, 2006, the Company received notice that the Panel had granted its request for continued listing on the Nasdaq Global Market, subject to certain conditions we expect to satisfy within the time period requested by the Panel.

The Company is not aware of any additional pending legal proceedings that, individually or in the aggregate, would have a material adverse effect on the Company's business, operating results, or financial condition. The Company may in the future be party to litigation arising in the ordinary course of business, including claims that allegedly infringe upon third-party trademarks or other intellectual property rights. Such claims, even if not meritorious, could result in the expenditure of significant financial and managerial resources.

8. Employee Benefit Plans

The Company has a 401(k) savings plan whereby eligible employees may voluntarily contribute a percentage of their compensation. The Company may, at its discretion, match a portion of the employees' eligible contributions. Contributions by the Company to the plan during the years ended September 30, 2006, 2005, and 2004 were approximately \$1.3 million, \$1.2 million and \$1.0 million, respectively. Contributions made by the Company vest over four years.

9. Geographic Sales and Significant Customers

Operating segments are defined as components of an enterprise for which separate financial information is available and evaluated regularly by the chief operating decision-maker, or decision-making group, in deciding how to allocate resources and in assessing performance. The Company is organized as, and operates in, one reportable segment: the development, marketing and selling of a comprehensive suite of application networking solutions that helps customers efficiently and securely manage application traffic on their Internet-based networks. We manage our business based on four geographic regions: the Americas (primarily the United States); Europe, the Middle East, and Africa (EMEA); Japan; and Asia Pacific. Our chief operating decision-making group reviews financial information presented on a consolidated basis accompanied by information about revenues by geographic region. Our foreign offices conduct sales, marketing and support activities. The Company's management evaluates performance based primarily on revenues in the geographic locations in which the Company operates. Revenues are attributed by geographic location based on the location of the customer. The Company's assets are primarily located in the United States and not allocated to any specific region. Therefore, geographic information is presented only for net product revenue.

The following presents revenues by geographic region (in thousands):

	Years Ended September 30,		
	2006	2005	2004
Americas	\$ 226,242	\$ 167,322	\$ 103,603

Edgar Filing: F5 NETWORKS INC - Form 10-K

EMEA	70,716	47,198	25,606
Japan	51,560	38,435	26,801
Asia Pacific	45,531	28,455	15,180
	\$ 394,049	\$ 281,410	\$ 171,190

Net revenues from international customers are primarily denominated in U.S. dollars and totaled \$167.8 million, \$114.1 million, and \$67.6 million for the years ended September 30, 2006, 2005 and 2004,

Table of Contents**F5 NETWORKS, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

respectively. One domestic distributor accounted for 13.6%, 18.6% and 19.1% of total net revenue for the fiscal years 2006, 2005 and 2004, respectively. This distributor accounted for 8.5%, 26.2% and 26.9% of accounts receivable as of September 30, 2006, 2005 and 2004, respectively. Another domestic distributor accounted for 11.6% of net revenue for the year ended September 30, 2006.

10. Subsequent Events

On October 31, 2006, the Company entered into an office lease agreement to lease a total of approximately 137,000 square feet of office space in the building known as 333 Elliott West, which is next to the three buildings that currently serve as the Company's corporate headquarters. The lease term is 10 years with an option for renewal. The Company plans to occupy this new building during the second quarter of fiscal 2008 after construction is completed.

11. Quarterly Results of Operations

The following presents the Company's unaudited quarterly results of operations for the eight quarters ended September 30, 2006. The information should be read in conjunction with the Company's financial statements and related notes included elsewhere in this report. This unaudited information has been prepared on the same basis as the audited financial statements and includes all adjustments, consisting only of normal recurring adjustments that were considered necessary for a fair statement of our operating results for the quarters presented.

	Three Months Ended							
	Sept. 30, 2006	June 30, 2006	March 31, 2006	Dec. 31, 2005	Sept. 30, 2005(1)(3)	June 30, 2005(3)	March 31, 2005(3)	Dec. 31, 2004(3)
(Unaudited and in thousands)								
Net revenues								
Products	\$ 86,320	\$ 77,192	\$ 72,775	\$ 68,591	\$ 62,762	\$ 57,112	\$ 53,332	\$ 46,397
Services	25,397	22,937	21,341	19,496	17,845	15,952	14,398	13,612
Total	111,717	100,129	94,116	88,087	80,607	73,064	67,730	60,009
Cost of net revenues								
Products	17,716	15,869	15,441	14,593	13,886	12,752	11,822	10,530
Services	7,065	6,649	5,846	4,974	4,572	4,312	3,915	3,395
Total	24,781	22,518	21,287	19,567	18,458	17,064	15,737	13,925
Gross profit	86,936	77,611	72,829	68,520	62,149	56,000	51,993	46,084

Table of Contents**F5 NETWORKS, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

	Sept. 30, 2006	June 30, 2006	March 31, 2006	Three Months Ended				Dec. 31, 2004(3)
				Dec. 31, 2005	Sept. 30, 2005(1)(3)	June 30, 2005(3)	March 31, 2005(3)	
				(Unaudited and in thousands)				
Operating expenses								
Sales and marketing	35,087	32,364	31,162	28,865	25,575	23,219	20,988	20,084
Research and development	13,900	12,517	12,276	10,478	9,066	7,584	7,834	7,032
General and administrative(2)	14,389	10,175	7,148	7,397	7,338	6,316	6,341	5,491
Total operating expenses	63,376	55,056	50,586	46,740	41,979	37,119	35,163	32,607
Income from operations	23,560	22,555	22,243	21,780	20,170	18,881	16,830	13,477
Other income, net	5,825	4,759	3,877	2,970	2,925	2,123	1,641	1,387
Income before income taxes	29,385	27,314	26,120	24,750	23,095	21,004	18,471	14,864
Provision (benefit) for income taxes	11,633	10,349	10,053	9,529	8,188	8,311	7,507	6,526
Net income	\$ 17,752	\$ 16,965	\$ 16,067	\$ 15,221	\$ 14,907	\$ 12,693	\$ 10,964	\$ 8,338
Net income per share basic	\$ 0.44	\$ 0.42	\$ 0.40	\$ 0.39	\$ 0.39	\$ 0.33	\$ 0.30	\$ 0.23
Weighted average shares basic	40,724	40,553	40,120	39,163	38,479	37,918	36,905	35,577
Net income per share diluted	\$ 0.43	\$ 0.41	\$ 0.39	\$ 0.37	\$ 0.37	\$ 0.32	\$ 0.28	\$ 0.22
Weighted average shares diluted	41,645	41,659	41,627	40,805	40,014	39,433	38,939	37,848

(1) The Company adopted FAS 123R on July 1, 2005, and as a result recognized \$4.6 million of compensation expense related to stock-based compensation charges included in operating expenses in the fourth quarter of fiscal 2005.

- (2) The fourth quarter of fiscal 2006, includes general and administrative expenses of \$5.0 million, related to third parties cost for legal, accounting, tax and other professional services in connection with the Special Committee investigation and related restatement described below.
- (3) In our Annual Report on Form 10-K/A No. 2 for fiscal year 2005 (filed on December 12, 2006), we restated our consolidated financial statements for the years ended September 30, 2005, 2004 and 2003, and the selected consolidated financial data as of and for the years ended September 30, 2005, 2004, 2003, 2002 and 2001. In addition, we restated our condensed consolidated financial statements for the quarters ended December 31, 2005 and March 31, 2006 in our Quarterly Reports on Form 10-Q/A for the quarters ended December 31, 2005 and March 31, 2006, each of which was filed on December 13, 2006. All financial information included in this Annual Report on Form 10-K reflects our restatement.

Table of Contents**F5 NETWORKS, INC.****SUPPLEMENTARY DATA
VALUATION AND QUALIFYING ACCOUNTS AND RESERVES**

Description	Balance at Beginning of Period	Charges to Costs and Expenses	Charges to Other Accounts (In thousands)	Deductions	Balance at End of Period
Year Ended September 30, 2006					
Allowance for doubtful accounts	\$ 1,747	\$ (854)	\$	\$ 7	\$ 900
Allowance for sales returns	\$ 1,222	\$ 920	\$ 921	\$ (1,105)	\$ 1,958
Year Ended September 30, 2005					
Allowance for doubtful accounts	\$ 1,594	\$ 653	\$	\$ (500)	\$ 1,747
Allowance for sales returns	\$ 1,567	\$ 766	\$ 626	\$ (1,737)	\$ 1,222
Income tax valuation allowance	\$ 2,649	\$	\$	\$ (2,649)	\$
Year Ended September 30, 2004					
Allowance for doubtful accounts	\$ 1,524	\$ 150	\$	\$ (80)	\$ 1,594
Allowance for sales returns	\$ 1,525	\$ 1,009	\$ 1,566	\$ (2,533)	\$ 1,567
Income tax valuation allowance	\$ 30,711	\$	\$	\$ (28,062)	\$ 2,649

Table of Contents

Item 9. *Changes in and Disagreements with Accountants on Accounting and Financial Disclosure*

None.

Item 9A. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

The Company maintains disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the Exchange Act)) that are designed to ensure that required information is recorded, processed, summarized and reported within the required timeframe, as specified in the rules set forth by the Securities Exchange Commission. Our disclosure controls and procedures are also designed to ensure that information required to be disclosed is accumulated and communicated to management, including the Chief Executive Officer and Chief Accounting Officer, to allow timely decisions regarding required disclosures.

Our management, with the participation of our Chief Executive Officer and Chief Accounting Officer, evaluated the effectiveness of our disclosure controls and procedures as of September 30, 2006 and, based on this evaluation, our Chief Executive Officer and Chief Accounting Officer have concluded that our disclosure controls and procedures were effective as of September 30, 2006.

Management's Report on Internal Control over Financial Reporting

Management is responsible for establishing and maintaining adequate internal control over financial reporting, as such term is defined in Exchange Act Rules 13a-15(f) and 15d-15(f). Internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles.

Internal control over financial reporting cannot provide absolute assurance of achieving financial reporting objectives because of its inherent limitations. Internal control over financial reporting is a process that involves human diligence and compliance and is subject to lapses in judgment and breakdowns resulting from human failures. Internal control over financial reporting also can be circumvented by collusion or improper management override. Because of such limitations, there is a risk that material misstatements may not be prevented or detected on a timely basis by internal control over financial reporting. However, these inherent limitations are known features of the financial reporting process. Therefore, it is possible to design into the process safeguards to reduce, though not eliminate, this risk.

Management conducted an assessment of the effectiveness of our internal control over financial reporting as of September 30, 2006. In making this assessment, management used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission in *Internal Control - Integrated Framework*. Based on the results of this assessment and on those criteria, management concluded that our internal control over financial reporting was effective as of September 30, 2006.

Management's assessment of the effectiveness of our internal control over financial reporting as of September 30, 2006 has been audited by PricewaterhouseCoopers LLP, an independent registered public accounting firm, as stated in their report appearing herein.

Remediation of Material Weakness

As previously disclosed in our amended Annual Report on Form 10-K/A No. 2 for the year ended September 30, 2005, which we filed on December 12, 2006, our management concluded that, as of September 30, 2005, a material weakness existed over our granting and modification of stock options and the related accounting for and disclosure of stock-based compensation expense. Subsequent to the initiation of our investigation into our stock-option granting practices in May 2006, we considered the effectiveness of both the design and operation of our internal control over financial reporting, as they relate to the granting and modification of stock-based compensation. We implemented a number of significant improvements in our

Table of Contents

internal control over financial reporting during the fourth quarter of 2006. In particular, we developed and implemented the following policies, processes, procedures and controls over the granting and modification of stock-based compensation:

Review and approval of all stock-based compensation awards by the accounting and finance function.

Enhanced and standardized documentation required to be maintained for the granting of all such stock-based compensation awards.

Enhanced and standardized documentation required to be maintained for the exercise and/or cancellation of all such stock-based compensation awards.

A quarterly review and reconciliation of all such stock-based compensation awards by the accounting and finance function.

Formal communication to all relevant personnel involved in the stock-based compensation process regarding the importance of the accounting and legal implications of the Company's stock-based compensation process.

As of September 30, 2006, management has implemented these additional policies, procedures and controls. Additionally, we have evaluated the design of these new controls, which have been placed into operation for a sufficient period of time, and tested their operating effectiveness. The Company considers that the steps identified and implemented above have improved the effectiveness of the Company's internal control over financial reporting and, as of September 30, 2006, have remediated the material weakness described above.

Changes in Internal Control over Financial Reporting

As described above in the *Remediation of Material Weakness* section, there were changes to our internal control over financial reporting during the fourth quarter of fiscal 2006, that materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Item 9B. *Other Information*

None.

Table of Contents

PART III

Item 10. *Directors and Executive Officers of the Registrant*

We intend to furnish to the SEC a definitive Proxy Statement not later than 120 days after the close of the fiscal year ended September 30, 2006 (the Proxy Statement). Certain information required by this item is incorporated herein by reference to the Proxy Statement. Also see *Directors and Executive Officers of the Registrant* in Part I of this Annual Report on Form 10-K.

Item 11. *Executive Compensation*

The information required by this item is incorporated herein by reference to the Proxy Statement.

Item 12. *Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters*

The information required by this item is incorporated herein by reference to the Proxy Statement.

Item 13. *Certain Relationships and Related Transactions*

The information required by this item is incorporated herein by reference to the Proxy Statement.

Item 14. *Principal Accountant Fees and Services*

The information required by this item is incorporated herein by reference to the Proxy Statement.

PART IV

Item 15. *Exhibits and Financial Statement Schedules*

(a) Documents filed as part of this report are as follows:

1. *Consolidated Financial Statements:*

See Index to Consolidated Financial Statements included under Item 8 in Part II of this Annual Report on Form 10-K.

2. *Exhibits:*

The required exhibits are included at the end of this Annual Report on Form 10-K and are described in the Exhibit Index immediately preceding the first exhibit.

Table of Contents

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) 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.

F5 Networks, Inc.

By: /s/ JOHN MCADAM
 John McAdam
Chief Executive Officer and President

Dated: December 13, 2006

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the Registrant and in the capacities and on the dates indicated.

Signature	Title	Date
By: /s/ JOHN MCADAM John McAdam	Chief Executive Officer, President, and Director (principal executive officer)	December 13, 2006
By: /s/ JOHN RODRIGUEZ John Rodriguez	Senior Vice President, Chief Accounting Officer (principal financial officer)	December 13, 2006
By: /s/ A. GARY AMES A. Gary Ames	Director	December 13, 2006
By: /s/ DEBORAH L. BEVIER Deborah L. Bevier	Director	December 13, 2006
By: /s/ KEITH D. GRINSTEIN Keith D. Grinstein	Director	December 13, 2006
By: /s/ KARL D. GUELICH Karl D. Guelich	Director	December 13, 2006
By: /s/ ALAN J. HIGGINSON Alan J. Higginson	Director	December 13, 2006

By: /s/ RICH MALONE

Director

December 13, 2006

Rich Malone

Table of Contents**EXHIBIT INDEX**

Exhibit Number	Exhibit Description
2.1	Agreement and Plan of Merger dated as of May 31, 2004, by and among the Registrant, Fire5, Inc., a wholly owned subsidiary of the Registrant, MagniFire Websystems, Inc., and Lucent Venture Partners III LLC(1)
2.2	Agreement and Plan of Merger, dated September 6, 2005, among F5 Networks, Inc., Sparrow Acquisition Corp., Swan Labs Corporation and the other parties referred to therein.(2)
3.1	Second Amended and Restated Articles of Incorporation of the Registrant(3)
3.2	Amended and Restated Bylaws of the Registrant(3)
4.1	Specimen Common Stock Certificate(3)
10.1	Amended and Restated Office Lease Agreement dated April 3, 2000, between the Registrant and 401 Elliott West LLC(4)
10.2	Sublease Agreement dated March 30, 2001 between the Registrant and Cell Therapeutics, Inc.(5)
10.3	uRoam Acquisition Equity Incentive Plan(6)
10.4	Form of Indemnification Agreement between the Registrant and each of its directors and certain of its officers(3)
10.5	1998 Equity Incentive Plan, as amended(7)
10.6	Form of Option Agreement under the 1998 Equity Incentive Plan(3)
10.7	Amended and Restated Directors Nonqualified Stock Option Plan(3)
10.8	Form of Option Agreement under the Amended and Restated Directors Nonqualified Stock Option Plan(3)
10.9	Amended and Restated 1996 Stock Option Plan(3)
10.10	Form of Option Agreement under the Amended and Restated 1996 Stock Option Plan(3)
10.11	1999 Non-Employee Directors Stock Option Plan(3)
10.12	Form of Option Agreement under 1999 Non-Employee Directors Stock Option Plan(3)
10.13	NonQualified Stock Option Agreement between John McAdam and the Registrant dated July 24, 2000(8)
10.14	2000 Employee Equity Incentive Plan(9)
10.15	Form of Option Agreement under the 2000 Equity Incentive Plan(10)
10.16	NonQualified Stock Option Agreement between M. Thomas Hull and the Registrant dated October 20, 2003(11)
10.17	1999 Employee Stock Purchase Plan, as amended(12)
10.18	MagniFire Acquisition Equity Incentive Plan(13)
10.19	NonQualified Stock Option Agreement between Karl Triebes and the Registrant dated August 16, 2004(13)
10.20	Incentive Compensation Plan for Executive Officers(13)
10.21	2005 Equity Incentive Plan(14)
10.22	Form of Restricted Stock Unit agreement under the 2005 Equity Incentive Plan (with acceleration upon change of control)(15)
10.23	Form of Restricted Stock Unit agreement under the 2005 Equity Incentive Plan (no acceleration upon change of control)(15)
10.24	Amendment to F5 Networks, Inc. 2005 Equity Incentive Plan Award Agreement, dated March 8, 2006, between the Registrant and John Rodriquez(16)
10.25	Amendment to F5 Networks, Inc. 2005 Equity Incentive Plan Award Agreement, dated March 8, 2006, between the Registrant and Andy Reinland(16)

10.26	Compensation arrangement for current and future members to special committees of the Registrant's Board of Directors effective September 1, 2006(17)
-------	--

Table of Contents

Exhibit Number	Exhibit Description
10.27	Office Lease Agreement with Selig Real Estate Holdings IIX, L.L.C. dated October 31, 2006(18)
10.28*	First Amendment to Sublease Agreement dated April 13, 2001 between the Registrant and Cell Therapeutics, Inc.
10.29*	Second Amendment to Sublease Agreement dated March 6, 2002 between the Registrant and Cell Therapeutics, Inc.
10.30*	Third Amendment to Sublease Agreement dated as of December 22, 2005 between the Registrant and Cell Therapeutics, Inc.
21.1*	Subsidiaries of the Registrant
23.1*	Consent of PricewaterhouseCoopers LLP, Independent Registered Public Accounting Firm
31.1*	Certification Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.2*	Certification Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32.1*	Certification Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

* Filed herewith.

- (1) Incorporated by reference from Current Report on Form 8-K dated May 31, 2004 and filed with the SEC on June 2, 2004.
- (2) Incorporated by reference from Current Report on Form 8-K dated October 4, 2005 and filed with the SEC on October 5, 2005.
- (3) Incorporated by reference from Registration Statement on Form S-1, File No. 333-75817.
- (4) Incorporated by reference from Quarterly Report on Form 10-Q for the quarter ended June 30, 2003.
- (5) Incorporated by reference from Quarterly Report on Form 10-Q for the quarter ended June 30, 2001.
- (6) Incorporated by reference from Registration Statement on Form S-8, File No. 333-109895.
- (7) Incorporated by reference from Registration Statement on Form S-8, File No. 333-104169.
- (8) Incorporated by reference from Annual Report on Form 10-K for the year ended September 30, 2000.
- (9) Incorporated by reference from Registration Statement on Form S-8, File No. 333-51878.
- (10) Incorporated by reference from Annual Report on Form 10-K for the year ended September 30, 2001.
- (11) Incorporated by reference from Registration Statement on Form S-8, File No. 333-112022.
- (12) Incorporated by reference from Registration Statement on Form S-8, File No. 333-116187.
- (13) Incorporated by reference from Annual Report on Form 10-K for the year ended September 30, 2004.
- (14) Incorporated by reference from Quarterly Report on Form 10-Q for the quarter ended March 31, 2005.

- (15) Incorporated by reference from Quarterly Report on Form 10-Q for the quarter ended June 30, 2005.
- (16) Incorporated by reference from Current Report on Form 8-K dated March 8, 2006 and filed with the SEC on March 10, 2006.
- (17) Incorporated by reference from Current Report on Form 8-K dated September 1, 2006 and filed with the SEC on September 5, 2006.
- (18) Incorporated by reference from Current Report on Form 8-K dated October 31, 2006 and filed with the SEC on November 3, 2006.