

CISCO SYSTEMS INC
Form 10-Q
February 17, 2009
Table of Contents

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

FORM 10-Q

(Mark one)

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended January 24, 2009

OR

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

Commission file number 0-18225

CISCO SYSTEMS, INC.

(Exact name of Registrant as specified in its charter)

California
(State or other jurisdiction of
incorporation or organization)

170 West Tasman Drive

San Jose, California 95134

77-0059951
(I.R.S. Employer
Identification Number)

Edgar Filing: CISCO SYSTEMS INC - Form 10-Q

(Address of principal executive office and zip code)

(408) 526-4000

(Registrant's telephone number, including area code)

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act.

Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller reporting company

(Do not check if a smaller reporting company)

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 February 12, 2009, 5,837,016,965 shares of the registrant's common stock were outstanding.

Table of Contents

Cisco Systems, Inc.

FORM 10-Q for the Quarter Ended January 24, 2009

INDEX

	Page
Part I.	
Item 1.	
<u>Financial Information</u>	
<u>Financial Statements (Unaudited)</u>	
<u>Consolidated Balance Sheets at January 24, 2009 and July 26, 2008</u>	3
<u>Consolidated Statements of Operations for the three and six months ended January 24, 2009 and January 26, 2008</u>	4
<u>Consolidated Statements of Cash Flows for the six months ended January 24, 2009 and January 26, 2008</u>	5
<u>Consolidated Statements of Shareholders' Equity for the six months ended January 24, 2009 and January 26, 2008</u>	6
<u>Notes to Consolidated Financial Statements</u>	7
Item 2.	34
Item 3.	56
Item 4.	59
Part II.	
<u>Other Information</u>	
Item 1.	59
Item 1A.	60
Item 2.	74
Item 3.	74
Item 4.	74
Item 5.	75
Item 6.	75
<u>Exhibits</u>	75
<u>Signature</u>	76

Table of Contents**PART I. FINANCIAL INFORMATION****Item 1. Financial Statements (Unaudited)****CISCO SYSTEMS, INC.****CONSOLIDATED BALANCE SHEETS**

(in millions, except par value)

(Unaudited)

	January 24, 2009	July 26, 2008
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 4,175	\$ 5,191
Investments	25,356	21,044
Accounts receivable, net of allowance for doubtful accounts of \$230 at January 24, 2009 and \$177 at July 26, 2008	2,893	3,821
Inventories	1,107	1,235
Deferred tax assets	2,134	2,075
Prepaid expenses and other current assets	2,330	2,333
Total current assets	37,995	35,699
Property and equipment, net	4,141	4,151
Goodwill	12,572	12,392
Purchased intangible assets, net	1,792	2,089
Other assets	4,857	4,403
TOTAL ASSETS	\$ 61,357	\$ 58,734
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities:		
Current portion of long-term debt	\$ 500	\$ 500
Accounts payable	625	869
Income taxes payable	108	107
Accrued compensation	2,078	2,428
Deferred revenue	6,592	6,197
Other current liabilities	3,701	3,757
Total current liabilities	13,604	13,858
Long-term debt	6,348	6,393
Income taxes payable	1,198	749
Deferred revenue	2,708	2,663
Other long-term liabilities	698	669
Total liabilities	24,556	24,332

Edgar Filing: CISCO SYSTEMS INC - Form 10-Q

Minority interest	18	49
Shareholders' equity:		
Preferred stock, no par value: 5 shares authorized; none issued and outstanding		
Common stock and additional paid-in capital, \$0.001 par value: 20,000 shares authorized; 5,844 and 5,893 shares issued and outstanding at January 24, 2009 and July 26, 2008, respectively	34,092	33,505
Retained earnings	2,695	120
Accumulated other comprehensive income (loss)	(4)	728
Total shareholders' equity	36,783	34,353
TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY	\$ 61,357	\$ 58,734

See Notes to Consolidated Financial Statements.

Table of Contents**CISCO SYSTEMS, INC.****CONSOLIDATED STATEMENTS OF OPERATIONS****(in millions, except per-share amounts)****(Unaudited)**

	Three Months Ended		Six Months Ended	
	January 24, 2009	January 26, 2008	January 24, 2009	January 26, 2008
NET SALES:				
Product	\$ 7,347	\$ 8,245	\$ 15,982	\$ 16,260
Service	1,742	1,586	3,438	3,125
Total net sales	9,089	9,831	19,420	19,385
COST OF SALES:				
Product	2,737	2,890	5,718	5,720
Service	629	636	1,298	1,220
Total cost of sales	3,366	3,526	7,016	6,940
GROSS MARGIN	5,723	6,305	12,404	12,445
OPERATING EXPENSES:				
Research and development	1,279	1,260	2,685	2,492
Sales and marketing	2,155	2,158	4,438	4,236
General and administrative	380	367	775	709
Amortization of purchased intangible assets	136	116	248	233
In-process research and development			3	3
Total operating expenses	3,950	3,901	8,149	7,673
OPERATING INCOME	1,773	2,404	4,255	4,772
Interest income, net	159	212	354	435
Other income (loss), net	(64)	22	(136)	53
Interest and other income (loss), net	95	234	218	488
INCOME BEFORE PROVISION FOR INCOME TAXES	1,868	2,638	4,473	5,260
Provision for income taxes	364	578	768	995
NET INCOME	\$ 1,504	\$ 2,060	\$ 3,705	\$ 4,265
Net income per share:				
Basic	\$ 0.26	\$ 0.34	\$ 0.63	\$ 0.71
Diluted	\$ 0.26	\$ 0.33	\$ 0.63	\$ 0.68

Shares used in per-share calculation:

Edgar Filing: CISCO SYSTEMS INC - Form 10-Q

Basic	5,848	6,010	5,865	6,049
Diluted	5,864	6,202	5,901	6,273

See Notes to Consolidated Financial Statements.

Table of Contents**CISCO SYSTEMS, INC.****CONSOLIDATED STATEMENTS OF CASH FLOWS****(in millions)****(Unaudited)**

	Six Months Ended	
	January 24, 2009	January 26, 2008
Cash flows from operating activities:		
Net income	\$ 3,705	\$ 4,265
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	818	878
Employee share-based compensation expense	558	499
Share-based compensation expense related to acquisitions and investments	44	45
Provision for doubtful accounts	59	29
Deferred income taxes	(293)	(632)
Excess tax benefits from share-based compensation	(21)	(338)
In-process research and development	3	3
Net losses (gains) on investments	123	(104)
Change in operating assets and liabilities, net of effects of acquisitions:		
Accounts receivable	818	(196)
Inventories	113	66
Lease receivables, net	(109)	(260)
Accounts payable	(228)	(33)
Income taxes payable and receivable	467	220
Accrued compensation	(213)	(38)
Deferred revenue	544	946
Other assets	(470)	38
Other liabilities	(2)	144
Net cash provided by operating activities	5,916	5,532
Cash flows from investing activities:		
Purchases of investments	(24,110)	(7,846)
Proceeds from sales of investments	12,545	8,235
Proceeds from maturities of investments	6,920	1,218
Acquisition of property and equipment	(585)	(591)
Acquisition of businesses, net of cash and cash equivalents acquired	(327)	(385)
Change in investments in privately held companies	(53)	(55)
Other	(54)	(111)
Net cash (used in) provided by investing activities	(5,664)	465
Cash flows from financing activities:		
Issuance of common stock	441	2,165
Repurchase of common stock	(1,603)	(7,120)
Excess tax benefits from share-based compensation	21	338
Other	(127)	94
Net cash used in financing activities	(1,268)	(4,523)

Edgar Filing: CISCO SYSTEMS INC - Form 10-Q

Net (decrease) increase in cash and cash equivalents	(1,016)	1,474
Cash and cash equivalents, beginning of period	5,191	3,728
Cash and cash equivalents, end of period	\$ 4,175	\$ 5,202

See Notes to Consolidated Financial Statements.

Table of Contents**CISCO SYSTEMS, INC.****CONSOLIDATED STATEMENTS OF SHAREHOLDERS EQUITY**

(in millions)

(Unaudited)

	Shares of Common Stock	Common Stock and Additional Paid-In Capital	Retained Earnings (Accumulated Deficit)	Accumulated Other Comprehensive Income (Loss)	Total Shareholders Equity
Six Months Ended January 26, 2008					
BALANCE AT JULY 28, 2007	6,100	\$ 30,687	\$ 231	\$ 562	\$ 31,480
Cumulative effect of adopting FIN 48		249	202		451
BALANCE AT JULY 29, 2007	6,100	30,936	433	562	31,931
Net income			4,265		4,265
Change in unrealized gains and losses on investments, net of tax				468	468
Cumulative translation adjustment and other				82	82
Comprehensive income					4,815
Issuance of common stock	111	2,165			2,165
Repurchase of common stock	(236)	(1,249)	(5,771)		(7,020)
Tax benefits from employee stock incentive plans		368			368
Purchase acquisitions		9			9
Employee share-based compensation expense		499			499
Share-based compensation expense related to acquisitions and investments		45			45
BALANCE AT JANUARY 26, 2008	5,975	\$ 32,773	\$ (1,073)	\$ 1,112	\$ 32,812
Six Months Ended January 24, 2009					
BALANCE AT JULY 26, 2008	5,893	\$ 33,505	\$ 120	\$ 728	\$ 34,353
Net income			3,705		3,705
Change in unrealized gains and losses on investments, net of tax				(147)	(147)
Cumulative translation adjustment and other				(585)	(585)
Comprehensive income					2,973
Issuance of common stock	34	441			441
Repurchase of common stock	(83)	(485)	(1,130)		(1,615)
Tax benefits from employee stock incentive plans		16			16
Purchase acquisitions		13			13
Employee share-based compensation expense		558			558

Edgar Filing: CISCO SYSTEMS INC - Form 10-Q

Share-based compensation expense related to acquisitions and investments			44			44
BALANCE AT JANUARY 24, 2009	5,844	\$ 34,092	\$ 2,695	\$ (4)	\$ 36,783	

Supplemental Information

In September 2001, the Company's Board of Directors authorized a stock repurchase program. As of January 24, 2009, the Company's Board of Directors had authorized an aggregate repurchase of up to \$62 billion of common stock under this program. For additional information regarding stock repurchases, see Note 12 to the Consolidated Financial Statements. The stock repurchases since the inception of this program and the related impact on shareholders' equity are summarized in the table below (in millions):

	Shares of Common Stock	Common Stock and Additional Paid-In Capital	Retained Earnings (Accumulated Deficit)	Accumulated Other Comprehensive Income (Loss)	Total Shareholders Equity
Repurchases of common stock	2,683	\$ 10,045	\$ 45,134	\$	\$ 55,179

See Notes to Consolidated Financial Statements.

Table of Contents

CISCO SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

1. Basis of Presentation

The fiscal year for Cisco Systems, Inc. (the Company or Cisco) is the 52 or 53 weeks ending on the last Saturday in July. Fiscal 2009 and 2008 are 52-week fiscal years. The Consolidated Financial Statements include the accounts of Cisco and its subsidiaries. All significant intercompany accounts and transactions have been eliminated. The Company conducts business globally and is primarily managed on a geographic basis in the following theaters: United States and Canada; European Markets; Emerging Markets; Asia Pacific; and Japan. The Emerging Markets theater consists of Eastern Europe, Latin America, the Middle East and Africa, and Russia and the Commonwealth of Independent States (CIS).

The accompanying financial data as of January 24, 2009 and for the three and six months ended January 24, 2009 and January 26, 2008 has been prepared by the Company, without audit, pursuant to the rules and regulations of the Securities and Exchange Commission (SEC). Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States have been condensed or omitted pursuant to such rules and regulations. The July 26, 2008 Consolidated Balance Sheet was derived from audited financial statements, but does not include all disclosures required by accounting principles generally accepted in the United States. However, the Company believes that the disclosures are adequate to make the information presented not misleading. These Consolidated Financial Statements should be read in conjunction with the Consolidated Financial Statements and the notes thereto, included in the Company's Annual Report on Form 10-K for the fiscal year ended July 26, 2008.

In the opinion of management, all adjustments (which include normal recurring adjustments, except as disclosed herein) necessary to present fairly the statement of financial position as of January 24, 2009, and results of operations for the three months and six months ended January 24, 2009 and January 26, 2008, cash flows, and shareholders' equity for the six months ended January 24, 2009 and January 26, 2008, as applicable, have been made. The results of operations for the three and six months ended January 24, 2009 are not necessarily indicative of the operating results for the full fiscal year or any future periods.

During the first quarter of fiscal 2009, the Company began to allocate certain costs, which had previously been recorded in general and administrative expenses (related to information technology, financing business, and human resources), to sales and marketing, research and development, and cost of sales, as applicable. These changes also resulted in reclassifications to prior period gross margin by theater amounts. In addition, the Company has made certain reclassifications to prior period amounts relating to net sales by theater and net sales for similar groups of products due to refinement of the respective categories. The Company has made certain other reclassifications to prior period amounts in order to conform to the current period's presentation.

2. Summary of Significant Accounting Policies

(a) Fair Value Measures

In September 2006, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 157, Fair Value Measurements (SFAS 157). SFAS 157 defines fair value, establishes a framework for measuring fair value, and enhances fair value measurement disclosure. In October 2008, the FASB issued FSP 157-3 Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active (FSP 157-3). FSP 157-3 clarifies the application of SFAS No. 157 in a market that is not active, and provides guidance on the key considerations in determining the fair value of a financial asset when the market for that financial asset is not active. Effective July 27, 2008, the Company adopted the measurement and disclosure requirements related to financial assets and financial liabilities. The adoption of SFAS 157 for financial assets and financial liabilities did not have a material impact on the Company's results of operations or the fair values of its financial assets and liabilities.

FASB Staff Position 157-2, Effective Date of FASB Statement No. 157, (FSP 157-2) delayed the effective date of SFAS 157 for all nonfinancial assets and nonfinancial liabilities, except for items that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually), until the beginning of fiscal 2010. The Company is currently assessing the impact that the application of SFAS 157 to nonfinancial assets and liabilities will have on its results of operations and financial position.

Edgar Filing: CISCO SYSTEMS INC - Form 10-Q

In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities Including an amendment of FASB Statement No. 115 (SFAS 159). Under SFAS 159, a company may choose, at specified election dates, to measure eligible items at fair value and report unrealized gains and losses on items for which the fair value option has been elected in earnings at each subsequent reporting date. Effective July 27, 2008, the Company adopted SFAS 159, but the Company has not elected the fair value option for any eligible financial instruments as of January 24, 2009.

Table of Contents**(b) Recent Accounting Pronouncements***SFAS 141(R) and SFAS 160*

In December 2007, the FASB issued SFAS No. 141 (revised 2007), Business Combinations (SFAS 141(R)) and SFAS No. 160, Noncontrolling Interests in Consolidated Financial Statements – an amendment of ARB No. 51 (SFAS 160). SFAS 141(R) will significantly change current practices regarding business combinations. Among the more significant changes, SFAS 141(R) expands the definition of a business and a business combination; requires the acquirer to recognize the assets acquired, liabilities assumed and noncontrolling interests (including goodwill), measured at fair value at the acquisition date; requires acquisition-related expenses and restructuring costs to be recognized separately from the business combination; requires assets acquired and liabilities assumed from contractual and noncontractual contingencies to be recognized at their acquisition-date fair values with subsequent changes recognized in earnings; and requires in-process research and development to be capitalized at fair value as an indefinite-lived intangible asset. SFAS 160 will change the accounting and reporting for minority interests, reporting them as equity separate from the parent entity's equity, as well as requiring expanded disclosures. SFAS 141(R) and SFAS 160 are effective for financial statements issued for fiscal years beginning after December 15, 2008. The Company is currently assessing the impact that SFAS 141(R) and SFAS 160 will have on its results of operations and financial position.

SFAS 161

In March 2008, the FASB issued SFAS No. 161, Disclosures about Derivative Instruments and Hedging Activities – an amendment of FASB Statement No. 133 (SFAS 161), which requires additional disclosures about the objectives of using derivative instruments, the method by which the derivative instruments and related hedged items are accounted for under FASB Statement No. 133 and its related interpretations, and the effect of derivative instruments and related hedged items on financial position, financial performance, and cash flows. SFAS 161 also requires disclosure of the fair values of derivative instruments and their gains and losses in a tabular format. SFAS 161 is effective for the Company in the third quarter of fiscal 2009. The Company is currently assessing the impact that the adoption of SFAS 161 will have on its financial statement disclosures.

3. Business Combinations**(a) Purchase Acquisitions**

A summary of the purchase acquisitions for the six months ended January 24, 2009 is as follows (in millions):

	Purchase Consideration	In-Process R&D Expense	Purchased Intangible Assets	Goodwill
Pure Networks, Inc.	\$ 105	\$	\$ 30	\$ 79
PostPath, Inc.	197	3	52	152
Other	43		12	32
Total	\$ 345	\$ 3	\$ 94	\$ 263

The Company acquired Pure Networks, Inc. to provide solutions designed to allow end users to easily set up and manage a home network and connect a range of devices, applications and services.

The Company acquired PostPath, Inc. to enhance the existing email and calendaring capabilities of Cisco's WebEx Connect collaboration platform.

Under the terms of the definitive agreements related to the Company's purchase acquisitions completed during the six months ended January 24, 2009, the purchase consideration consisted of cash and fully vested share-based awards assumed. The purchase consideration for the Company's purchase acquisitions is also allocated to tangible assets acquired and liabilities assumed.

Edgar Filing: CISCO SYSTEMS INC - Form 10-Q

The Consolidated Financial Statements include the operating results of each business from the date of acquisition. Pro forma results of operations for the acquisitions completed during the six months ended January 24, 2009 have not been presented because the effects of the acquisitions, individually or in the aggregate, were not material to the Company's financial results.

Table of Contents***(b) Compensation Expense Related to Acquisitions and Investments***

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

	Three Months Ended		Six Months Ended	
	January 24, 2009	January 26, 2008	January 24, 2009	January 26, 2008
Share-based compensation expense	\$ 22	\$ 21	\$ 44	\$ 45
Cash compensation expense	37	13	159	28
Total	\$ 59	\$ 34	\$ 203	\$ 73

Share-Based Compensation Expense

As of January 24, 2009, the remaining balance of share-based compensation related to acquisitions and investments to be recognized over the vesting periods was approximately \$213 million.

Cash Compensation Expense

In connection with the Company's purchase acquisitions, asset purchases, and acquisitions of variable interest entities, the Company has agreed to pay certain additional amounts contingent upon the achievement of certain agreed-upon technology, development, product, or other milestones, or the continued employment with the Company of certain employees of the acquired entities. In each case, any additional amounts paid will be recorded as compensation expense. As of January 24, 2009, the Company may be required to recognize future compensation expense pursuant to these agreements of up to \$417 million, which includes the remaining potential amount of additional compensation expense related to Nuova Systems, Inc., as discussed below.

Nuova Systems, Inc.

During fiscal 2008, the Company purchased the remaining interests in Nuova Systems, Inc. (Nuova Systems) not previously held by the Company, representing approximately 20% of Nuova Systems. Under the terms of the merger agreement, the former minority interest holders of Nuova Systems are eligible to receive up to three milestone payments based on agreed-upon formulas. During the first six months of fiscal 2009, the Company recorded \$40 million of compensation expense, and through January 24, 2009, the Company has recorded aggregate compensation expense of \$317 million related to the fair value of amounts that are expected to be earned by the minority interest holders pursuant to a vesting schedule. Actual amounts payable to the former minority interest holders of Nuova Systems will depend upon achievement under the agreed-upon formulas.

Subsequent changes to the fair value of the amounts probable of being earned and the continued vesting will result in adjustments to the recorded compensation expense. The potential amount that could be recorded as compensation expense may be up to a maximum of \$678 million, including the \$317 million that has been expensed as of January 24, 2009. The compensation is expected to be paid during fiscal 2010 through fiscal 2012.

Table of Contents**4. Goodwill and Purchased Intangible Assets****(a) Goodwill**

The following table presents the changes in goodwill allocated to the Company's reportable segments during the six months ended January 24, 2009 (in millions):

	Balance at July 26, 2008	Acquisitions	Other	Balance at January 24, 2009
United States and Canada	\$ 9,059	\$ 206	\$	\$ 9,265
European Markets	1,650	31	(77)	1,604
Emerging Markets	405	11	(6)	410
Asia Pacific	479	13		492
Japan	799	2		801
Total	\$ 12,392	\$ 263	\$ (83)	\$ 12,572

In the table above, Other primarily includes foreign currency translation and purchase accounting adjustments.

(b) Purchased Intangible Assets

The following table presents details of the purchased intangible assets acquired through business combinations during the six months ended January 24, 2009 (in millions, except years):

	TECHNOLOGY		CUSTOMER RELATIONSHIPS		TOTAL Amount
	Weighted- Average Useful Life (in Years)	Amount	Weighted- Average Useful Life (in Years)	Amount	
Pure Networks, Inc.	4.0	\$ 27	3.0	\$ 3	\$ 30
PostPath, Inc.	6.0	52			52
Other	6.0	10	2.6	2	12
Total		\$ 89		\$ 5	\$ 94

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

January 24, 2009	Gross	Accumulated Amortization	Net
Technology ⁽¹⁾	\$ 1,612	\$ (862)	\$ 750
Customer relationships	1,666	(661)	1,005
Other	174	(137)	37
Total	\$ 3,452	\$ (1,660)	\$ 1,792

Table of Contents

July 26, 2008	Gross	Accumulated Amortization	Net
Technology ⁽¹⁾	\$ 1,785	\$ (905)	\$ 880
Customer relationships	1,821	(674)	1,147
Other	247	(185)	62
Total	\$ 3,853	\$ (1,764)	\$ 2,089

⁽¹⁾ The technology category includes technology intangible assets acquired through business combinations as well as through technology licenses.

The following table presents the amortization of purchased intangible assets (in millions):

	Three Months Ended		Six Months Ended	
	January 24, 2009	January 26, 2008	January 24, 2009	January 26, 2008
Amortization of purchased intangible assets				
Cost of sales	\$ 59	\$ 61	\$ 118	\$ 122
Operating expenses	136	116	248	233
Total	\$ 195	\$ 177	\$ 366	\$ 355

During the second quarter of fiscal 2009, the Company recorded an impairment charge of \$23 million from write-downs of purchased intangible assets related to certain technologies due to reductions in expected future cash flows, and the amount was recorded as amortization of purchased intangible assets.

The estimated future amortization expense of purchased intangible assets as of January 24, 2009 is as follows (in millions):

Fiscal Year	Amount
2009 (remaining six months)	\$ 289
2010	530
2011	440
2012	304
2013	217
Thereafter	12
Total	\$ 1,792

Table of Contents**5. Balance Sheet Details**

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

	January 24, 2009	July 26, 2008
Inventories:		
Raw materials	\$ 142	\$ 111
Work in process	50	53
Finished goods:		
Distributor inventory and deferred cost of sales	431	452
Manufactured finished goods	277	381
Total finished goods	708	833
Service-related spares	169	191
Demonstration systems	38	47
Total	\$ 1,107	\$ 1,235
Property and equipment, net:		
Land, buildings, and leasehold improvements	\$ 4,499	\$ 4,445
Computer equipment and related software	1,785	1,770
Production, engineering, and other equipment	4,975	4,839
Operating lease assets	217	209
Furniture and fixtures	451	439
	11,927	11,702
Less accumulated depreciation and amortization	(7,786)	(7,551)
Total	\$ 4,141	\$ 4,151
Other assets:		
Deferred tax assets	\$ 2,139	\$ 1,770
Investments in privately held companies	716	706
Lease receivables, net	874	862
Financed service contracts	550	588
Other	578	477
Total	\$ 4,857	\$ 4,403
Deferred revenue:		
Service	\$ 6,073	\$ 6,133
Product:		
Unrecognized revenue on product shipments and other deferred revenue	2,315	2,152
Cash receipts related to unrecognized revenue from two-tier distributors	912	575
Total product deferred revenue	3,227	2,727

Edgar Filing: CISCO SYSTEMS INC - Form 10-Q

Total	\$	9,300	\$	8,860
Reported as:				
Current	\$	6,592	\$	6,197
Noncurrent		2,708		2,663
Total	\$	9,300	\$	8,860

Table of Contents**6. Financing Arrangements****(a) Lease Receivables**

Lease receivables represent sales-type and direct-financing leases resulting from the sale of the Company's and complementary third-party products. These lease arrangements typically have terms from two to three years and are generally collateralized by a security interest in the underlying assets. The net lease receivables are summarized as follows (in millions):

	January 24, 2009	July 26, 2008
Gross lease receivables	\$ 1,789	\$ 1,730
Unearned income	(176)	(178)
Allowances	(189)	(136)
Lease receivables, net	\$ 1,424	\$ 1,416
Reported as:		
Current	\$ 550	\$ 554
Noncurrent	874	862
Lease receivables, net	\$ 1,424	\$ 1,416

Contractual maturities of the gross lease receivables at January 24, 2009 were \$390 million in the remaining six months of fiscal 2009, \$597 million in fiscal 2010, \$432 million in fiscal 2011, \$242 million in fiscal 2012, and \$128 million in fiscal 2013 and thereafter. Actual cash collections may differ from the contractual maturities due to early customer buyouts, refinancings, or defaults.

(b) Financed Service Contracts

Financed service contracts are summarized as follows (in millions):

	January 24, 2009	July 26, 2008
Gross financed service contracts	\$ 1,326	\$ 1,328
Allowances	(25)	(10)
Financed service contracts, net	\$ 1,301	\$ 1,318
Reported as:		
Current	\$ 751	\$ 730
Noncurrent	550	588
Financed service contracts, net	\$ 1,301	\$ 1,318

The revenue related to financed service contracts, which primarily relates to technical support services, is deferred and included in deferred service revenue. The revenue is recognized ratably over the period during which the related services are to be performed, which is typically from one to three years.

Table of Contents**(c) Loan Receivables**

Loan receivables are summarized as follows (in millions):

	January 24, 2009	July 26, 2008
Gross loan receivables	\$ 670	\$ 607
Allowances	(106)	(128)
Loan receivables, net	\$ 564	\$ 479
Reported as:		
Current	\$ 260	\$ 263
Noncurrent	304	216
Loan receivables, net	\$ 564	\$ 479

A portion of the revenue related to loan receivables is deferred and included in deferred product revenue based on revenue recognition criteria.

(d) Financing Guarantees

In the ordinary course of business, the Company provides financing guarantees, which are generally for various third-party financing arrangements extended to channel partners and other customers.

Channel Financing Guarantees

The Company facilitates financing arrangements for third-party financing extended to channel partners, consisting of revolving short-term financing, generally with payment terms ranging from 60 to 90 days. The Company receives a payment from the third-party financing organizations based on the Company's standard payment terms. These financing arrangements facilitate the working capital requirements of the channel partners and, in some cases, the Company guarantees a portion of these arrangements. During the three and six months ended January 24, 2009, the volume of channel partner financing was \$3.5 billion and \$7.6 billion, respectively, compared with \$3.5 billion and \$6.8 billion for the three and six months ended January 26, 2008, respectively. As of January 24, 2009 and July 26, 2008, the balance of the channel partner financing subject to guarantees was \$1.4 billion and \$1.7 billion, respectively.

Customer Financing Guarantees

The Company also provides financing guarantees for third-party financing arrangements extended to customers related to leases and loans, which typically have terms of three years. During the three and six months ended January 24, 2009, the volume of financing provided by third parties for leases and loans on which the Company has provided guarantees was \$246 million and \$644 million, respectively, compared with \$272 million and \$572 million for the three and six months ended January 26, 2008, respectively.

Guarantee Summary

The aggregate amount of guarantees outstanding at January 24, 2009 and July 26, 2008, representing the total maximum potential future payments under financing arrangements with third parties, and the related revenue deferred in accordance with revenue recognition policies and FIN 45 are summarized below (in millions):

	January 24, 2009	July 26, 2008
Maximum potential future payments relating to guarantees:		

Edgar Filing: CISCO SYSTEMS INC - Form 10-Q

Channel partner financing	\$ 427	\$ 450
Customer financing	409	380
Total	\$ 836	\$ 830
Deferred revenue associated with guarantees:		
Channel partner financing	\$ 266	\$ 263
Customer financing	362	347
Total	\$ 628	\$ 610

Table of Contents**7. Investments****(a) Summary of Investments**

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

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
January 24, 2009				
Fixed income securities:				
Government securities	\$ 9,192	\$ 115	\$ (3)	\$ 9,304
Government agency securities ⁽¹⁾	11,598	150	(1)	11,747
Corporate debt securities	3,409	38	(141)	3,306
Asset-backed securities	321		(37)	284
Total fixed income securities	24,520	303	(182)	24,641
Publicly traded equity securities	813	91	(189)	715
Total	\$ 25,333	\$ 394	\$ (371)	\$ 25,356

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
July 26, 2008				
Fixed income securities:				
Government securities	\$ 7,249	\$ 50	\$ (33)	\$ 7,266
Government agency securities	5,815	34	(10)	5,839
Corporate debt securities	5,814	24	(96)	5,742
Asset-backed securities	1,035	5	(18)	1,022
Total fixed income securities	19,913	113	(157)	19,869
Publicly traded equity securities	860	391	(76)	1,175
Total	\$ 20,773	\$ 504	\$ (233)	\$ 21,044

⁽¹⁾ Government agency securities as of January 24, 2009 include bank-issued securities that are guaranteed by the Federal Deposit Insurance Corporation (FDIC).

The Company's management has determined that the unrealized losses on its investment securities at January 24, 2009 are temporary in nature. The Company reviews its investments to identify and evaluate investments that have indications of possible impairment. Factors considered in determining whether a loss is temporary include the length of time and extent to which fair value has been less than the cost basis, the financial condition and near-term prospects of the investee, and the Company's intent and ability to hold the investment for a period of time sufficient to allow for any anticipated recovery in market value.

Table of Contents**(b) Gains and Losses on Investments**

The following table summarizes the realized net gains (losses) associated with the Company's investments (in millions):

	Three Months Ended		Six Months Ended	
	January 24, 2009	January 26, 2008	January 24, 2009	January 26, 2008
Net (losses) gains on investments in publicly traded equity securities	\$ (23)	\$ 39	\$ 68	\$ 84
Net (losses) gains on investments in fixed income securities	(7)	26	(159)	35
Net (losses) gains on investments	\$ (30)	\$ 65	\$ (91)	\$ 119

For the second quarter and first six months of fiscal 2009, net losses on fixed income securities included impairment charges of \$19 million and \$202 million, respectively, and net gains and losses on publicly traded equity securities included impairment charges of \$18 million and \$35 million, respectively. The impairment charges in both periods were due to a decline in the fair value of the investments below their cost basis that were judged to be other-than-temporary and were recorded as a reduction to the amortized cost of the respective investments. There were no impairments of fixed income securities or publicly traded equity securities during the first six months of fiscal 2008.

(c) Maturities of Fixed Income Securities

The following table summarizes the maturities of the Company's fixed income securities at January 24, 2009 (in millions):

	Amortized Cost	Fair Value
Less than 1 year	\$ 14,969	\$ 15,032
Due in 1 to 2 years	3,816	3,863
Due in 2 to 5 years	4,971	5,066
Due after 5 years	764	680
Total	\$ 24,520	\$ 24,641

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

Table of Contents

8. Fair Value Measures

SFAS 157 defines fair value as the price that would be received from selling an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. When determining the fair value measurements for assets and liabilities required or permitted to be recorded at fair value, the Company considers the principal or most advantageous market in which it would transact and it considers assumptions that market participants would use when pricing the asset or liability.

(a) Fair Value Hierarchy

SFAS 157 requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. SFAS 157 establishes a fair value hierarchy based on the level of independent, objective evidence surrounding the inputs used to measure fair value. A financial instrument's categorization within the fair value hierarchy is based upon the lowest level of input that is significant to the fair value measurement. SFAS 157 prioritizes the inputs into three levels that may be used to measure fair value:

Level 1

Level 1 applies to assets or liabilities for which there are quoted prices in active markets for identical assets or liabilities.

Level 2

Level 2 applies to assets or liabilities for which there are inputs other than quoted prices that are observable for the asset or liability such as quoted prices for similar assets or liabilities in active markets; quoted prices for identical assets or liabilities in markets with insufficient volume or infrequent transactions (less active markets); or model-derived valuations in which significant inputs are observable or can be derived principally from, or corroborated by, observable market data.

Level 3

Level 3 applies to assets or liabilities for which there are unobservable inputs to the valuation methodology that are significant to the measurement of the fair value of the assets or liabilities.

Table of Contents**(b) Assets and Liabilities Measured at Fair Value on a Recurring Basis**

Assets and liabilities measured at fair value on a recurring basis as of January 24, 2009 were as follows (in millions):

January 24, 2009	Fair Value Measurements Using			Total Balance
	Quoted Prices in Active Markets for Identical Instruments (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	
Assets:				
Money market funds	\$ 3,048	\$	\$	\$ 3,048
Government securities		9,383		9,383
Government agency securities		11,862		11,862
Corporate debt securities		3,308		3,308
Asset-backed securities			284	284
Publicly traded equity securities	715			715
Derivative assets		83		83
Total assets measured at fair value	\$ 3,763	\$ 24,636	\$ 284	\$ 28,683
Liabilities:				
Derivative liabilities	\$	\$ 77	\$	\$ 77
Total liabilities measured at fair value	\$	\$ 77	\$	\$ 77

Level 2 fixed income securities are priced using quoted market prices for similar instruments, non-binding market prices that are corroborated by observable market data, or discounted cash flow techniques. The Company's derivative instruments are classified as Level 2 as they are not actively traded and are valued using pricing models that use observable market inputs. Level 3 assets include asset-backed securities whose values are determined based on discounted cash flow models using inputs that the Company could not corroborate with market quotes.

Assets and liabilities measured at fair value on a recurring basis were presented on the Company's consolidated balance sheet as of January 24, 2009 as follows (in millions):

January 24, 2009	Fair Value Measurements Using			Total Balance
	Quoted Prices in Active Markets for Identical Instruments (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	
Cash equivalents	\$ 3,048	\$ 196	\$	\$ 3,244
Investments	715	24,357	284	25,356
Prepaid expenses and other current assets		83		83
Total assets measured at fair value	\$ 3,763	\$ 24,636	\$ 284	\$ 28,683
Other current liabilities	\$	\$ 77	\$	\$ 77
Total liabilities measured at fair value	\$	\$ 77	\$	\$ 77

Table of Contents

The following table presents a reconciliation for all assets measured at fair value on a recurring basis using significant unobservable inputs (Level 3) for the indicated periods (in millions):

	Asset-Backed Securities
BALANCE AT JULY 27, 2008	\$
Transfers in to Level 3	618
BALANCE AT OCTOBER 25, 2008	\$ 618
Total net losses (realized and unrealized):	
Included in other income (loss), net	(20)
Included in other comprehensive income	(15)
Purchases, sales, and maturities	(299)
BALANCE AT JANUARY 24, 2009	\$ 284
Impairment charges for the three months ended January 24, 2009 in other income (loss), net attributable to assets still held as of January 24, 2009	\$ (7)

(c) Assets Measured at Fair Value on a Nonrecurring Basis

The following table presents the Company's assets that were measured at fair value on a nonrecurring basis during the six months ended January 24, 2009 and the losses recorded to other income (loss), net during the three and six months ended January 24, 2009 on those assets (in millions):

	Fair Value Measured Using					
	Quoted Prices			Significant Unobservable Inputs (Level 3)	Impairment Charges for the Three Months Ended January 24, 2009	Impairment Charges for the Six Months Ended January 24, 2009
	Six Months Ended January 24, 2009	In Active Markets for Identical Instruments (Level 1)	Other Observable Inputs (Level 2)			
Investments in Privately Held Companies	\$ 40	\$	\$	\$ 40	\$ (30)	\$ (53)

The above assets, all still held as of January 24, 2009, were measured at fair value during the first six months of fiscal 2009 due to events or circumstances the Company identified that significantly impacted the fair value of these investments. The Company measured fair value using financial metrics, comparison to other private and public companies, analysis of the financial condition and near-term prospects of the investees, including recent financing activities and their capital structure as well as other economic variables. These investments were classified as Level 3 assets because the Company used unobservable inputs to value them, reflecting the Company's assumptions about the assumptions market participants would use in pricing these investments due to the absence of quoted market prices and inherent lack of liquidity.

Table of Contents**9. Borrowings****(a) Long-Term Debt**

In February 2006, the Company issued \$500 million of senior floating interest rate notes based on the London Interbank Offered Rate (LIBOR) due 2009 (the 2009 Notes), \$3.0 billion of 5.25% senior notes due 2011 (the 2011 Notes), and \$3.0 billion of 5.50% senior notes due 2016 (the 2016 Notes), for an aggregate principal amount of \$6.5 billion. The following table summarizes the Company's long-term debt (in millions, except percentages):

	January 24, 2009		July 26, 2008	
	Amount	Effective Rate	Amount	Effective Rate
Senior notes:				
Floating-rate notes, due 2009	\$ 500	2.23%	\$ 500	2.74%
5.25% fixed-rate notes, due 2011	3,000	3.12%	3,000	3.12%
5.50% fixed-rate notes, due 2016	3,000	4.34%	3,000	4.34%
Total senior notes	6,500		6,500	
Other notes	2		4	
Unaccreted discount	(13)		(15)	
Hedge accounting adjustment of the carrying amount of the fixed-rate debt	359		404	
Total	\$ 6,848		\$ 6,893	
Reported as:				
Current portion of long-term debt	\$ 500		\$ 500	
Long-term debt	6,348		6,393	
Total	\$ 6,848		\$ 6,893	

During the third quarter of fiscal 2008, the Company terminated the interest rate swaps entered into in connection with the 2011 Notes and the 2016 Notes and received proceeds of \$432 million, net of accrued interest, which was recorded as a hedge accounting adjustment of the carrying amount of the fixed-rate debt and is being amortized as a reduction to interest expense over the remaining terms of the fixed-rate notes. The effective rates for the fixed-rate debt include the interest on the notes, the amortization of the hedge accounting adjustment and the accretion of the discount.

The 2011 Notes and the 2016 Notes are redeemable by the Company at any time, subject to a make-whole premium. Based on market prices, the fair value of the Company's long-term debt, including the current portion of long-term debt, was \$6.9 billion as of January 24, 2009. The Company was in compliance with all debt covenants as of January 24, 2009.

Interest is payable quarterly on the 2009 Notes and semi-annually on the 2011 Notes and 2016 Notes. Interest expense and cash paid for interest are summarized as follows (in millions):

	Three Months Ended		Six Months Ended	
	January 24, 2009	January 26, 2008	January 24, 2009	January 26, 2008
Interest expense	\$ 63	\$ 91	\$ 127	\$ 187
Cash paid for interest	\$ 4	\$ 7	\$ 169	\$ 185

(b) Credit Facility

Edgar Filing: CISCO SYSTEMS INC - Form 10-Q

In August 2007, the Company entered into a credit agreement with certain institutional lenders that provides for a \$3.0 billion unsecured revolving credit facility that is scheduled to expire on August 17, 2012. Due to the bankruptcy of one of the lenders during the first quarter of fiscal 2009, the Company believes the amount available under the credit facility as of January 24, 2009 may be effectively reduced to \$2.9 billion.

Table of Contents

Any advances under the credit agreement will accrue interest at rates that are equal to, based on certain conditions, either (i) the higher of the Federal Funds rate plus 0.50% or Bank of America's prime rate as announced from time to time, or (ii) LIBOR plus a margin that is based on the Company's senior debt credit ratings as published by Standard & Poor's Ratings Services and Moody's Investors Service, Inc. The credit agreement requires that the Company maintain an interest coverage ratio as defined in the agreement.

As of January 24, 2009, the Company was in compliance with the required interest coverage ratio, and the Company had not borrowed any funds under the credit facility. The Company may also, upon the agreement of either the then existing lenders or of additional lenders not currently parties to the agreement, increase the commitments under the credit facility up to a total of \$5.0 billion and/or extend the expiration date of the credit facility up to August 15, 2014.

10. Derivative Instruments

The Company uses derivative instruments primarily to manage exposures to foreign currency, interest rate, and equity security price risks. The Company's primary objective in holding derivatives is to reduce the volatility of earnings and cash flows associated with changes in foreign currency, interest rates, and equity security prices. The Company's derivatives expose it to credit risk to the extent that the counterparties may be unable to meet the terms of the agreement. The Company seeks to mitigate such risks by limiting its counterparties to major financial institutions. In addition, the potential risk of loss with any one counterparty resulting from this type of credit risk is monitored. Management does not expect material losses as a result of defaults by counterparties.

(a) Foreign Currency Derivatives

The Company's foreign exchange forward and option contracts are summarized as follows (in millions):

	January 24, 2009		July 26, 2008	
	Notional Amount	Fair Value	Notional Amount	Fair Value
Forward contracts:				
Purchased	\$ 1,688	\$ (3)	\$ 1,803	\$ 5
Sold	\$ 904	\$ 86	\$ 902	\$ 2
Option contracts:				
Purchased	\$ 1,977	\$ 25	\$ 1,440	\$ 50
Sold	\$ 1,863	\$ (102)	\$ 1,256	\$ (6)

The Company conducts business globally in numerous currencies. As such, it is exposed to adverse movements in foreign currency exchange rates. To limit the exposure related to foreign currency changes, the Company enters into foreign currency contracts. The Company does not enter into foreign exchange forward or option contracts for trading purposes.

The Company enters into foreign exchange forward contracts to reduce the short-term effects of foreign currency fluctuations on assets and liabilities such as foreign currency receivables, including long-term customer financings, investments, and payables. Gains and losses on the contracts are included in other income (loss), net, and offset foreign exchange gains and losses from the revaluation of intercompany balances or other current assets, investments, or liabilities denominated in currencies other than the functional currency of the reporting entity. The Company's foreign exchange forward contracts related to current assets and liabilities generally range from one to three months in original maturity. Additionally, the Company has entered into foreign exchange forward contracts with maturities of up to two years related to long-term customer financings. The foreign exchange forward contracts related to investments generally have maturities of less than two years. The Company also hedges certain net investments in its foreign subsidiaries with forward contracts which generally have maturities of less than six months.

The Company hedges certain foreign currency forecasted transactions related to certain operating expenses and service cost of sales with currency options and forward contracts. These currency option and forward contracts, designated as cash flow hedges, generally have maturities of less than 18 months. The effective portion of the derivative's gain or loss is initially reported as a component of accumulated other comprehensive income (loss) and subsequently reclassified into earnings when the hedged exposure affects earnings. The ineffective portion, if any, of the gain or loss is reported in earnings immediately. During the six months ended January 24, 2009, and January 26, 2008, there were no significant gains or losses recognized in earnings for hedge ineffectiveness. The Company did not discontinue any hedges during any of the periods presented because it was probable that the original forecasted transaction would not occur.

Table of Contents**(b) Interest Rate Derivatives**

The Company's interest rate derivatives are summarized as follows (in millions):

	January 24, 2009		July 26, 2008	
	Notional Amount	Fair Value	Notional Amount	Fair Value
Interest rate swaps	\$	\$	\$ 1,000	\$ (4)

The Company's primary objective for holding fixed income securities is to achieve an appropriate investment return consistent with preserving principal and managing risk. To realize these objectives, the Company may utilize interest rate swaps or other derivatives designated as fair value or cash flow hedges. During the first six months of fiscal 2009, the Company received proceeds of \$1.0 billion for the underlying hedged investments and terminated the related interest rate swaps designated as fair value hedges.

(c) Equity Derivatives

The Company's equity derivatives are summarized as follows (in millions):

	January 24, 2009		July 26, 2008	
	Notional Amount	Fair Value	Notional Amount	Fair Value
Forward sale agreements	\$	\$	\$ 157	\$ 32

The Company maintains a portfolio of publicly traded equity securities that are subject to price risk. The Company may hold equity securities for strategic purposes or to diversify the Company's overall investment portfolio. To manage its exposure to changes in the fair value of certain equity securities, the Company may enter into equity derivatives, including forward sale and option agreements. The gains and losses due to changes in the value of the hedging instruments were included in other income (loss), net, and offset the change in the fair value of the underlying hedged investment. As of January 24, 2009, there were no outstanding forward sale agreements, as the Company terminated all of its previously existing forward sale agreements on publicly traded equity securities designated as fair value hedges during the first quarter of fiscal 2009.

(d) Other Derivative Instruments

The Company has entered into certain other derivative instruments, with immaterial fair market values, which are designed to hedge commodity-related expense items and deferred compensation liabilities.

11. Commitments and Contingencies**(a) Operating Leases**

The Company leases office space in several U.S. locations. Outside the United States, larger leased sites include sites in Australia, Belgium, China, France, Germany, India, Israel, Italy, Japan, and the United Kingdom. Future annual minimum lease payments under all noncancelable operating leases with an initial term in excess of one year as of January 24, 2009 are as follows (in millions):

Fiscal Year	Amount
2009 (remaining six months)	\$ 150
2010	225
2011	185

Edgar Filing: CISCO SYSTEMS INC - Form 10-Q

2012	138
2013	119
Thereafter	466
Total	\$ 1,283

Table of Contents***(b) Purchase Commitments with Contract Manufacturers and Suppliers***

The Company purchases components from a variety of suppliers and uses several contract manufacturers to provide manufacturing services for its products. During the normal course of business, in order to manage manufacturing lead times and help ensure adequate component supply, the Company enters into agreements with contract manufacturers and suppliers that either allow them to procure inventory based upon criteria as defined by the Company or that establish the parameters defining the Company's requirements. A significant portion of the Company's reported purchase commitments arising from these agreements are firm, noncancelable, and unconditional commitments. In certain instances, these agreements allow the Company the option to cancel, reschedule, and adjust the Company's requirements based on its business needs prior to firm orders being placed. As of January 24, 2009 and July 26, 2008, the Company had total purchase commitments for inventory of \$2.7 billion.

In addition, the Company records a liability for firm, noncancelable, and unconditional purchase commitments for quantities in excess of its future demand forecasts consistent with the valuation of the Company's excess and obsolete inventory. As of January 24, 2009 and July 26, 2008, the liability for these purchase commitments was \$219 million and \$184 million, respectively, and was included in other current liabilities.

(c) Compensation Expense Related to Acquisitions and Investments

In connection with the Company's purchase acquisitions, asset purchases, and acquisitions of variable interest entities, the Company has agreed to pay certain additional amounts contingent upon the achievement of certain agreed-upon technology, development, product, or other milestones or the continued employment with the Company of certain employees of acquired entities. See Note 3.

(d) Other Commitments

The Company also has certain funding commitments primarily related to its investments in privately held companies and venture funds, some of which are based on the achievement of certain agreed-upon milestones, and some of which are required to be funded on demand. The funding commitments were approximately \$293 million and \$359 million as of January 24, 2009 and July 26, 2008, respectively.

(e) Variable Interest Entities

In the ordinary course of business, the Company has investments in privately held companies and provides financing to certain customers. These privately held companies and customers may be considered to be variable interest entities. The Company has evaluated its investments in these privately held companies and its customer financings and has determined that there were no significant unconsolidated variable interest entities as of January 24, 2009.

(f) Product Warranties and Guarantees

The following table summarizes the activity related to the product warranty liability during the six months ended January 24, 2009 and January 26, 2008 (in millions):

	Six Months Ended	
	January 24, 2009	January 26, 2008
Balance at beginning of period	\$ 399	\$ 340
Provision for warranties issued	194	247
Payments	(234)	(233)
Fair value of warranty liability acquired		3
Balance at end of period	\$ 359	\$ 357

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

Edgar Filing: CISCO SYSTEMS INC - Form 10-Q

In the normal course of business, the Company indemnifies other parties, including customers, lessors, and parties to other transactions with the Company, with respect to certain matters. The Company has agreed to hold the other parties harmless against losses arising from a breach of representations or covenants, or out of intellectual property infringement or other claims made against certain parties. These agreements may limit the time within which an indemnification claim can be made and the amount of the claim. In addition, the Company has entered into indemnification agreements with its officers and directors, and the Company's bylaws contain similar indemnification obligations to the Company's agents. It is not possible to determine the maximum potential amount under these indemnification agreements due to the Company's limited history with prior indemnification claims and the unique facts and circumstances involved in each particular agreement. Historically, payments made by the Company under these agreements have not had a material effect on the Company's operating results, financial position, or cash flows.

Table of Contents

The Company also provides financing guarantees, which are generally for various third-party financing arrangements to channel partners and other customers. See Note 6. The Company's other arrangements as of January 24, 2009 that were subject to recognition and disclosure requirements under FIN 45 were not material.

(g) Legal Proceedings

Brazilian authorities are investigating the Company's Brazilian subsidiary and certain of its current and former employees, as well as a Brazilian importer of the Company's products, and its affiliates and employees, relating to the allegation of evading import taxes and other alleged improper transactions involving the subsidiary and the importer. The Company is conducting a thorough review of the matter. In December 2008, Brazilian authorities asserted claims against the Company for calendar year 2003 and the Company believes claims may also be asserted for calendar year 2004 through calendar year 2007. The Company believes the asserted claims are without merit and intends to defend the claims vigorously. The Company is unable to determine the likelihood of an unfavorable outcome on any potential further claims against it. While the Company believes there is no legal basis for its alleged liability, due to the complexities and uncertainty surrounding the judicial process in Brazil, and the nature of the claims asserting joint liability with the importer, the Company is unable to reasonably estimate a range of loss, if any. In addition, the Company is investigating the allegations regarding improper transactions, the Company has proactively communicated with United States authorities to provide information and report on its findings, and the United States authorities are currently investigating such allegations.

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

12. Shareholders Equity**(a) Stock Repurchase Program**

In September 2001, the Company's Board of Directors authorized a stock repurchase program. As of January 24, 2009, the Company's Board of Directors had authorized an aggregate repurchase of up to \$62 billion of common stock under this program and the remaining authorized repurchase amount was \$6.8 billion with no termination date. The stock repurchase activity under the stock repurchase program during the first six months of fiscal 2009 is summarized as follows (in millions, except per-share amounts):

	Shares Repurchased	Weighted- Average Price per Share	Amount Repurchased
Six Months Ended January 24, 2009			
Cumulative balance at July 26, 2008	2,600	\$ 20.60	\$ 53,579
Repurchase of common stock ⁽¹⁾	83	19.48	1,600
Cumulative balance at January 24, 2009	2,683	\$ 20.57	\$ 55,179

⁽¹⁾ Includes stock repurchases that were pending settlement as of January 24, 2009.

The purchase price for the shares of the Company's stock repurchased is reflected as a reduction to shareholders' equity. In accordance with Accounting Principles Board Opinion No. 6, Status of Accounting Research Bulletins, the Company is required to allocate the purchase price of the repurchased shares as (i) a reduction to retained earnings until retained earnings are zero and then as an increase to accumulated deficit and (ii) a reduction of common stock and additional paid-in capital. Issuance of common stock and the tax benefit related to employee stock incentive plans are recorded as an increase to common stock and additional paid-in capital.

Table of Contents**(b) Other Repurchases of Common Stock**

The Company also repurchases shares in settlement of employee tax withholding obligations due upon the vesting of restricted stock or stock units.

(c) Comprehensive Income

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

	Three Months Ended		Six Months Ended	
	January 24, 2009	January 26, 2008	January 24, 2009	January 26, 2008
Net income	\$ 1,504	\$ 2,060	\$ 3,705	\$ 4,265
Other comprehensive income:				
Change in unrealized gains and losses on investments, net of tax benefit (expense) of \$(8) and \$94, for the three and six months ended January 24, 2009, respectively and \$160 and \$(74) for the corresponding periods in fiscal 2008.	294	(181)	(178)	539
Cumulative translation adjustment and other	32	2	(585)	82
Comprehensive income before minority interest	1,830	1,881	2,942	4,886
Change in minority interest	6	50	31	(71)
Total	\$ 1,836	\$ 1,931	\$ 2,973	\$ 4,815

The Company consolidates its investment in a venture fund managed by SOFTBANK Corp. and its affiliates (SOFTBANK) as the Company is the primary beneficiary as defined under FIN 46(R). As a result, SOFTBANK 's interest in the change in the unrealized gains and losses on the investments in the venture fund is recorded as a component of accumulated other comprehensive income (loss) and is reflected as a change in minority interest.

13. Employee Benefit Plans**(a) Employee Stock Purchase Plan**

The Company has an Employee Stock Purchase Plan, which includes its sub-plan, the International Employee Stock Purchase Plan (together, the Purchase Plan), under which 321.4 million shares of the Company 's stock have been reserved for issuance. Eligible employees may purchase a limited number of shares of the Company 's stock at a discount of up to 15% of the lesser of the market value on the subscription date or the purchase date, which is approximately six months after the subscription date. The Purchase Plan terminates on January 3, 2010. The Company issued 14 million shares and 9 million shares, under the Purchase Plan, during the six months ended January 24, 2009 and January 26, 2008, respectively. As of January 24, 2009, 48 million shares were available for issuance under the Purchase Plan.

(b) Employee Stock Incentive Plans*Stock Incentive Plan Program Description*

As of January 24, 2009, the Company had five stock incentive plans: the 2005 Stock Incentive Plan (the 2005 Plan); the 1996 Stock Incentive Plan (the 1996 Plan); the 1997 Supplemental Stock Incentive Plan (the Supplemental Plan); the Cisco Systems, Inc. SA Acquisition Long-Term Incentive Plan (the SA Acquisition Plan); and the Cisco Systems, Inc. WebEx Acquisition Long-Term Incentive Plan (the WebEx Acquisition Plan). In addition, the Company has, in connection with the acquisitions of various companies, assumed the share-based awards granted under stock incentive plans of the acquired companies or issued share-based awards in replacement thereof. Share-based awards are designed to reward employees for their long-term contributions to the Company and provide incentives for them to remain with the Company. The number and frequency of share-based awards are based on competitive practices, operating results of the Company, government regulations, and other

Edgar Filing: CISCO SYSTEMS INC - Form 10-Q

factors. Since the inception of the stock incentive plans, the Company has granted share-based awards to a significant percentage of its employees, and the majority has been granted to employees below the vice president level. The Company's primary stock incentive plans are summarized as follows:

Table of Contents**2005 Plan**

As amended on November 15, 2007, the maximum number of shares issuable under the 2005 Plan over its term is 559 million shares plus the amount of any shares underlying awards outstanding on November 15, 2007 under the 1996 Plan, the SA Acquisition Plan and the WebEx Acquisition Plan that are forfeited or are terminated for any other reason before being exercised or settled. However, any shares underlying awards outstanding on November 15, 2007 under the 1996 Plan, the SA Acquisition Plan, and the WebEx Acquisition Plan that expire unexercised at the end of their maximum terms will not be considered to become available for reissuance under the 2005 Plan. If any awards granted under the 2005 Plan are forfeited or are terminated for any other reason before being exercised or settled, then the shares underlying the awards will again be available under the 2005 Plan. The number of shares available for issuance under the 2005 Plan will be reduced by 2.5 shares for each share awarded as stock grants or stock units.

The 2005 Plan permits the granting of stock options, stock, stock units, and stock appreciation rights to employees (including employee directors and officers) and consultants of the Company and its subsidiaries and affiliates, and non-employee directors of the Company. Stock options granted under the 2005 Plan have an exercise price of at least 100% of the fair market value of the underlying stock on the grant date and expire no later than nine years from the grant date. The stock options will generally become exercisable for 20% or 25% of the option shares one year from the date of grant and then ratably over the following 48 or 36 months, respectively. Stock grants and stock units will generally vest with respect to 20% or 25% of the shares covered by the grant on each of the first through fifth or fourth anniversaries of the date of the grant, respectively. The Compensation and Management Development Committee of the Board of Directors has the discretion to use different vesting schedules. Stock appreciation rights may be awarded in combination with stock options or stock grants and such awards shall provide that the stock appreciation rights will not be exercisable unless the related stock options or stock grants are forfeited. Stock grants may be awarded in combination with non-statutory stock options, and such awards may provide that the stock grants will be forfeited in the event that the related non-statutory stock options are exercised.

1996 Plan

The 1996 Plan expired on December 31, 2006, and the Company can no longer make equity awards under the 1996 Plan. The maximum number of shares issuable over the term of the 1996 Plan was 2.5 billion shares. Stock options granted under the 1996 Plan have an exercise price of at least 100% of the fair market value of the underlying stock on the grant date and expire no later than nine years from the grant date. The stock options generally become exercisable for 20% or 25% of the option shares one year from the date of grant and then ratably over the following 48 or 36 months, respectively. Certain other grants have utilized a 60-month ratable vesting schedule. In addition, the Board of Directors, or other committees administering the plan, have the discretion to use a different vesting schedule and have done so from time to time.

Supplemental Plan

The Supplemental Plan expired on December 31, 2007, and the Company can no longer make equity awards under the Supplemental Plan. Officers and members of the Company's Board of Directors were not eligible to participate in the Supplemental Plan. Nine million shares were reserved for issuance under the Supplemental Plan.

Acquisition Plans

In connection with the Company's acquisitions of Scientific-Atlanta, Inc. (Scientific-Atlanta) and WebEx Communications, Inc. (WebEx), the Company adopted the SA Acquisition Plan and the WebEx Acquisition Plan, respectively, each effective upon completion of the applicable acquisition. These plans constitute assumptions, amendments, restatements, and renamings of the 2003 Long-Term Incentive Plan of Scientific-Atlanta and the WebEx Communications, Inc. Amended and Restated 2000 Stock Incentive Plan, respectively. The plans permit the grant of stock options, stock, stock units, and stock appreciation rights to certain employees of the Company and its subsidiaries and affiliates who had been employed by Scientific-Atlanta or its subsidiaries or WebEx or its subsidiaries, as applicable. As a result of the shareholder approval of the amendment and extension of the 2005 Plan, as of November 15, 2007, the Company will no longer make stock option grants or direct share issuances under either the SA Acquisition Plan or the WebEx Acquisition Plan.

Table of Contents*General Share-Based Award Information*Stock Option Awards

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

	STOCK OPTIONS OUTSTANDING	
	Number Outstanding	Weighted-Average Exercise Price per Share
BALANCE AT JULY 28, 2007	1,289	\$ 26.60
Granted and assumed	159	31.12
Exercised	(146)	18.50
Canceled/forfeited/expired	(103)	30.74
BALANCE AT JULY 26, 2008	1,199	27.83
Granted and assumed	5	21.58
Exercised	(15)	15.74
Canceled/forfeited/expired	(137)	49.13
BALANCE AT JANUARY 24, 2009	1,052	\$ 25.19

The following table summarizes significant ranges of outstanding and exercisable stock options as of January 24, 2009 (in millions, except years and share prices):

Range of Exercise Prices	STOCK OPTIONS OUTSTANDING				STOCK OPTIONS EXERCISABLE		
	Number Outstanding	Weighted-Average Remaining Contractual Life (in Years)	Weighted-Average Exercise Price per Share	Aggregate Intrinsic Value	Number Exercisable	Weighted-Average Exercise Price per Share	Aggregate Intrinsic Value
\$ 0.01 15.00	88	3.22	\$ 11.20	\$ 413	82	\$ 11.28	\$ 373
15.01 18.00	186	4.47	17.29	3	136	17.10	3
18.01 20.00	249	4.07	19.22		214	19.24	
20.01 25.00	219	5.48	22.46		127	22.18	
25.01 30.00	53	6.77	26.70		19	26.97	
30.01 35.00	126	7.55	32.16		33	32.16	
35.01 50.00	9	0.93	43.09		9	43.09	
50.01 72.56	122	0.61	55.23		122	55.23	
Total	1,052	4.49	\$ 25.19	\$ 416	742	\$ 25.45	\$ 376

The aggregate intrinsic value in the preceding table represents the total pretax intrinsic value, based on the Company's closing stock price of \$15.89 as of January 23, 2009, which would have been received by the option holders had those option holders exercised their stock options as of that date. The total number of in-the-money stock options exercisable as of January 24, 2009 was 88 million. As of July 26, 2008, 795 million outstanding stock options were exercisable and the weighted-average exercise price was \$29.53.

Table of ContentsRestricted Stock and Stock Unit Awards

A summary of the restricted stock and stock unit activity is as follows (in millions, except per-share amounts):

	Restricted Stock/Stock Units	Weighted- Average Price per Share
BALANCE AT JULY 28, 2007	11	\$ 22.52
Granted and assumed	4	27.29
Vested	(4)	22.49
Canceled/forfeited	(1)	24.24
BALANCE AT JULY 26, 2008	10	24.27
Granted and assumed	33	22.65
Vested	(3)	23.44
BALANCE AT JANUARY 24, 2009	40	\$ 23.01

Certain of the restricted stock units are awarded contingent on the future achievement of financial performance metrics.

Share-Based Awards Available for Grant

A summary of share-based awards available for grant are as follows (in millions):

	Share- Based Awards Available for Grant
BALANCE AT JULY 28, 2007	294
Options granted and assumed	(159)
Restricted stock, stock units, and other share-based awards granted and assumed	(11)
Share-based awards canceled/forfeited/expired	27
Additional shares reserved	211
BALANCE AT JULY 26, 2008	362
Options granted and assumed	(5)
Restricted stock, stock units, and other share-based awards granted and assumed	(81)
Share-based awards canceled/forfeited/expired	22
Additional shares reserved	2
BALANCE AT JANUARY 24, 2009	300

As reflected in the table above, for each share awarded as restricted stock or subject to a restricted stock unit award under the 2005 Plan subsequent to November 15, 2007, an equivalent of 2.5 shares is deducted from the available share-based award balance.

Table of Contents*Valuation and Expense Information Under SFAS 123(R)*

Share-based compensation expense recognized under SFAS 123(R) consists primarily of expenses for stock options, stock purchase rights, restricted stock, and restricted stock units granted to employees. The following table summarizes employee share-based compensation expense (in millions):

	Three Months Ended		Six Months Ended	
	January 24, 2009	January 26, 2008	January 24, 2009	January 26, 2008
Cost of sales - product	\$ 10	\$ 11	\$ 21	\$ 20
Cost of sales - service	32	30	63	53
Employee share-based compensation expense in cost of sales	42	41	84	73
Research and development	84	81	166	146
Sales and marketing	104	111	217	210
General and administrative	46	40	91	70
Employee share-based compensation expense in operating expenses	234	232	474	426
Total employee share-based compensation expense ⁽¹⁾	\$ 276	\$ 273	\$ 558	\$ 499

⁽¹⁾ Share-based compensation expense of \$22 million and \$44 million related to acquisitions and investments for the three and six months ended January 24, 2009, respectively, and \$21 million and \$45 million for the three and six months ended January 26, 2008, respectively, is disclosed in Note 3 and is not included in the above table.

As of January 24, 2009, total compensation cost related to unvested share-based awards, including share-based compensation relating to acquisitions and investments, not yet recognized was \$3.3 billion, which is expected to be recognized over approximately 3.2 years on a weighted-average basis. The income tax benefit for employee share-based compensation expense was \$73 million and \$150 million for the three and six months ended January 24, 2009, respectively, and \$86 million and \$160 million for the three and six months ended January 26, 2008, respectively.

Valuation of Employee Stock Options and Employee Stock Purchase Rights

Upon adoption of SFAS 123(R) at the beginning of fiscal 2006, the Company began estimating the value of employee stock options and employee stock purchase rights on the date of grant using a lattice-binomial option-pricing model. The Company's employee stock options have vesting provisions and various restrictions including restrictions on transfer and hedging, among others, and are often exercised prior to their contractual maturity. Lattice-binomial models are more capable of incorporating the features of the Company's employee stock options than closed-form models such as the Black-Scholes model. The use of a lattice-binomial model requires extensive actual employee exercise behavior data and a number of complex assumptions including expected volatility, risk-free interest rate, expected dividends, kurtosis, and skewness.

The valuation of employee stock options is summarized as follows:

	Six Months Ended	
	January 24, 2009	January 26, 2008
Number of options granted (in millions)	5	142
Weighted-average assumptions:		
Expected volatility	37.6%	30.8%
Risk-free interest rate	2.9%	4.4%

Edgar Filing: CISCO SYSTEMS INC - Form 10-Q

Expected dividend	0.0%	0.0%
Kurtosis	4.6	4.6
Skewness	(0.28)	(0.80)
Weighted-average expected life (in years)	5.9	6.3
Weighted-average estimated grant date fair value (per option share)	\$ 6.85	\$ 9.87

Table of Contents

The valuation of employee stock purchase rights is summarized as follows:

	Six Months Ended	
	January 24, 2009	January 26, 2008
Expected volatility	43.4%	33.0%
Risk-free interest rate	0.3%	3.3%
Expected dividend	0.0%	0.0%
Weighted-average expected life (in years)	0.5	0.5
Weighted-average estimated grant date fair value (per share)	\$ 4.61	\$ 6.58

The determination of the fair value of share-based payment awards on the date of grant using the lattice-binomial model is impacted by the Company's stock price as well as assumptions regarding a number of highly complex and subjective variables. The weighted-average assumptions were determined as follows:

For employee stock options, the Company used the implied volatility for two-year traded options on the Company's stock as the expected volatility assumption required in the lattice-binomial model, consistent with SFAS 123(R) and SAB 107. For employee stock purchase rights, the Company used the implied volatility for six-month traded options on the Company's stock. The selection of the implied volatility approach was based upon the availability of actively traded options on the Company's stock and the Company's assessment that implied volatility is more representative of future stock price trends than historical volatility.

The risk-free interest rate assumption is based upon observed interest rates appropriate for the term of the Company's employee stock options and employee stock purchase rights.

The dividend yield assumption is based on the history and expectation of dividend payouts.

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

The expected life of employee stock options represents the weighted-average period the stock options are expected to remain outstanding and is a derived output of the lattice-binomial model. The expected life of employee stock options is impacted by all of the underlying assumptions and calibration of the Company's model. The lattice-binomial model assumes that employees' exercise behavior is a function of the option's remaining vested life and the extent to which the option is in-the-money. The lattice-binomial model estimates the probability of exercise as a function of these two variables based on the entire history of exercises and cancellations on all past option grants made by the Company.

Accuracy of Fair Value Estimates

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

Table of Contents**14. Income Taxes**

The following table provides details of income taxes (in millions, except percentages):

	Three Months Ended		Six Months Ended	
	January 24, 2009	January 26, 2008	January 24, 2009	January 26, 2008
Effective tax rate	19.5%	21.9%	17.2%	18.9%
Cash paid for income taxes	\$ 133	\$ 888	\$ 593	\$ 1,402

The effective tax rate for the six months ended January 24, 2009 reflected a \$106 million tax benefit recorded in the first quarter of fiscal 2009 as a result of the Tax Extenders and Alternative Minimum Tax Relief Act of 2008, which reinstated the U.S. federal R&D tax credit retroactive to January 1, 2008. The effective tax rate for the first six months of fiscal 2008 reflected a net tax benefit of \$162 million recorded in the first quarter of fiscal 2008 from the settlement of certain tax matters with the Internal Revenue Service (IRS).

The amount of unrecognized tax benefits was determined in accordance with Financial Interpretation No. 48, Accounting for Uncertainty in Income Taxes—an interpretation of FASB Statement No. 109 (FIN 48). The Company had \$2.6 billion of unrecognized tax benefits as of January 24, 2009, of which \$2.2 billion, if recognized, would favorably impact the effective tax rate at January 24, 2009. Although timing of the resolution of audits is highly uncertain, the Company does not believe it is reasonably possible that the total amount of unrecognized tax benefits as of January 24, 2009 will materially change in the next 12 months.

15. Segment Information and Major Customers

The Company's operations involve the design, development, manufacturing, marketing, and technical support of networking and other products and services related to the communications and information technology industry. Cisco products include routers, switches, advanced technologies, and other products. These products, primarily integrated by Cisco IOS Software, link geographically dispersed local-area networks (LANs), metropolitan-area networks (MANs) and wide-area networks (WANs).

(a) Net Sales and Gross Margin by Theater

The Company conducts business globally and is primarily managed on a geographic basis. The Company's management makes financial decisions and allocates resources based on the information it receives from its internal management system. Sales are attributed to a geographic theater based on the ordering location of the customer.

The Company does not allocate research and development, sales and marketing, or general and administrative expenses to its geographic theaters in this internal management system because management does not include the information in its measurement of the performance of the operating segments. In addition, the Company does not allocate amortization of acquisition-related intangible assets, share-based compensation expense, and the effects of purchase accounting adjustments to inventory to the gross margin for each theater because management does not include this information in its measurement of the performance of the operating segments.

Table of Contents

Summarized financial information by theater for the three and six months ended January 24, 2009 and January 26, 2008, based on the Company's internal management system and as utilized by the Company's Chief Operating Decision Maker (CODM), is as follows (in millions):

	Three Months Ended		Six Months Ended	
	January 24, 2009	January 26, 2008 ⁽³⁾	January 24, 2009	January 26, 2008 ⁽³⁾
Net sales:				
United States and Canada ⁽¹⁾	\$ 4,736	\$ 5,229	\$ 10,285	\$ 10,711
European Markets	2,008	1,988	4,161	3,899
Emerging Markets	1,089	1,230	2,318	2,102
Asia Pacific	923	1,053	1,945	2,035
Japan	333	331	711	638
Total	\$ 9,089	\$ 9,831	\$ 19,420	\$ 19,385
Gross margin:				
United States and Canada	\$ 3,020	\$ 3,436	\$ 6,690	\$ 7,075
European Markets	1,343	1,294	2,756	2,536
Emerging Markets	648	766	1,427	1,262
Asia Pacific	574	679	1,228	1,317
Japan	234	232	495	450
Theater total	5,819	6,407	12,596	12,640
Unallocated corporate items ⁽²⁾	(96)	(102)	(192)	(195)
Total	\$ 5,723	\$ 6,305	\$ 12,404	\$ 12,445

(1) Net sales in the United States were \$4.5 billion and \$5.0 billion for the three months ended January 24, 2009 and January 26, 2008, respectively. Net sales in the United States were \$9.7 billion and \$10.2 billion for the six months ended January 24, 2009 and January 26, 2008, respectively.

(2) The unallocated corporate items for the three and six months ended January 24, 2009 and January 26, 2008 include the effects of amortization of purchased intangible assets and share-based compensation expense.

(3) Certain reclassifications have been made to prior period amounts to conform to the current period's presentation.

(b) Net Sales for Groups of Similar Products and Services

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

	Three Months Ended		Six Months Ended	
	January 24, 2009	January 26, 2008 ⁽¹⁾	January 24, 2009	January 26, 2008 ⁽¹⁾
Net sales:				
Routers	\$ 1,523	\$ 1,967	\$ 3,407	\$ 3,830
Switches	3,019	3,380	6,614	6,697
Advanced technologies	2,388	2,363	5,102	4,688
Other	417	535	859	1,045
Product	7,347	8,245	15,982	16,260

Edgar Filing: CISCO SYSTEMS INC - Form 10-Q

Service	1,742	1,586	3,438	3,125
Total	\$ 9,089	\$ 9,831	\$ 19,420	\$ 19,385

⁽¹⁾ Certain reclassifications have been made to prior period amounts to conform to the current period's presentation. The Company refers to some of its products and technologies as advanced technologies. As of January 24, 2009, the Company had identified the following advanced technologies for particular focus: application networking services, home networking, security, storage area networking, unified communications, video systems, and wireless technology. The Company continues to identify additional advanced technologies for focus and investment in the future, and the Company's investments in some previously identified advanced technologies may be curtailed or eliminated depending on market developments.

Table of Contents**(c) Other Segment Information**

The majority of the Company's assets, excluding cash and cash equivalents and investments, as of January 24, 2009 and July 26, 2008 were attributable to its U.S. operations. The Company's total cash and cash equivalents and investments held outside of the United States in various foreign subsidiaries was \$26.3 billion as of January 24, 2009, and the remaining \$3.2 billion was held in the United States. For the three months and six months ended January 24, 2009 and January 26, 2008, no single customer accounted for 10% or more of the Company's net sales.

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

	January 24, 2009	July 26, 2008
Property and equipment, net:		
United States	\$ 3,487	\$ 3,478
International	654	673
Total	\$ 4,141	\$ 4,151

16. Net Income per Share

SFAS No. 128, Earnings per Share, requires that employee equity share options, unvested shares, and similar equity instruments granted by the Company be treated as potential common shares outstanding in computing diluted earnings per share. Diluted shares outstanding include the dilutive effect of in-the-money options and nonvested restricted stock and stock units, which is calculated based on the average share price for each fiscal period using the treasury stock method. Under the treasury stock method, the amount the employee must pay for exercising stock options, the amount of compensation cost for future service that the Company has not yet recognized, and the amount of tax benefits that would be recorded in additional paid-in capital when the award becomes deductible are assumed to be used to repurchase shares. The following table presents the calculation of basic and diluted net income per share (in millions, except per-share amounts):

	Three Months Ended		Six Months Ended	
	January 24, 2009	January 26, 2008	January 24, 2009	January 26, 2008
Net income	\$ 1,504	\$ 2,060	\$ 3,705	\$ 4,265
Weighted-average shares - basic	5,848	6,010	5,865	6,049
Effect of dilutive potential common shares	16	192	36	224
Weighted-average shares - diluted	5,864	6,202	5,901	6,273
Net income per share - basic	\$ 0.26	\$ 0.34	\$ 0.63	\$ 0.71
Net income per share - diluted	\$ 0.26	\$ 0.33	\$ 0.63	\$ 0.68
Antidilutive employee share based awards	963	456	823	397

17. Subsequent Event

On February 9, 2009 the Company filed a Form S-3 Registration Statement with the Securities and Exchange Commission to offer debt securities, subject to market conditions. On February 9, 2009, the Company also entered into an underwriting agreement to issue senior unsecured notes in aggregate principal amount of \$4.0 billion under the Registration Statement. Of these notes, \$2.0 billion will mature in 2019

Edgar Filing: CISCO SYSTEMS INC - Form 10-Q

and bear interest at a fixed rate of 4.95% per annum and \$2.0 billion will mature in 2039 and bear interest at a fixed rate of 5.90% per annum. This offering is expected to be completed in February 2009, subject to customary closing conditions. The Company intends to use the proceeds from the offering for general corporate purposes and to repay its floating rate notes due in February 2009, in the aggregate principal amount of \$500 million.

Table of Contents

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

Forward-Looking Statements

This Quarterly Report on Form 10-Q, including this Management's Discussion and Analysis of Financial Condition and Results of Operations, contains forward-looking statements regarding future events and our future results that are subject to the safe harbors created under the Securities Act of 1933 (the Securities Act) and the Securities Exchange Act of 1934 (the Exchange Act). All statements other than statements of historical facts are statements that could be deemed forward-looking statements. These statements are based on current expectations, estimates, forecasts, and projections about the industries in which we operate and the beliefs and assumptions of our management. Words such as expects, anticipates, targets, goals, projects, intends, plans, believes, seeks, estimates, continues, endeavors, may, variations of such expressions are intended to identify such forward-looking statements. In addition, any statements that refer to projections of our future financial performance, our anticipated growth and trends in our businesses, and other characterizations of future events or circumstances are forward-looking statements. Readers are cautioned that these forward-looking statements are only predictions and are subject to risks, uncertainties, and assumptions that are difficult to predict, including those identified below, under Part II, Item 1A. Risk Factors, and elsewhere herein. Therefore, actual results may differ materially and adversely from those expressed in any forward-looking statements. We undertake no obligation to revise or update any forward-looking statements for any reason.

Overview

In the second quarter of fiscal 2009, our results reflected a 7.5% decrease in net sales compared with the second quarter of fiscal 2008. Net sales were relatively flat during the first six months of fiscal 2009 compared with the first six months of fiscal 2008. As the second quarter of fiscal 2009 progressed, we saw our markets becoming increasingly affected by the continuing global macroeconomic downturn, especially in January 2009, the final month of the quarter. Compared with the corresponding periods of fiscal 2008, net income decreased by 27% and 13% in the second quarter and the first six months of fiscal 2009, respectively, as a result of the lower revenue and lower gross margins. We have undertaken initiatives to reduce our operating expenses, which are expected to have a further impact in future periods. Lower interest and other income during the second quarter and the first six months of fiscal 2009 also contributed to the decrease in net income. Net income per diluted share decreased by 21% and 7% in the second quarter and the first six months of fiscal 2009, respectively, compared with the corresponding periods of fiscal 2008.

The downturn which first started in the United States clearly has spread to customers in our other geographic theaters. During the second quarter and first six months of fiscal 2009, the declines in the enterprise and service provider markets were the most significant and were characterized by cautious spending by customers in those markets. During the second quarter of fiscal 2009, we experienced stronger sales to the public sector relative to our other customer markets. We believe it is likely that this economic downturn will persist; however, we cannot predict its severity or duration.

Strategy and Focus Areas

Drawing from our experience from managing through economic downturns in the past, we have developed a multifaceted strategy for addressing the current economic downturn that involves the following:

Vision, strategy, and execution: We believe our vision of how the industry will evolve is being driven by the increasing role intelligent networks will play as nearly all forms of communication and information technology are enabled by the network. This transition appears to be occurring as we expected. Our differentiated strategy enabled by networked collaboration, we believe, will allow us to move into market adjacencies with speed, scale and flexibility. We intend to remain focused on both the technology and business architectures to enable our customers' objectives.

Collaboration and Web 2.0: The investments we have made and our architectural approach are based on the belief that collaboration and networked Web 2.0 technologies that enable user collaboration, including unified communications and Cisco TelePresence systems, and the increased use of the network as the platform for all forms of communications and information technology will create new market opportunities for us. As part of the second major phase of the Internet, we believe the industry is evolving as personal and business process collaboration enabled by networked Web 2.0 technologies such as wikis and blogs help to increase innovation and productivity. We will attempt to lead this market transition through product development and adoption in the external customer marketplace and through our own internal adoption and use.

Table of Contents

Resource management and realignment: During the second quarter of fiscal 2009, we continued to realign resources to increase the focus on our priorities and reduce expenses. During the second half of fiscal 2009, we plan to continue this realignment and our expense reduction initiatives, which include a pause in hiring, as well as reducing certain discretionary expenses such as travel, offsite meetings, outside services, marketing, and other expenses.

Implementation of our strategy: During the economic downturn, we will attempt to prudently take advantage of opportunities to capture market transitions and to put our assets to use in existing and new markets when the macroeconomic recovery occurs. In addition to collaboration and Web 2.0, we will endeavor to prioritize and focus on continuing to evolve into a next-generation company and developing next-generation customer relationships, the data center and virtualization, video, and globalization.

Focus on the United States and selected emerging countries: We intend to devote particular attention to two distinct geographic sectors: the United States and selected emerging countries. We believe it is likely that since the economic uncertainty began in the United States, the U.S. economy may be the first major economy to recover. We also believe that selected emerging countries may be less adversely impacted during this economic downturn as compared with other countries.

The network as the platform: We believe that the growth we experienced in previous quarters was attributable to the continued deployment by customers of our end-to-end architecture and the convergence of data, voice, video, and mobility into IP networks. Video applications, including IP television (IPTV), Cisco TelePresence systems, unified communications, physical security and other video products, have the potential to accelerate the growth of bandwidth demand and to increase loads on networks, which may require upgrades to existing networks.

As we have done in the past, we will attempt to use the current economic downturn as an opportunity to expand our share of our customers information technology spending and to continue moving into product markets similar, related, or adjacent to those in which we currently are active, which we refer to as product adjacencies. Our approach of aiming to achieve balance across products and services, customer markets and geographic theaters has contributed to the growth we experienced in the past. We have delivered several new products recently, and we are pleased with the breadth and depth of our innovation across all aspects of our business and the impact that we believe this innovation will have on our long-term prospects. We believe that our strategy and our ability to innovate and execute may enable us to improve our relative competitive position in difficult business conditions and may continue to provide us with long-term growth opportunities.

Revenue

For the second quarter of fiscal 2009, revenue in three of our geographic theaters decreased year over year, while revenue grew by 1% in our European Markets and Japan theaters compared with the second quarter of fiscal 2008. For the first six months of fiscal 2009, total revenue growth was relatively flat compared with the first six months of fiscal 2008, with the revenue increases in our Emerging Markets, Japan and European Markets theaters being offset by the revenue decreases in the United States and Canada and Asia Pacific theaters.

In the second quarter and first six months of fiscal 2009, our net service revenue increased by approximately 10% compared with the corresponding periods of fiscal 2008. Our service and support strategy seeks to capitalize on increased globalization, and we believe this strategy, along with our architectural approach, has the potential to further differentiate us from competitors. Among our product categories, only the advanced technologies category achieved year-over-year revenue growth in the second quarter, with growth in the second quarter and the first six months of fiscal 2009 of 1% and 9%, respectively. The increase in our sales of advanced technologies reflects our balanced product portfolio and our efforts to constantly innovate and evolve into new markets and product adjacencies. Categories within our advanced technologies that showed relative strength during the second quarter of fiscal 2009 were video systems and security products.

In the second quarter and the first six months of fiscal 2009, our revenue from routing products declined by 23% and 11%, respectively compared with the corresponding periods of fiscal 2008, as revenue from high-end, midrange and low-end routers decreased. In the second quarter and the first six months of fiscal 2009, our revenue from switching products declined by 11% and 1%, respectively, compared with the corresponding periods of fiscal 2008.

In view of the decline in our business that we began to experience in the first quarter of fiscal 2009, a decline that continued throughout the second quarter of fiscal 2009 with particular weakness in January 2009, we anticipate that our revenue will continue to decline on a year-over-year basis in the third quarter of fiscal 2009.

Table of Contents

Operating Margin

In the second quarter and the first six months of fiscal 2009, our gross margin percentage decreased compared with the corresponding periods of fiscal 2008. The decrease was driven by lower product gross margin, which was due to higher sales discounts and rebates, product mix, product pricing, and lower shipment volume, partially offset by lower manufacturing costs. If our shipment volumes, product mix, pricing or other significant factors that impact our gross margin continue to be adversely affected by the economic downturn or market factors, our gross margin could continue to be adversely affected. The decrease in our product margin during the second quarter and first six months of fiscal 2009 was partially offset by higher service margins.

Operating expenses in the second quarter and the first six months of fiscal 2009 increased in both absolute dollars and as a percentage of revenue compared with the corresponding periods of fiscal 2008. For the second quarter and first six months of fiscal 2009, the increase was primarily a result of acquisition-related milestone payments and, for the first six months of fiscal 2009, higher headcount-related expenses also contributed to the increase. In the near term, we anticipate that despite the efforts to reduce operating expenses, operating expenses will continue to increase as a percentage of total revenue, as the anticipated cost savings may not keep pace with expected revenue declines.

Other Financial Highlights

The following is a summary of other financial highlights for the second quarter and first six months of fiscal 2009:

We generated cash flows from operations of \$3.2 billion and \$5.9 billion during the second quarter and first six months of fiscal 2009, respectively. Our cash and cash equivalents, together with our investments, were \$29.5 billion at the end of the second quarter of fiscal 2009, compared with \$26.2 billion at the end of fiscal 2008.

Our deferred revenue at the end of the second quarter of fiscal 2009 was \$9.3 billion, compared with \$8.9 billion at the end of fiscal 2008.

We repurchased 37 million shares of our common stock for \$600 million during the second quarter of fiscal 2009 and 83 million shares of our common stock for \$1.6 billion for the first six months of fiscal 2009.

Days sales outstanding in accounts receivable (DSO) at the end of the second quarter of fiscal 2009 was 29 days, compared with 34 days at the end of fiscal 2008.

Our inventory balance was \$1.1 billion at the end of the second quarter of fiscal 2009, compared with \$1.2 billion at the end of fiscal 2008. Annualized inventory turns were 11.6 in the second quarter of fiscal 2009, compared with 11.9 in the fourth quarter of fiscal 2008. Our purchase commitments with contract manufacturers and suppliers were \$2.7 billion at the end of the second quarter of fiscal 2009 and at the end of fiscal 2008.

We believe that our strong cash position, our solid balance sheet, our visibility into our supply chain, our strong investment portfolio management, and our financing capabilities together provide a key competitive advantage and collectively enable us to be well positioned to manage our business through the current economic downturn.

Critical Accounting Estimates

The preparation of financial statements and related disclosures in conformity with accounting principles generally accepted in the United States requires us to make judgments, assumptions, and estimates that affect the amounts reported in the Consolidated Financial Statements and accompanying notes. Note 2 to the Consolidated Financial Statements in our Annual Report on Form 10-K for the fiscal year ended July 26, 2008 describes the significant accounting policies and methods used in the preparation of the Consolidated Financial Statements.

Edgar Filing: CISCO SYSTEMS INC - Form 10-Q

The accounting policies described below are significantly affected by critical accounting estimates. Such accounting policies require significant judgments, assumptions, and estimates used in the preparation of the Consolidated Financial Statements, and actual results could differ materially from the amounts reported based on these policies.

Revenue Recognition

Our products are generally integrated with software that is essential to the functionality of the equipment. Additionally, we provide unspecified software upgrades and enhancements related to the equipment through our maintenance contracts for most of our products. Accordingly, we account for revenue in accordance with Statement of Position No. 97-2, Software Revenue Recognition, and all related interpretations. For sales of products where software is incidental to the equipment, or in hosting arrangements, we apply the provisions of Staff Accounting Bulletin No. 104, Revenue Recognition, and all related interpretations. Revenue is recognized when all of the following criteria have been met:

When persuasive evidence of an arrangement exists. Contracts, Internet commerce agreements, and customer purchase orders are generally used to determine the existence of an arrangement.

Table of Contents

Delivery has occurred. Shipping documents and customer acceptance, when applicable, are used to verify delivery.

The fee is fixed or determinable. We assess whether the fee is fixed or determinable based on the payment terms associated with the transaction and whether the sales price is subject to refund or adjustment.

Collectibility is reasonably assured. We assess collectibility based primarily on the creditworthiness of the customer as determined by credit checks and analysis, as well as the customer's payment history.

In instances where final acceptance of the product, system, or solution is specified by the customer, revenue is deferred until all acceptance criteria have been met. When a sale involves multiple elements, such as sales of products that include services, the entire fee from the arrangement is allocated to each respective element based on its relative fair value and recognized when revenue recognition criteria for each element are met. The amount of product and service revenue recognized is affected by our judgment as to whether an arrangement includes multiple elements and, if so, whether vendor-specific objective evidence of fair value exists. Changes to the elements in an arrangement and our ability to establish vendor-specific objective evidence for those elements could affect the timing of the revenue recognition.

Revenue deferrals relate to the timing of revenue recognition for specific transactions based on financing arrangements, service, support, and other factors. Financing arrangements may include sales-type, direct-financing, and operating leases, loans, and guarantees of third-party financing. Our total deferred revenue for products was \$3.2 billion and \$2.7 billion as of January 24, 2009 and July 26, 2008, respectively. Technical support services revenue is deferred and recognized ratably over the period during which the services are to be performed, which typically ranges from one to three years. Advanced services revenue is recognized upon delivery or completion of performance. Our total deferred revenue for services was \$6.1 billion as of January 24, 2009 and July 26, 2008.

We make sales to distributors and retail partners and recognize revenue based on a sell-through method using information provided by them. Our distributors and retail partners participate in various cooperative marketing and other programs, and we maintain estimated accruals and allowances for these programs. If actual credits received by our distributors and retail partners under these programs were to deviate significantly from our estimates, which are based on historical experience, our revenue could be adversely affected.

Allowance for Doubtful Accounts and Sales Returns

Our accounts receivable balance, net of allowance for doubtful accounts, was \$2.9 billion and \$3.8 billion as of January 24, 2009 and July 26, 2008, respectively. The allowance for doubtful accounts was \$230 million, or 7.4% of the gross accounts receivable balance, as of January 24, 2009, and \$177 million, or 4.4% of the gross accounts receivable balance, as of July 26, 2008. The allowance is based on our assessment of the collectibility of customer accounts. We regularly review the allowance by considering factors such as historical experience, credit quality, age of the accounts receivable balances, and current economic conditions that may affect a customer's ability to pay.

Our provision for doubtful accounts was \$59 million and \$29 million for the first six months of fiscal 2009 and 2008, respectively. If a major customer's creditworthiness deteriorates, or if actual defaults are higher than our historical experience, or if other circumstances arise, our estimates of the recoverability of amounts due to us could be overstated, and additional allowances could be required, which could have an adverse impact on our revenue.

A reserve for future sales returns is established based on historical trends in product return rates. The reserve for future sales returns as of January 24, 2009 and July 26, 2008 was \$98 million and \$103 million, respectively, and was recorded as a reduction of our accounts receivable. If the actual future returns were to deviate from the historical data on which the reserve had been established, our revenue could be adversely affected.

Inventory Valuation and Liability for Purchase Commitments with Contract Manufacturers and Suppliers

Our inventory balance was \$1.1 billion and \$1.2 billion as of January 24, 2009 and July 26, 2008, respectively. Inventory is written down based on excess and obsolete inventories determined primarily by future demand forecasts. Inventory write-downs are measured as the difference between the cost of the inventory and market based upon assumptions about future demand and are charged to the provision for inventory, which is a component of our cost of sales. At the point of the loss recognition, a new, lower cost basis for that inventory is established, and subsequent changes in facts and circumstances do not result in the restoration or increase in that newly established cost basis.

Table of Contents

We record a liability for firm, noncancelable, and unconditional purchase commitments with contract manufacturers and suppliers for quantities in excess of our future demand forecasts consistent with the valuation of our excess and obsolete inventory. As of January 24, 2009, the liability for these purchase commitments was \$219 million, compared with \$184 million as of July 26, 2008 and was included in other current liabilities.

Our provision for inventory was \$25 million and \$70 million for the first six months of fiscal 2009 and 2008, respectively. The provision for the liability related to purchase commitments with contract manufacturers and suppliers was \$79 million and \$37 million for the first six months of fiscal 2009 and 2008, respectively. If there were to be a sudden and significant decrease in demand for our products, or if there were a higher incidence of inventory obsolescence because of rapidly changing technology and customer requirements, we could be required to increase our inventory write-downs and our liability for purchase commitments with contract manufacturers and suppliers and gross margin could be adversely affected. Inventory and supply chain management remain areas of focus as we balance the need to maintain supply chain flexibility to help ensure competitive lead times with the risk of inventory obsolescence.

Warranty Costs

The liability for product warranties, included in other current liabilities, was \$359 million as of January 24, 2009, compared with \$399 million as of July 26, 2008. See Note 11 to the Consolidated Financial Statements. Our products are generally covered by a warranty for periods ranging from 90 days to five years, and for some products we provide a limited lifetime warranty. We accrue for warranty costs as part of our cost of sales based on associated material costs, technical support labor costs, and associated overhead. Material cost is estimated based primarily upon historical trends in the volume of product returns within the warranty period and the cost to repair or replace the equipment. Technical support labor cost is estimated based primarily upon historical trends in the rate of customer cases and the cost to support the customer cases within the warranty period. Overhead cost is applied based on estimated time to support warranty activities.

The provision for product warranties issued during the first six months of fiscal 2009 and 2008 was \$194 million and \$247 million, respectively. If we experience an increase in warranty claims compared with our historical experience, or if the cost of servicing warranty claims is greater than expected, our gross margin could be adversely affected.

Share-Based Compensation Expense

Share-based compensation expense recognized under SFAS 123(R) was as follows (in millions):

	Three Months Ended		Six Months Ended	
	January 24, 2009	January 26, 2008	January 24, 2009	January 26, 2008
Employee share-based compensation expense	\$ 276	\$ 273	\$ 558	\$ 499
Share-based compensation expense related to acquisitions and investments	22	21	44	45
Total	\$ 298	\$ 294	\$ 602	\$ 544

The determination of fair value of share-based payment awards on the date of grant using an option-pricing model is affected by our stock price as well as assumptions regarding a number of highly complex and subjective variables. These variables include, but are not limited to, the expected stock price volatility over the term of the awards and actual and projected employee stock option exercise behaviors. The use of a lattice-binomial model requires extensive actual employee exercise behavior data and a number of complex assumptions including expected volatility, risk-free interest rate, expected dividends, kurtosis, and skewness.

Because share-based compensation expense recognized in the Consolidated Statements of Operations is based on awards ultimately expected to vest, it has been reduced for forfeitures. If factors change and we employ different assumptions in the application of SFAS 123(R) in future periods, the compensation expense that we record under SFAS 123(R) may differ significantly from what we have recorded in the current period.

Table of Contents*Fair Value Measurements*

Our fixed income and publicly traded equity securities, collectively, are reflected in the Consolidated Balance Sheets at a fair value of \$25.3 billion as of January 24, 2009, compared with \$21.0 billion as of July 26, 2008. See Note 7 to the Consolidated Financial Statements. We apply SFAS 157 in determining the fair value of our investment securities. As described more fully in Note 8 to the Consolidated Financial Statements, SFAS 157 establishes a valuation hierarchy based on the level of independent, objective evidence available regarding the value of the investments. It establishes three classes of investments: Level 1 consists of securities for which there are quoted prices in active markets for identical securities; Level 2 consists of securities for which inputs other than Level 1 inputs are used, such as prices for similar securities in active markets or for identical securities in inactive markets and model-derived valuations for which the variables are derived from, or corroborated by, observable market data; and Level 3 consists of securities for which there are unobservable inputs to the valuation methodology that are significant to the measurement of the fair value.

Our fixed income investment portfolio consists primarily of high quality investment grade securities and as of January 24, 2009 had a weighted-average credit rating exceeding AA. Our Level 2 securities are valued using quoted market prices for similar instruments, non-binding market prices that are corroborated by observable market data, or discounted cash flow techniques in limited circumstances. We use inputs such as actual trade data, benchmark yields, broker/dealer quotes and other similar data which are obtained from independent pricing vendors, quoted market prices or other sources to determine the ultimate fair value of our assets and liabilities. We use such pricing data as the primary input, to which we have not made any material adjustments, to make our assessments and determinations as to the ultimate valuation of our investment portfolio, and we are ultimately responsible for the financial statements and underlying estimates. The fair value and inputs are reviewed for reasonableness, may be further validated by comparison to publicly available information and could be adjusted based on market indices or other information that management deems material to their estimate of fair value.

In the current market environment, the assessment of fair value can be difficult and subjective. However, because of the relative reliability of the inputs we use to value our investment portfolio, and because substantially all of our valuation inputs are obtained using quoted market prices for similar or identical assets, we do not believe that the nature of estimates and assumptions affected by levels of subjectivity and judgment was material to the valuation of the investment portfolio as of January 24, 2009. Level 3 assets do not represent a significant portion of our total investment portfolio as of January 24, 2009.

We recognize an impairment charge when the declines in the fair values of our fixed income or publicly traded equity securities fall below their cost basis and the declines are judged to be other-than-temporary. The ultimate value realized on these securities, to the extent unhedged, is subject to market price volatility until they are sold. We consider various factors in determining whether we should recognize an impairment charge, including the length of time and extent to which the fair value has been less than our cost basis, the financial condition and near-term prospects of the investee, and our intent and ability to hold the investment for a period of time sufficient to allow for any anticipated recovery in market value. Our ongoing consideration of these factors could result in additional impairment charges in the future, which could adversely affect our net income. The total impairment charges on investments in fixed income securities and publicly traded equity securities during the first six months of fiscal 2009 were \$237 million. There were no impairments of fixed income or publicly traded equity securities during the first six months of fiscal 2008. Our impairment charges on investments in privately held companies were \$53 million and \$8 million during the first six months of fiscal 2009 and 2008, respectively.

Table of Contents*Goodwill Impairments*

Our methodology for allocating the purchase price relating to purchase acquisitions is determined through established valuation techniques. Goodwill is measured as the excess of the cost of acquisition over the sum of the amounts assigned to tangible and identifiable intangible assets acquired less liabilities assumed. We perform goodwill impairment tests on an annual basis and between annual tests in certain circumstances for each reporting unit. The goodwill recorded in the Consolidated Balance Sheets as of January 24, 2009 and July 26, 2008 was \$12.6 billion and \$12.4 billion, respectively. In response to changes in industry and market conditions, we could be required to strategically realign our resources and consider restructuring, disposing of, or otherwise exiting businesses, which could result in an impairment of goodwill. There was no impairment of goodwill in the first six months of fiscal 2009 and 2008.

Income Taxes

We are subject to income taxes in the United States and numerous foreign jurisdictions. Our effective tax rates differ from the statutory rate primarily due to the tax impact of state taxes, foreign operations, R&D tax credits, tax audit settlements, nondeductible compensation, and international realignments. Our effective tax rate was 19.5% and 21.9% in second quarter of fiscal 2009 and 2008, respectively. The effective tax rate was 17.2% and 18.9% for the first six months of fiscal 2009 and 2008, respectively.

Significant judgment is required in evaluating our uncertain tax positions and determining our provision for income taxes. Although we believe our reserves are reasonable, no assurance can be given that the final tax outcome of these matters will not be different from that which is reflected in our historical income tax provisions and accruals. We adjust these reserves in light of changing facts and circumstances, such as the closing of a tax audit or the refinement of an estimate. To the extent that the final tax outcome of these matters is different than the amounts recorded, such differences will impact the provision for income taxes in the period in which such determination is made. The provision for income taxes includes the impact of reserve provisions and changes to reserves that are considered appropriate, as well as the related net interest.

Significant judgment is also required in determining any valuation allowance recorded against deferred tax assets. In assessing the need for a valuation allowance, we consider all available evidence, including past operating results, estimates of future taxable income, and the feasibility of tax planning strategies. In the event that we change our determination as to the amount of deferred tax assets that can be realized, we will adjust our valuation allowance with a corresponding impact to the provision for income taxes in the period in which such determination is made.

Our provision for income taxes is subject to volatility and could be adversely impacted by earnings being lower than anticipated in countries that have lower tax rates and higher than anticipated in countries that have higher tax rates; by changes in the valuation of our deferred tax assets and liabilities; by expiration of or lapses in the R&D tax credit laws; by transfer pricing adjustments including the effect of acquisitions on our intercompany R&D cost sharing arrangement and legal structure; by tax effects of nondeductible compensation; by tax costs related to intercompany realignments; or by changes in tax laws, regulations, or accounting principles, including accounting for uncertain tax positions or interpretations thereof. Significant judgment is required to determine the recognition and measurement attribute prescribed in FIN 48. In addition, FIN 48 applies to all income tax positions, including the potential recovery of previously paid taxes, which if settled unfavorably could adversely impact our provision for income taxes or additional paid-in capital. Further, as a result of certain of our ongoing employment and capital investment actions and commitments, our income in certain countries is subject to reduced tax rates and in some cases is wholly exempt from tax. Our failure to meet these commitments could adversely affect our provision for income taxes. In addition, we are subject to the continuous examination of our income tax returns by the Internal Revenue Service and other tax authorities. We regularly assess the likelihood of adverse outcomes resulting from these examinations to determine the adequacy of our provision for income taxes. There can be no assurance that the outcomes from these continuous examinations will not have an adverse impact on our operating results and financial condition.

Loss Contingencies

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

Third parties, including customers, have in the past and may in the future assert claims or initiate litigation related to exclusive patent, copyright, trademark, and other intellectual property rights to technologies and related standards that are relevant to us. These assertions have increased over time as a result of our growth and the general increase in the pace of patent claims assertions, particularly in the United States. If any infringement or other intellectual property claim made against us by any third party is successful, or if we fail to develop non-infringing technology or license the proprietary rights on commercially reasonable terms and conditions, our business, operating results, and financial

condition could be materially and adversely affected.

Table of Contents**Reclassifications**

During the first quarter of fiscal 2009, we began to allocate certain costs, which had previously been recorded in general and administrative expenses (related to information technology, financing business, and human resources), to sales and marketing, research and development, and cost of sales, as applicable. These changes also resulted in reclassifications to prior period gross margin by theater amounts. In addition, we have made certain reclassifications to prior period amounts relating to net sales by theater and net sales for similar groups of products due to refinement of the respective categories.

Net Sales

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

	Three Months Ended				Six Months Ended			
	January 24, 2009	January 26, 2008	Variance in Dollars	Variance in Percent	January 24, 2009	January 26, 2008	Variance in Dollars	Variance in Percent
Net sales:								
Product	\$ 7,347	\$ 8,245	\$ (898)	(10.9)%	\$ 15,982	\$ 16,260	\$ (278)	(1.7)%
Service	1,742	1,586	156	9.8%	3,438	3,125	313	10.0%
Total	\$ 9,089	\$ 9,831	\$ (742)	(7.5)%	\$ 19,420	\$ 19,385	\$ 35	0.2%

Net sales, which include product and service revenue, for each theater are summarized in the following table (in millions, except percentages):

	Three Months Ended				Six Months Ended			
	January 24, 2009	January 26, 2008	Variance in Dollars	Variance in Percent	January 24, 2009	January 26, 2008	Variance in Dollars	Variance in Percent
Net sales:								
United States and Canada	\$ 4,736	\$ 5,229	\$ (493)	(9.4)%	\$ 10,285	\$ 10,711	\$ (426)	(4.0)%
<i>Percentage of net sales</i>	<i>52.0%</i>	<i>53.2%</i>			<i>53.0%</i>	<i>55.3%</i>		
European Markets	2,008	1,988	20	1.0%	4,161	3,899	262	6.7%
<i>Percentage of net sales</i>	<i>22.1%</i>	<i>20.2%</i>			<i>21.4%</i>	<i>20.1%</i>		
Emerging Markets	1,089	1,230	(141)	(11.5)%	2,318	2,102	216	10.3%
<i>Percentage of net sales</i>	<i>12.0%</i>	<i>12.5%</i>			<i>11.9%</i>	<i>10.8%</i>		
Asia Pacific	923	1,053	(130)	(12.3)%	1,945	2,035	(90)	(4.4)%
<i>Percentage of net sales</i>	<i>10.2%</i>	<i>10.7%</i>			<i>10.0%</i>	<i>10.5%</i>		
Japan	333	331	2	0.6%	711	638	73	11.4%
<i>Percentage of net sales</i>	<i>3.7%</i>	<i>3.4%</i>			<i>3.7%</i>	<i>3.3%</i>		
Total	\$ 9,089	\$ 9,831	\$ (742)	(7.5)%	\$ 19,420	\$ 19,385	\$ 35	0.2%

In the second quarter of fiscal 2009, we experienced a decline in our business compared with the second quarter of fiscal 2008 due, we believe, to the global economic downturn and the effect it has had on information technology spending. The market weakness, which was particularly evident during January 2009, was not confined to the financial, automotive, and retail sectors, but was also reflected among other enterprise customers, as well as our commercial and service provider customers. While the weakness began in the United States several months ago, it has now clearly spread to all geographic theaters. As a result, we expect our net product sales across our geographic theaters will continue to be impacted by this unfavorable economic environment. We believe that the economic downturn will persist, but we cannot predict its severity or duration. During the second quarter of fiscal 2009, we did however experience stronger sales to the public sector, relative to our other customer markets.

Edgar Filing: CISCO SYSTEMS INC - Form 10-Q

We conduct business globally in numerous currencies. The direct effect of foreign currency fluctuations on sales has not been material because our sales are primarily denominated in U.S. dollars. However, as the U.S. dollar strengthens relative to other currencies, it could have an indirect effect on our sales to the extent it raises the cost of our products to non-U.S. customers and thereby reduces demand. A weaker U.S. dollar could have the opposite effect. However, the precise indirect effect of currency fluctuations is difficult to measure or predict because our sales are influenced by many factors in addition to the impact of such currency fluctuations.

In addition to the impact of macroeconomic factors described above, net sales by theater in a particular period may be significantly impacted by several factors related to revenue recognition, including the complexity of transactions such as multiple element arrangements; the mix of financings provided to our channel partners and customers; and final acceptance of the product, system, or solution, among other factors. In addition, certain customers tend to make large and sporadic purchases and the net sales related to these transactions may also be affected by the timing of revenue recognition.

Table of Contents**Net Product Sales by Theater**

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

	Three Months Ended				Six Months Ended			
	January 24, 2009	January 26, 2008	Variance in Dollars	Variance in Percent	January 24, 2009	January 26, 2008	Variance in Dollars	Variance in Percent
Net product sales:								
United States and Canada	\$ 3,632	\$ 4,163	\$ (531)	(12.8)%	\$ 8,079	\$ 8,616	\$ (537)	(6.2)%
<i>Percentage of net product sales</i>	<i>49.5%</i>	<i>50.5%</i>			<i>50.5%</i>	<i>53.0%</i>		
European Markets	1,730	1,733	(3)	(0.2)%	3,609	3,388	221	6.5%
<i>Percentage of net product sales</i>	<i>23.5%</i>	<i>21.0%</i>			<i>22.6%</i>	<i>20.8%</i>		
Emerging Markets	930	1,126	(196)	(17.4)%	2,022	1,902	120	6.3%
<i>Percentage of net product sales</i>	<i>12.7%</i>	<i>13.7%</i>			<i>12.7%</i>	<i>11.7%</i>		
Asia Pacific	789	942	(153)	(16.2)%	1,685	1,808	(123)	(6.8)%
<i>Percentage of net product sales</i>	<i>10.7%</i>	<i>11.4%</i>			<i>10.5%</i>	<i>11.1%</i>		
Japan	266	281	(15)	(5.3)%	587	546	41	7.5%
<i>Percentage of net product sales</i>	<i>3.6%</i>	<i>3.4%</i>			<i>3.7%</i>	<i>3.4%</i>		
Total	\$ 7,347	\$ 8,245	\$ (898)	(10.9)%	\$ 15,982	\$ 16,260	\$ (278)	(1.7)%

United States and Canada

Net product sales in the United States and Canada theater during the second quarter and the first six months of fiscal 2009 decreased compared with the corresponding periods of fiscal 2008, which we believe was primarily attributable to the continuing weakness in the macroeconomic environment in this theater during the second quarter of fiscal 2009. For the second quarter and first six months of fiscal 2009, we experienced lower sales to the service provider market in the United States due to lower spending by a few large customers. In the enterprise market, our net product sales decreased in the second quarter and first six months of fiscal 2009, compared with the corresponding periods of fiscal 2008, due to the cautious spending by our enterprise customers. Sales to the U.S. federal government increased slightly in the second quarter and first six months of fiscal 2009, and sales to the commercial market decreased in the second quarter and first six months of fiscal 2009, compared with the corresponding periods of fiscal 2008. Net product sales increased in Canada during the first six months of fiscal 2009 compared with the first six months of fiscal 2008, due in part to strength in sales to the service provider market in Canada.

European Markets

Net product sales in the European Markets theater during the second quarter of fiscal 2009 were relatively flat compared with the second quarter of fiscal 2008. For the first six months of fiscal 2009, net product sales increased compared with the first six months of fiscal 2008. In the second quarter and first six months of fiscal 2009, we continued to experience strong growth in Germany compared with the corresponding periods of fiscal 2008, while we experienced lower net product sales in other large countries such as the United Kingdom and Italy, particularly in the second quarter as economic conditions continued to deteriorate.

Emerging Markets

In the second quarter of fiscal 2009, net product sales in the Emerging Markets theater decreased compared with the second quarter of fiscal 2008, as a result of decreased sales across our customer markets, with particular weakness in the enterprise and service provider markets. In terms of geographies, in the second quarter of fiscal 2009, we experienced particular weakness in Russia and the Middle East, and our sales increased in Mexico. For the first six months of fiscal 2009, net product sales in the Emerging Markets theater increased moderately compared with the first six months of fiscal 2008, primarily due to the growth in the first quarter of fiscal 2009. Certain of our customers in the Emerging Markets theater tend to make large and sporadic purchases, and the net sales related to these transactions may also be affected by the timing of revenue recognition. Further, some customers may continue to require greater levels of financing arrangements, service, and support in future periods which may also impact the timing of recognition of the revenue for this theater.

Asia Pacific

Edgar Filing: CISCO SYSTEMS INC - Form 10-Q

The decrease in net product sales in the Asia Pacific theater in the second quarter and first six months of fiscal 2009 compared with the corresponding periods of fiscal 2008 was attributable to a decline in sales across our customer markets in this theater. We experienced particular weakness in India during the second quarter of fiscal 2009, while sales in China were down slightly, and we had increased sales in Australia.

Table of Contents*Japan*

Net product sales in the Japan theater decreased in the second quarter of fiscal 2009 but increased slightly in the first six months of fiscal 2009 compared with the corresponding periods of fiscal 2008.

Net Product Sales by Groups of Similar Products

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

	Three Months Ended				Six Months Ended			
	January 24, 2009	January 26, 2008	Variance in Dollars	Variance in Percent	January 24, 2009	January 26, 2008	Variance in Dollars	Variance in Percent
Net product sales:								
Routers	\$ 1,523	\$ 1,967	\$ (444)	(22.6)%	\$ 3,407	\$ 3,830	\$ (423)	(11.0)%
<i>Percentage of net product sales</i>	<i>20.7%</i>	<i>23.9%</i>			<i>21.3%</i>	<i>23.6%</i>		
Switches	3,019	3,380	(361)	(10.7)%	6,614	6,697	(83)	(1.2)%
<i>Percentage of net product sales</i>	<i>41.1%</i>	<i>40.9%</i>			<i>41.4%</i>	<i>41.2%</i>		
Advanced technologies	2,388	2,363	25	1.1%	5,102	4,688	414	8.8%
<i>Percentage of net product sales</i>	<i>32.5%</i>	<i>28.7%</i>			<i>31.9%</i>	<i>28.8%</i>		
Other	417	535	(118)	(22.1)%	859	1,045	(186)	(17.8)%
<i>Percentage of net product sales</i>	<i>5.7%</i>	<i>6.5%</i>			<i>5.4%</i>	<i>6.4%</i>		
Total	\$ 7,347	\$ 8,245	\$ (898)	(10.9)%	\$ 15,982	\$ 16,260	\$ (278)	(1.7)%

Routers

Sales of our routers, which are primarily categorized as high-end, midrange and low-end routers, decreased across all categories in both the second quarter and the first six months of fiscal 2009 compared with the corresponding periods of fiscal 2008. Our high-end router sales are primarily to service providers, and during the second quarter of fiscal 2009 high-end router sales continued to be adversely impacted by, among other factors, a slowdown in capital expenditures in the global service provider market, as well as by the tendency of service providers to make large and sporadic purchases. Sales of our integrated services routers, which were included in the category of midrange and low-end routers, also decreased in the second quarter of fiscal 2009.

Switches

The decrease in net product sales related to switches in the second quarter of fiscal 2009 compared with the second quarter of 2008 was due to lower sales of both our LAN fixed-configuration switches and modular switches. The decrease in sales of modular switches was primarily due to the decreased sales of Cisco Catalyst 6000 Series Switches. The decrease in sales of LAN fixed-configuration switches was a result of the lower sales in Cisco Catalyst 3560 and 3750 Series Switches. The decrease in net product sales related to switches in the first six months of fiscal 2009 compared with the first six months of 2008 was due to lower sales of our LAN fixed-configuration switches. Sales of modular switches were flat during the first six months of fiscal 2009 compared with the first six months of fiscal 2008.

Advanced Technologies

The increase in net product sales related to advanced technologies in the second quarter of fiscal 2009 compared with the second quarter of fiscal 2008 was due to the following:

Sales of video systems, which include solutions and systems designed to enable video-specific delivery systems for service providers, increased by approximately \$100 million. The increase was primarily attributable to an increase in the demand for IP set-top boxes.

Sales of security products increased by approximately \$10 million.

The aforementioned increases were partially offset by lower sales of unified communications and home networking products, each of which decreased by approximately \$30 million, and lower sales of wireless LAN and storage area networking products, which decreased by \$15 million and \$10 million, respectively. Sales of application networking services were relatively flat for the second quarter of fiscal 2009 compared with the second quarter of fiscal 2008.

Table of Contents

The increase in net product sales related to advanced technologies in the first six months of fiscal 2009 compared with the first six months of fiscal 2008 was due to the following:

Sales of video systems products, which increased by approximately \$210 million. The increase was primarily attributable to higher demand for IP set-top boxes, high-definition cable set-top boxes, and international growth.

Sales of unified communications products, which increased \$100 million primarily due to sales of IP phones and associated software as our customers continued to transition from an analog-based to an IP-based infrastructure and increased adoption of our web-based collaborative applications.

Sales of security products, which increased by approximately \$80 million primarily due to module and line-card sales related to our routers and LAN switches, sales of our next-generation adaptive security appliance products which integrate multiple technologies (including virtual private network (VPN), firewall, and intrusion prevention services) on one platform, and sales of our web and email security products as customers continued to emphasize network security.

Sales of wireless LAN products, which increased by approximately \$35 million primarily due to new customers, continued deployments with existing customers, and customers' adoption of our unified architecture platform.

Sales of application networking services, which increased by approximately \$30 million. The increase was due to higher demand from customers for wide area network (WAN) optimization solutions.

The above increases were partially offset by lower sales of home networking products, which decreased by approximately \$30 million, and lower sales of storage area networking products, which decreased by \$15 million.

Other Product Revenue

The decrease in other product revenue in the second quarter and first six months of fiscal 2009, compared with the corresponding periods of fiscal 2008, was primarily due to the decline in sales of our optical, cable, and service provider voice products. Other product revenue also includes sales of emerging technology products.

Net Service Revenue

The increase in net service revenue in the second quarter and first six months of fiscal 2009 compared with the corresponding periods of fiscal 2008 was primarily due to higher revenue from technical support service contracts as well as increased revenue from advanced services, which relates to consulting support services for specific networking needs. Renewals and technical support service contract initiations associated with recent product sales have resulted in a new installed base of equipment being serviced and revenue is recognized ratably over the period during which the related services are to be performed.

Gross Margin

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

Three Months Ended				Six Months Ended			
Amount		Percentage		Amount		Percentage	
January 24, 2009	January 26, 2008	January 24, 2009	January 26, 2008	January 24, 2009	January 26, 2008	January 24, 2009	January 26, 2008

Gross margin:

Edgar Filing: CISCO SYSTEMS INC - Form 10-Q

Product	\$ 4,610	\$ 5,355	62.7%	64.9%	\$ 10,264	\$ 10,540	64.2%	64.8%
Service	1,113	950	63.9%	59.9%	2,140	1,905	62.2%	61.0%
Total	\$ 5,723	\$ 6,305	63.0%	64.1%	\$ 12,404	\$ 12,445	63.9%	64.2%

Table of Contents

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

	Three Months Ended				Six Months Ended			
	Amount		Percentage		Amount		Percentage	
	January 24, 2009	January 26, 2008	January 24, 2009	January 26, 2008	January 24, 2009	January 26, 2008	January 24, 2009	January 26, 2008
Gross margin:								
United States and Canada	\$ 3,020	\$ 3,436	63.8%	65.7%	\$ 6,690	\$ 7,075	65.0%	66.1%
European Markets	1,343	1,294	66.9%	65.1%	2,756	2,536	66.2%	65.0%
Emerging Markets	648	766	59.5%	62.3%	1,427	1,262	61.6%	60.0%
Asia Pacific	574	679	62.2%	64.5%	1,228	1,317	63.1%	64.7%
Japan	234	232	70.3%	70.1%	495	450	69.6%	70.5%
Theater Total	5,819	6,407	64.0%	65.2%	12,596	12,640	64.9%	65.2%
Unallocated corporate items ⁽¹⁾	(96)	(102)			(192)	(195)		
Total	\$ 5,723	\$ 6,305	63.0%	64.1%	\$ 12,404	\$ 12,445	63.9%	64.2%

⁽¹⁾ The unallocated corporate items primarily include the effects of amortization of acquisition-related intangible assets and employee share-based compensation expense. We do not allocate these items to the gross margin for each theater because management does not include the information in measuring the performance of the operating segments.

The gross margin for each theater is derived from information from our internal management system. The gross margin percentage for a particular theater may fluctuate and period-to-period changes in such percentages may or may not be indicative of a trend for that theater. Our gross margin percentage in the Emerging Markets theater declined during the second quarter of fiscal 2009 as a result of lower volume and additional reserves.

Product Gross Margin

The decrease in total product gross margin percentage during the second quarter of fiscal 2009 compared with the second quarter of fiscal 2008 was due to the following factors:

Sales discounts, rebates and product pricing decreased product gross margin percentage by 1.7%.

Changes in the mix of products sold decreased product gross margin percentage by 1.3%.

Lower shipment volume, net of certain variable costs, decreased product gross margin percentage by 0.5%.

The factors above were partially offset by lower overall manufacturing costs, driven by lower component costs, value engineering and other manufacturing-related costs, increased product gross margin percentage by 1.3%. Value engineering is the process by which production costs are reduced through component redesign, board configuration, test processes, and transformation processes.

The decrease in total product gross margin percentage during the first six months of fiscal 2009 compared with the first six months of fiscal 2008 was due to the following factors:

Sales discounts, rebates, and product pricing decreased product gross margin percentage by 1.7%.

Changes in the mix of products sold decreased product gross margin percentage by 0.8%.
The preceding factors were partially offset by the following:

Lower overall manufacturing costs, driven by lower component costs, value engineering, and other manufacturing-related costs, increased product gross margin percentage by 1.8%.

Net effects of amortization of purchased intangible assets and share-based compensation expense increased product gross margin percentage by 0.1%.

Table of Contents*Service Gross Margin*

Our service gross margin percentage increased in the second quarter and the first six months of fiscal 2009 compared with the corresponding periods of fiscal 2008 primarily due to higher technical support and advanced services margins and the fact that advanced services constituted a lower proportion of total service revenue. Technical support margins will experience some variability due to various factors such as the timing of technical support service contract initiations and renewals and the timing of our strategic investments in headcount and resources to support this business. Our service gross margin from technical support services is higher than the service gross margin from our advanced services, and our revenue from advanced services may increase to a higher proportion of total service revenue due to our continued focus on providing comprehensive support to our customers' networking devices, applications, and infrastructures. Additionally, we have continued to invest in building out our technical support and advanced services capabilities in the Emerging Markets theater.

Factors That May Impact Net Sales and Gross Margin

Net product sales may continue to be affected by factors including the current global economic downturn and related market uncertainty, which so far have resulted in cautious spending in our global enterprise, service provider and commercial markets; changes in the geopolitical environment and global economic conditions; competition, including price-focused competitors from Asia, especially from China; new product introductions; sales cycles and product implementation cycles; changes in the mix of our customers between service provider and enterprise markets; changes in the mix of direct sales and indirect sales; variations in sales channels; and final acceptance criteria of the product, system, or solution as specified by the customer. Sales to the service provider market have been characterized by large and sporadic purchases, especially relating to our router sales and sales of certain advanced technologies. In addition, service provider customers typically have longer implementation cycles, require a broader range of services, including network design services, and often have acceptance provisions that can lead to a delay in revenue recognition. Certain of our customers in the Emerging Markets theater also tend to make large and sporadic purchases and the net sales related to these transactions may similarly be affected by the timing of revenue recognition. As we focus on new market opportunities, customers may require greater levels of financing arrangements, service, and support, especially in the Emerging Markets theater, which may result in a delay in the timing of revenue recognition. To improve customer satisfaction, we continue to focus on managing our manufacturing lead-time performance, which may result in corresponding reductions in order backlog. A decline in backlog levels could result in more variability and less predictability in our quarter-to-quarter net sales and operating results.

Net product sales may also be adversely affected by fluctuations in demand for our products, especially with respect to telecommunications service providers and Internet businesses, whether or not driven by any slowdown in capital expenditures in the service provider market; price and product competition in the communications and information technology industry; introduction and market acceptance of new technologies and products; adoption of new networking standards; and financial difficulties experienced by our customers. We may, from time to time, experience manufacturing issues that create a delay in our suppliers' ability to provide specific components, resulting in delayed shipments. To the extent that manufacturing issues and any related component shortages result in delayed shipments in the future, and particularly in periods when we and our suppliers are operating at higher levels of capacity, it is possible that revenue for a quarter could be adversely affected if such matters are not remediated within the same quarter. For additional factors that may impact net product sales, see Part II, Item 1A. Risk Factors. Our distributors and retail partners participate in various cooperative marketing and other programs. In addition, increasing sales to our distributors and retail partners generally results in greater difficulty in forecasting the mix of our products and, to a certain degree, the timing of orders from our customers. We recognize revenue for sales to our distributors and retail partners based on a sell-through method using information provided by them, and we maintain estimated accruals and allowances for all cooperative marketing and other programs.

Product gross margin may be adversely affected in the future by changes in the mix of products sold, including further periods of increased growth of some of our lower-margin products; introduction of new products, including products with price-performance advantages; our ability to reduce production costs; entry into new markets, including markets with different pricing structures and cost structures, as a result of internal development or through acquisitions; changes in distribution channels; price competition, including competitors from Asia, especially from China; changes in geographic mix of our product sales; the timing of revenue recognition and revenue deferrals; sales discounts; increases in material or labor costs; excess inventory and obsolescence charges; warranty costs; changes in shipment volume; loss of cost savings due to changes in component pricing; effects of value engineering; inventory holding charges; and the extent to which we successfully execute our strategy and operating plans. Service gross margin may be impacted by various factors such as the change in mix between technical support services and advanced services, the timing of technical support service contract initiations and renewals, and the timing of our strategic investments in headcount and resources to support this business.

Table of Contents**Research and Development, Sales and Marketing, and General and Administrative Expenses**

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

	Three Months Ended				Six Months Ended			
	January 24, 2009	January 26, 2008	Variance in Dollars	Variance in Percent	January 24, 2009	January 26, 2008	Variance in Dollars	Variance in Percent
Research and development	\$ 1,279	\$ 1,260	\$ 19	1.5%	\$ 2,685	\$ 2,492	\$ 193	7.7%
<i>Percentage of net sales</i>	<i>14.1%</i>	<i>12.8%</i>			<i>13.8%</i>	<i>12.9%</i>		
Sales and marketing	2,155	2,158	(3)	(0.1)%	4,438	4,236	202	4.8%
<i>Percentage of net sales</i>	<i>23.7%</i>	<i>22.0%</i>			<i>22.9%</i>	<i>21.9%</i>		
General and administrative	380	367	13	3.5%	775	709	66	9.3%
<i>Percentage of net sales</i>	<i>4.2%</i>	<i>3.7%</i>			<i>4.0%</i>	<i>3.7%</i>		
Total	\$ 3,814	\$ 3,785	\$ 29	0.8%	\$ 7,898	\$ 7,437	\$ 461	6.2%
<i>Percentage of net sales</i>	<i>42.0%</i>	<i>38.5%</i>			<i>40.7%</i>	<i>38.4%</i>		

Although our total R&D, sales and marketing, and G&A expenses for the second quarter of fiscal 2009 increased slightly compared with the second quarter of fiscal 2008, our total R&D, sales and marketing, and G&A expenses decreased compared with the first quarter of fiscal 2009. The decrease was due in part to the following: (i) a decrease in certain discretionary expenses such as travel, offsite meetings, outside services, marketing, and other expenses; and (ii) a one week shutdown for our United States and Canada business locations during the second quarter of fiscal 2009. Foreign currency exchange rates also contributed to the decrease. During the second quarter of fiscal 2009, we continued to realign resources to better focus on our priorities as well as to reduce our expenses, as part of our strategy to address the global economic downturn. In the near term, we anticipate that despite these efforts, operating expenses will increase as a percentage of total revenue. If we do not achieve the benefits anticipated from these realignments or achieve expected cost reductions, our operating results may be adversely affected.

R&D Expenses

The increase in R&D expenses for the second quarter and first six months of fiscal 2009 compared with the corresponding periods in fiscal 2008 was primarily due to higher acquisition-related compensation expenses. The acquisition-related compensation expenses, primarily associated with the achievement of certain agreed-upon milestones, increased by approximately \$20 million and \$115 million in the second quarter and first six months of fiscal 2009, respectively, compared with the corresponding periods of fiscal 2008. Higher headcount-related expenses also contributed to the increase in research and development costs for the first six months of fiscal 2009. We have continued to purchase or license technology in order to bring a broad range of products to market in a timely fashion. If we believe that we are unable to enter a particular market in a timely manner with internally developed products, we may license technology from other businesses or acquire businesses as an alternative to internal R&D. All of our R&D costs have been expensed as incurred.

Sales and Marketing Expenses

Sales and marketing expenses for the second quarter of fiscal 2009 decreased slightly compared with the second quarter of fiscal 2008 primarily due to a decrease in marketing expenses of approximately \$20 million, partially offset by a slight increase in sales expenses. For the first six months of fiscal 2009, the increase in sales and marketing expenses was a result of higher sales expenses, which increased primarily due to an increase in headcount-related expenses.

G&A Expenses

G&A expenses for the second quarter of fiscal 2009 increased compared with the second quarter of fiscal 2008 primarily due to increased share-based compensation expense and increased acquisition-related compensation expense. G&A expenses for the first six months of fiscal 2009 increased compared with the first six months of fiscal 2008 due to increased information technology-related expenses, increased headcount-related expenses and increased share-based compensation expense.

Effect of Foreign Currency

Foreign currency fluctuations, net of hedging, decreased total R&D, sales and marketing, and G&A expenses by \$95 million, or approximately 2.5%, and \$49 million or approximately 0.7%, in the second quarter and first six months of fiscal 2009, respectively, compared with the corresponding periods of fiscal 2008.

Table of Contents**Headcount**

Our headcount increased by approximately 1,200 employees in the first six months of fiscal 2009, reflecting a seasonal increase in hires of recent college graduates in the first quarter of fiscal 2009 and acquisitions. During the second quarter of fiscal 2009, headcount decreased by approximately 330 employees, primarily as a result of employee attrition and the effects of a hiring pause. As we realign and restructure resources in the normal course of our business, we expect that our headcount will decrease in the near term.

Share-Based Compensation Expense

Employee share-based compensation expense under SFAS 123(R) was as follows (in millions):

	Three Months Ended		Six Months Ended	
	January 24, 2009	January 26, 2008	January 24, 2009	January 26, 2008
Cost of sales product	\$ 10	\$ 11	\$ 21	\$ 20
Cost of sales service	32	30	63	53
Employee share-based compensation expense in cost of sales	42	41	84	73
Research and development	84	81	166	146
Sales and marketing	104	111	217	210
General and administrative	46	40	91	70
Employee share-based compensation expense in operating expenses	234	232	474	426
Total employee share-based compensation expense ⁽¹⁾	\$ 276	\$ 273	\$ 558	\$ 499

⁽¹⁾ Share-based compensation expense related to acquisitions and investments of \$22 million and \$21 million for the second quarter of fiscal 2009 and fiscal 2008, respectively, and \$44 million and \$45 million for the first six months of fiscal 2009 and fiscal 2008, respectively, is disclosed in Note 3 to the Consolidated Financial Statements and is not included in the above table.

In conjunction with the adoption of SFAS 123(R), we changed our method of attributing the value of share-based compensation to expense from the accelerated multiple-option approach to the straight-line single-option method. Compensation expense for all share-based payment awards granted on or prior to July 30, 2005 is recognized using the accelerated multiple-option approach, whereas compensation expense for all share-based payment awards granted subsequent to July 30, 2005 is recognized using the straight-line single-option method. Employee share-based compensation expense for the first six months of fiscal 2009 increased compared with the corresponding period of fiscal 2008 primarily due to the effects of straight-line vesting of share-based awards and higher weighted-average fair value for each share-based award.

Amortization of Purchased Intangible Assets and In-Process Research and Development

The following table presents the amortization of purchased intangible assets and in-process R&D included in operating expenses (in millions):

	Three Months Ended		Six Months Ended	
	January 24, 2009	January 26, 2008	January 24, 2009	January 26, 2008
Amortization of purchased intangible assets	\$ 136	\$ 116	\$ 248	\$ 233
In-process research and development	\$	\$	\$ 3	\$ 3

The increase in the amortization of purchased intangible assets included in operating expenses for the second quarter and the first six months of fiscal 2009 compared with the corresponding periods of fiscal 2008 was due to an impairment charge of \$23 million during the second quarter of

Edgar Filing: CISCO SYSTEMS INC - Form 10-Q

fiscal 2009. For additional information regarding purchased intangibles, see Note 4 to the Consolidated Financial Statements.

Our methodology for allocating the purchase price for acquisitions to in-process R&D is determined through established valuation techniques. See Note 3 to the Consolidated Financial Statements for additional information regarding the acquisitions completed in the first six months of fiscal 2009. In-process R&D is expensed upon acquisition because technological feasibility has not been established and no future alternative uses exist.

Table of Contents**Interest Income, Net**

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

	Three Months Ended		Six Months Ended	
	January 24, 2009	January 26, 2008	January 24, 2009	January 26, 2008
Interest income	\$ 222	\$ 303	\$ 481	\$ 622
Interest expense	(63)	(91)	(127)	(187)
Total	\$ 159	\$ 212	\$ 354	\$ 435

The decrease in interest income in the second quarter and first six months of fiscal 2009 compared with the corresponding periods of fiscal 2008 was primarily due to lower average interest rates partially offset by higher average total cash and cash equivalents and fixed income security balances compared with the corresponding periods of fiscal 2008. The decrease in interest expense in the second quarter and first six months of fiscal 2009 compared with the corresponding periods of fiscal 2008 was due to lower effective interest rates on our debt.

Other Income (Loss), Net

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

	Three Months Ended		Six Months Ended	
	January 24, 2009	January 26, 2008	January 24, 2009	January 26, 2008
Net (losses) gains on investments in publicly traded equity securities	\$ (23)	\$ 39	\$ 68	\$ 84
Net (losses) gains on investments in fixed income securities	(7)	26	(159)	35
Net losses on investments in privately held companies	(23)	(15)	(32)	(15)
Net (losses) gains on investments	(53)	50	(123)	104
Other	(11)	(28)	(13)	(51)
Total	\$ (64)	\$ 22	\$ (136)	\$ 53

For the second quarter and first six months of fiscal 2009, the net losses on fixed income securities included impairment charges of \$19 million and \$202 million, respectively, and net gains and losses on publicly traded equity securities included impairment charges of \$18 million and \$35 million, respectively. There were no impairments of fixed income securities or publicly traded equity securities during the first six months of fiscal 2008. During the first quarter of fiscal 2009, we terminated our forward sale agreements designated as fair value hedges of publicly traded equity securities. See Note 7 to the Consolidated Financial Statements for the unrealized gains and losses on investments.

Net losses on investments in privately held companies included impairment charges of \$30 million and \$5 million for the second quarters of fiscal 2009 and fiscal 2008, respectively, and \$53 million and \$8 million for the first six months of fiscal 2009 and fiscal 2008, respectively.

Provision for Income Taxes

The provision for income taxes resulted in an effective tax rate of 19.5% for the second quarter of fiscal 2009, compared with an effective tax rate of 21.9% for the second quarter of fiscal 2008. The decrease in the effective tax rate was primarily attributable to an increase in foreign income taxed at rates lower than the U.S. federal statutory rate of 35%.

The provision for income taxes resulted in an effective tax rate of 17.2% for the first six months of fiscal 2009, compared with 18.9% for the first six months of fiscal 2008. The effective tax rate for the first six months of fiscal 2009 included the effect of a tax benefit of \$106 million, or 2.4%, related to fiscal 2008 R&D expenses due to the retroactive reinstatement of the U.S. federal R&D tax credit, while the effective tax rate

Edgar Filing: CISCO SYSTEMS INC - Form 10-Q

for the first six months of fiscal 2008 included a net tax benefit of \$162 million, or 3.1%, from the settlement of certain tax matters with the IRS. The remaining decrease in the effective tax rate was primarily attributable to an increase in foreign income taxed at rates lower than the U.S. federal statutory tax rate of 35%.

Table of Contents

Recent Accounting Pronouncements

SFAS 141(R) and SFAS 160

In December 2007, the FASB issued SFAS No. 141 (revised 2007), Business Combinations (SFAS 141(R)) and SFAS No. 160, Noncontrolling Interests in Consolidated Financial Statements an amendment of ARB No. 51 (SFAS 160). SFAS 141(R) will significantly change current practices regarding business combinations. Among the more significant changes, SFAS 141(R) expands the definition of a business and a business combination; requires the acquirer to recognize the assets acquired, liabilities assumed and noncontrolling interests (including goodwill), measured at fair value at the acquisition date; requires acquisition-related expenses and restructuring costs to be recognized separately from the business combination; requires assets acquired and liabilities assumed from contractual and noncontractual contingencies to be recognized at their acquisition-date fair values with subsequent changes recognized in earnings; and requires in-process research and development to be capitalized at fair value as an indefinite-lived intangible asset. SFAS 160 will change the accounting and reporting for minority interests, reporting them as equity separate from the parent entity's equity, as well as requiring expanded disclosures. SFAS 141(R) and SFAS 160 are effective for financial statements issued for fiscal years beginning after December 15, 2008. We are currently assessing the impact that SFAS 141(R) and SFAS 160 will have on our results of operations and financial position.

SFAS 161

In March 2008, the FASB issued SFAS 161 which requires additional disclosures about the objectives of using derivative instruments, the method by which the derivative instruments and related hedged items are accounted for under FASB Statement No.133 and its related interpretations, and the effect of derivative instruments and related hedged items on financial position, financial performance, and cash flows. SFAS 161 also requires disclosure of the fair values of derivative instruments and their gains and losses in a tabular format. SFAS 161 is effective for us in the third quarter of fiscal 2009. We are currently assessing the impact that the adoption of SFAS 161 will have on our financial statement disclosures.

IFRS

International Financial Reporting Standards (IFRS) is a comprehensive series of accounting standards published by the International Accounting Standards Board (IASB). In November 2008, the SEC issued for comment a proposed roadmap outlining several milestones that, if achieved, could lead to mandatory adoption of IFRS by U.S. issuers in 2014. The roadmap also contained proposed rule changes that would permit early adoption of IFRS by a limited number of eligible U.S. issuers beginning with filings in 2010. The SEC would make a determination in 2011 regarding the mandatory adoption of IFRS. We are currently assessing the impact that this potential change would have on our consolidated financial statements, and we will continue to monitor the development of the potential implementation of IFRS.

Table of Contents***Liquidity and Capital Resources***

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

Balance Sheet and Cash Flows**Cash and Cash Equivalents and Investments**

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

	January 24, 2009	July 26, 2008	Increase (Decrease)
Cash and cash equivalents	\$ 4,175	\$ 5,191	\$ (1,016)
Fixed income securities	24,641	19,869	4,772
Publicly traded equity securities	715	1,175	(460)
Total	\$ 29,531	\$ 26,235	\$ 3,296

The increase in cash and cash equivalents and investments was primarily a result of cash provided by operating activities of \$5.9 billion and issuance of common stock of \$441 million related to employee stock option exercises and employee stock purchases. These factors were partially offset by the repurchase of common stock of \$1.6 billion, capital expenditures of \$585 million, approximately \$340 million related to the change in unrealized gains and losses on publicly traded equity and fixed income securities as well as realized gains and losses from these investments, and acquisitions of businesses of \$327 million.

Our total cash and cash equivalents and investments held outside of the United States in various foreign subsidiaries was \$26.3 billion as of January 24, 2009, and the remaining \$3.2 billion was held in the United States. If cash and cash equivalents and investments held outside the United States are distributed to the United States in the form of dividends or otherwise, we may be subject to additional U.S. income taxes (subject to an adjustment for foreign tax credits) and foreign withholding taxes. For internal management purposes, we target specific ranges of net realizable cash, representing cash and cash equivalents and investments, net of (i) long-term debt and the present value of operating lease commitments, and (ii) U.S. income taxes that we estimate would be payable upon the distribution to the United States of cash and cash equivalents and investments held outside the United States. We believe that our strong total cash and cash equivalents and investments position allows us to use our cash resources for strategic investments to gain access to new technologies, acquisitions, customer financing activities, working capital, and the repurchase of shares. We also believe the overall credit quality of our portfolio is strong, with our cash equivalents and fixed income portfolio invested in securities with a weighted-average credit rating exceeding AA.

We expect that cash provided by operating activities may fluctuate in future periods as a result of a number of factors, including fluctuations in our operating results, the rate at which products are shipped during the quarter (which we refer to as shipment linearity), accounts receivable collections, inventory and supply chain management, excess tax benefits from share-based compensation, and the timing and amount of tax and other payments. For additional discussion, see Part II, Item 1A. Risk Factors.

Accounts Receivable, Net

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

	January 24, 2009	July 26, 2008	Increase (Decrease)
Accounts receivable, net	\$ 2,893	\$ 3,821	\$ (928)
DSO	29	34	(5)

Our DSO as of January 24, 2009 was positively affected by the rate at which products were shipped during the quarter.

Table of Contents**Inventories and Purchase Commitments with Contract Manufacturers and Suppliers**

The following table summarizes our inventories and purchase commitments with contract manufacturers and suppliers (in millions, except annualized inventory turns):

	January 24, 2009	July 26, 2008	Increase (Decrease)
Inventories:			
Raw materials	\$ 142	\$ 111	\$ 31
Work in process	50	53	(3)
Finished goods:			
Distributor inventory and deferred cost of sales	431	452	(21)
Manufactured finished goods	277	381	(104)
Total finished goods	708	833	(125)
Service-related spares	169	191	(22)
Demonstration systems	38	47	(9)
Total	\$ 1,107	\$ 1,235	\$ (128)
Annualized inventory turns	11.6	11.9	(0.3)
Purchase commitments with contract manufacturers and suppliers	\$ 2,669	\$ 2,727	\$ (58)

Our finished goods consist of distributor inventory and deferred cost of sales and manufactured finished goods. Distributor inventory and deferred cost of sales are related to unrecognized revenue on shipments to distributors and retail partners and shipments to customers. Manufactured finished goods consist primarily of build-to-order and build-to-stock products. Service-related spares consist of reusable equipment related to our technical support and warranty activities. All inventories are accounted for at the lower of cost or market. Inventory is written down based on excess and obsolete inventories determined primarily by future demand forecasts. Inventory write-downs are measured as the difference between the cost of the inventory and market, based upon assumptions about future demand, and are charged to the provision for inventory, which is a component of our cost of sales.

We purchase components from a variety of suppliers and use several contract manufacturers to provide manufacturing services for our products. During the normal course of business, in order to manage manufacturing lead times and help ensure adequate component supply, we enter into agreements with contract manufacturers and suppliers that either allow them to procure inventory based upon criteria as defined by us or that establish the parameters defining our requirements. A significant portion of our reported purchase commitments arising from these agreements are firm, noncancelable, and unconditional commitments. In certain instances, these agreements allow us the option to cancel, reschedule, and adjust our requirements based on our business needs prior to firm orders being placed. We record a liability, included in other current liabilities, for firm, noncancelable, and unconditional purchase commitments for quantities in excess of our future demand forecasts consistent with the valuation of our excess and obsolete inventory. The purchase commitments for inventory are expected to be primarily fulfilled within one year.

Inventory and supply chain management remain areas of focus as we balance the need to maintain supply chain flexibility to help ensure competitive lead times with the risk of inventory obsolescence because of rapidly changing technology and customer requirements. We believe the amount of our inventory and purchase commitments is appropriate for our revenue levels.

Table of Contents**Financing Receivables and Guarantees**

The following table summarizes our financing receivables, financing guarantees, and the related deferred revenue (in millions):

	January 24, 2009	July 26, 2008	Increase (Decrease)
Lease receivables	\$ 1,613	\$ 1,552	\$ 61
Financed service contracts	1,326	1,328	(2)
Loan receivables	670	607	63
Gross financing receivables	\$ 3,609	\$ 3,487	\$ 122
Financing guarantees- customer	409	380	
Financing guarantees- channel partner	427	450	
Gross financing receivables and guarantees	\$ 4,445	\$ 4,317	
Allowances for financing receivables	(320)	(274)	
Deferred revenue	(2,174)	(2,091)	
Financing receivables and guarantees, net	\$ 1,951	\$ 1,952	

We provide financing to certain customers and channel partners to enable sales of our products, services, and networking solutions. These financing arrangements include leases, financed service contracts, loans, and financing guarantees. These arrangements are generally collateralized by a security interest in the underlying assets.

Lease receivables include sales-type and direct-financing leases. We also provide certain qualified customers financing for long-term service contracts, which primarily relate to technical support services. Our loan financing arrangements may include not only financing the acquisition of our products and services but also providing additional funds for other costs associated with network installation and integration of our products and services.

Third parties may provide financing arrangements to our customers and channel partners in the normal course of business. The financing arrangements to customers provided by third parties are related to leases and loans and typically have terms of three years. The financing arrangements to channel partners consist of revolving short-term financing provided by third parties, generally with payment terms ranging from 60 to 90 days. These financing arrangements facilitate the working capital requirements of the channel partners and, in some cases, we guarantee a portion of these arrangements. We could be called upon to make payments under these guarantees in the event of nonpayment by the channel partner to the third party. Where we provide a guarantee, we defer the revenue associated with the channel partner and customer financing arrangement or we record a liability for the guarantee exposure and the amounts are recorded as deferred revenue in accordance with revenue recognition policies and FIN 45. In either case, the deferred revenue is recognized as revenue when the guarantee is removed.

The deferred revenue in the table above is primarily related to financed service contracts. The revenue related to financed service contracts, which primarily relates to technical support services, is deferred and included in deferred service revenue. The revenue related to financed service contracts is recognized ratably over the period during which the related services are to be performed. A portion of the revenue related to lease and loan receivables is also deferred and included in deferred product revenue based on revenue recognition criteria.

In the current economic environment, we have continued to consistently apply our credit standards and policies in making our financing decisions. We also monitor a variety of risk metrics which helps us to balance risks and rewards. We believe the global economic downturn did not materially impact the quality of our financing receivables during the second quarter and the first six months of fiscal 2009. We expect to continue to expand the use of our financing programs in the near term.

Table of Contents**Borrowings****a) Long-Term Debt**

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

	January 24, 2009	July 26, 2008	Increase (Decrease)
Senior notes:			
Floating-rate notes, due 2009	\$ 500	\$ 500	\$
5.25% fixed-rate notes, due 2011	3,000	3,000	
5.50% fixed-rate notes, due 2016	3,000	3,000	
Total senior notes	6,500	6,500	
Other notes	2	4	(2)
Unaccreted discount	(13)	(15)	2
Hedge accounting adjustment of the carrying amount of the fixed-rate debt	359	404	(45)
Total	\$ 6,848	\$ 6,893	\$ (45)
Reported as:			
Current portion of long-term debt	\$ 500	\$ 500	\$
Long-term debt	6,348	6,393	(45)
Total	\$ 6,848	\$ 6,893	\$ (45)

In February 2006, we issued \$500 million of senior floating interest rate notes based on LIBOR due 2009 (the 2009 Notes), \$3.0 billion of 5.25% senior notes due 2011 (the 2011 Notes), and \$3.0 billion of 5.50% senior notes due 2016 (the 2016 Notes), for an aggregate principal amount of \$6.5 billion. The proceeds from the debt issuance were used to fund the acquisition of Scientific-Atlanta and for general corporate purposes. The 2011 Notes and the 2016 Notes are redeemable by us at any time, subject to a make-whole premium. We were in compliance with all debt covenants as of January 24, 2009.

On February 9, 2009 we filed a Form S-3 Registration Statement with the Securities and Exchange Commission to offer debt securities, subject to market conditions. On February 9, 2009, we also entered into an underwriting agreement to issue senior unsecured notes in aggregate principal amount of \$4.0 billion under the Registration Statement. Of these notes, \$2.0 billion will mature in 2019 and bear interest at a fixed rate of 4.95% per annum and \$2.0 billion will mature in 2039 and bear interest at a fixed rate of 5.90% per annum. This offering is expected to be completed in February 2009, subject to customary closing conditions. We intend to use the proceeds from the offering for general corporate purposes and to repay our floating rate notes due in February 2009, in the aggregate principal amount of \$500 million.

b) Credit Facility

In August 2007, we entered into a credit agreement with certain institutional lenders that provides for a \$3.0 billion unsecured revolving credit facility that is scheduled to expire on August 17, 2012. Due to the bankruptcy of one of the lenders during the first quarter of fiscal 2009, we believe the amount available under the credit facility as of January 24, 2009 may be effectively reduced to \$2.9 billion.

Any advances under the credit agreement will accrue interest at rates that are equal to, based on certain conditions, either (i) the higher of the Federal Funds rate plus 0.50% or Bank of America's prime rate as announced from time to time, or (ii) LIBOR plus a margin that is based on our senior debt credit ratings as published by Standard & Poor's Ratings Services and Moody's Investors Service, Inc. The credit agreement requires that we maintain an interest coverage ratio as defined in the agreement.

As of January 24, 2009, we were in compliance with the required interest coverage ratio, and we had not borrowed any funds under the credit facility. We may also, upon the agreement of either the then existing lenders or of additional lenders not currently parties to the agreement, increase the commitments under the credit facility up to a total of \$5.0 billion and/or extend the expiration date of the credit facility up to

August 15, 2014.

Table of Contents**Deferred Revenue**

The following table presents the breakdown of deferred revenue (in millions):

	January 24, 2009	July 26, 2008	Increase (Decrease)
Service	\$ 6,073	\$ 6,133	\$ (60)
Product	3,227	2,727	500
Total	\$ 9,300	\$ 8,860	\$ 440
Reported as:			
Current	\$ 6,592	\$ 6,197	\$ 395
Noncurrent	2,708	2,663	45
Total	\$ 9,300	\$ 8,860	\$ 440

The increase in deferred product revenue was primarily related to timing of cash receipts related to unrecognized revenue from two-tier distributors, shipments not having met revenue recognition criteria, and other revenue deferrals. The decrease in deferred service revenue reflects the ongoing amortization of deferred service revenue, partially offset by the impact of new contract initiations and renewals.

Operating Leases

We lease office space in several U.S. locations. Outside the United States, larger leased sites include sites in Australia, Belgium, China, France, Germany, India, Israel, Italy, Japan, and the United Kingdom. As of January 24, 2009, the future minimum lease payments under all our noncancelable operating leases with an initial term in excess of one year were \$1.3 billion. For additional information see Note 11 to the Consolidated Financial Statements.

Compensation Expense Related to Acquisitions and Investments

In connection with our purchase acquisitions, asset purchases, and acquisitions of variable interest entities, we have agreed to pay certain additional amounts contingent upon the achievement of agreed-upon technology, development, product, or other milestones or continued employment with us of certain employees of acquired entities. See Note 3 to the Consolidated Financial Statements.

Other Commitments

We also have certain funding commitments primarily related to our investments in privately held companies and venture funds, some of which are based on the achievement of certain agreed-upon milestones, and some of which are required to be funded on demand. The funding commitments were approximately \$293 million as of January 24, 2009, compared with approximately \$359 million as of July 26, 2008.

Off-Balance Sheet Arrangements

We consider our investments in unconsolidated variable interest entities to be off-balance sheet arrangements. In the ordinary course of business, we have investments in privately held companies and provide financing to certain customers. These privately held companies and customers may be considered to be variable interest entities. We have evaluated our investments in these privately held companies and our customer financings and have determined that there were no significant unconsolidated variable interest entities as of January 24, 2009.

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

Edgar Filing: CISCO SYSTEMS INC - Form 10-Q

We provide financing guarantees, which are generally for various third-party financing arrangements to our channel partners and other customers. We could be called upon to make payments under these guarantees in the event of nonpayment to the third party. See further discussion of these financing guarantees under Financing Receivables and Guarantees above.

Table of Contents*Stock Repurchase Program*

In September 2001, our Board of Directors authorized a stock repurchase program. As of January 24, 2009, our Board of Directors had authorized an aggregate repurchase of up to \$62 billion of common stock under this program and the remaining authorized repurchase amount was \$6.8 billion with no termination date. The stock repurchase activity under the stock repurchase program during the first six months of fiscal 2009 is summarized as follows (in millions, except per-share amounts):

	Shares Repurchased	Weighted- Average Price per Share	Amount Repurchased
Six Months Ended January 24, 2009			
Cumulative balance at July 26, 2008	2,600	\$ 20.60	\$ 53,579
Repurchase of common stock ⁽¹⁾	83	19.48	1,600
Cumulative balance at January 24, 2009	2,683	\$ 20.57	\$ 55,179

⁽¹⁾ Includes stock repurchases that were pending settlement as of January 24, 2009.

The purchase price for the shares of our common stock repurchased is reflected as a reduction to shareholders' equity. In accordance with Accounting Principles Board Opinion No. 6, Status of Accounting Research Bulletins, we are required to allocate the purchase price of the repurchased shares as (i) a reduction to retained earnings until retained earnings are zero and then as an increase to accumulated deficit and (ii) a reduction of common stock and additional paid-in capital. Issuance of common stock and the tax benefit related to employee stock incentive plans are recorded as an increase to common stock and additional paid-in capital. As a result of future repurchases, we may report an accumulated deficit as a component in shareholders' equity.

Liquidity and Capital Resource Requirements

Based on past performance and current expectations, we believe our cash and cash equivalents, investments, and cash generated from operations, and our ability to access capital markets, including committed credit lines, will satisfy our working capital needs, capital expenditures, investment requirements, stock repurchases, contractual obligations, commitments, principal payments on outstanding debt, future customer financings, and other liquidity requirements associated with our operations through at least the next 12 months. There are no other transactions, arrangements, or other relationships with unconsolidated entities or other persons that are reasonably likely to materially affect liquidity, the availability, and our requirements for capital resources.

Item 3. Quantitative and Qualitative Disclosures About Market Risk*Investments*

We maintain an investment portfolio of various holdings, types, and maturities. See Note 7 to the Consolidated Financial Statements. As of January 24, 2009, these securities are classified as available-for-sale and consequently are recorded in the Consolidated Balance Sheets at fair value with unrealized gains or losses, to the extent unhedged, reported as a component of accumulated other comprehensive income (loss), net of tax. We believe the overall credit quality of our portfolio is strong, with our cash equivalents and fixed income portfolio invested in securities with a weighted-average credit rating exceeding AA.

We consider various factors in determining whether we should recognize an impairment charge for our fixed income securities and publicly traded equity securities, including the length of time and extent to which the fair value has been less than our cost basis, the financial condition and near-term prospects of the investee, and our intent and ability to hold the investment for a period of time sufficient to allow for any anticipated recovery in market value.

During the first six months ended January 24, 2009, we realized net losses of \$159 million on fixed income securities and realized net gains of \$68 million on publicly traded equity securities. Included in the realized net losses and gains were \$202 million and \$35 million of impairment charges on fixed income and publicly traded equity securities, respectively. There were no impairments of fixed income or publicly traded equity

securities for the first six months of fiscal 2008.

Fixed Income Securities

At any time, a sharp rise in interest rates or credit spreads could have a material adverse impact on the fair value of our fixed income investment portfolio. Conversely, declines in interest rates, including the impact from lower credit spreads, could have a material adverse impact on interest income for our investment portfolio. Our fixed income instruments are not leveraged as of January 24, 2009 and are held for purposes other than trading. We monitor our interest rate and credit risks, including our credit exposures to specific rating categories and to individual issuers.

Table of Contents

Our primary objective for holding fixed income securities is to achieve an appropriate investment return consistent with preserving principal and managing risk. To realize these objectives, we may utilize interest rate swaps or other derivatives designated as fair value or cash flow hedges. As of January 24, 2009, we had no outstanding interest rate swaps designated as fair value hedges of our investment portfolio, since during the first six months of fiscal 2009 we received proceeds of \$1.0 billion for underlying hedged investments and terminated the related interest rate swaps designated as fair value hedges.

Publicly Traded Equity Securities

The values of our equity investments in several publicly traded companies are subject to market price volatility. The following table presents the hypothetical fair values of publicly traded equity securities as a result of selected potential decreases and increases in the price of each equity security in the portfolio, excluding hedged equity securities. Potential fluctuations in the price of each equity security in the portfolio of plus or minus 10%, 20%, and 30% were selected based on potential near-term changes in those security prices. The hypothetical fair values as of January 24, 2009 and July 26, 2008 are as follows (in millions):

	VALUATION OF SECURITIES			FAIR VALUE	VALUATION OF SECURITIES		
	GIVEN AN X% DECREASE			AS OF	GIVEN AN X% INCREASE		
	(30%)	(20%)	(10%)	JANUARY 24, 2009	10%	20%	30%
Publicly traded equity securities	\$ 501	\$ 572	\$ 644	\$ 715	\$ 787	\$ 858	\$ 930

	VALUATION OF SECURITIES			FAIR VALUE	VALUATION OF SECURITIES		
	GIVEN AN X% DECREASE			AS OF	GIVEN AN X% INCREASE		
	(30%)	(20%)	(10%)	JULY 26, 2008	10%	20%	30%
Publicly traded equity securities	\$ 736	\$ 842	\$ 947	\$ 1,052	\$ 1,157	\$ 1,262	\$ 1,368

Our equity portfolio consists of securities with characteristics that most closely match the Standard & Poor's 500 Index or NASDAQ Composite Index. These equity securities are held for purposes other than trading. To manage our exposure to changes in the fair value of certain equity securities, we may enter into equity derivatives, including forward sale and option agreements. The gains and losses due to changes in the value of the hedging instruments are included in other income (loss), net, and offset the change in the fair value of the underlying hedged investment. As of January 24, 2009, we had no outstanding forward sale agreements designated as fair value hedges on our publicly traded equity securities, as a result of the termination of our forward sale agreements during the first quarter of fiscal 2009.

Investments in Privately Held Companies

We have invested in privately held companies, some of which are in the startup or development stages. These investments are inherently risky because the markets for the technologies or products these companies are developing are typically in the early stages and may never materialize. We could lose our entire investment in these companies.

These investments are primarily carried at cost, which as of January 24, 2009 was \$716 million, compared with \$706 million at July 26, 2008 and are recorded in other assets. Our impairment charges on investments in privately held companies were \$30 million and \$5 million for the second quarter of fiscal 2009 and 2008, respectively, and were \$53 million and \$8 million during the first six months of fiscal 2009 and fiscal 2008, respectively.

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

Table of Contents**Long-Term Debt**

As of January 24, 2009, we had \$6.0 billion in principal amount of fixed-rate long-term debt outstanding, with a carrying amount of \$6.3 billion and a fair value of \$6.4 billion, which fair value is based on market prices. A hypothetical 50 basis points increase or decrease in interest rates would decrease or increase, respectively, the fair value of the fixed-rate debt as of January 24, 2009 by approximately \$120 million. However, this hypothetical change in interest rates would not impact the interest expense on the fixed-rate debt. A sharp change in rates would not have a material impact on the fair value of our \$500 million variable-rate debt which matures in February 2009.

Foreign Currency Exchange Rate Risk

Our foreign exchange forward and option contracts are summarized as follows (in millions):

	January 24, 2009		July 26, 2008	
	Notional Amount	Fair Value	Notional Amount	Fair Value
Forward contracts:				
Purchased	\$ 1,688	\$ (3)	\$ 1,803	\$ 5
Sold	\$ 904	\$ 86	\$ 902	\$ 2
Option contracts:				
Purchased	\$ 1,977	\$ 25	\$ 1,440	\$ 50
Sold	\$ 1,863	\$ (102)	\$ 1,256	\$ (6)

We conduct business globally in numerous currencies. The direct effect of foreign currency fluctuations on sales has not been material because our sales are primarily denominated in U.S. dollars. However, as the U.S. dollar strengthens relative to other currencies, it could have an indirect effect on our sales to the extent it raises the cost of our products to non-U.S. customers and thereby reduces demand. A weaker U.S. dollar could have the opposite effect. However, the precise indirect effect of currency fluctuations is difficult to measure or predict because our sales are influenced by many factors in addition to the impact of such currency fluctuations. Foreign currency fluctuations, net of hedging, decreased total research and development, sales and marketing, and general and administrative expenses by approximately 2.5% and 0.7% in the second quarter and first six months of fiscal 2009, respectively, compared with the corresponding periods of fiscal 2008.

Approximately 70% of our operating expenses are U.S.-dollar denominated. To reduce variability in operating expenses and service cost of sales caused by non-U.S.-dollar denominated operating expenses and costs, we hedge certain foreign currency forecasted transactions with currency options and forward contracts. These hedging programs are not designed to provide foreign currency protection over long time horizons. In designing a specific hedging approach, we consider several factors, including offsetting exposures, significance of exposures, costs associated with entering into a particular hedge instrument, and potential effectiveness of the hedge. The gains and losses on foreign exchange contracts mitigate the effect of currency movements on our operating expenses and service cost of sales.

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

	Maturities
Forward and option contracts - forecasted transactions related to operating expenses	Less than 18 months
Forward contracts - current assets and liabilities	1 to 3 months
Forward contracts - net investments in foreign subsidiaries	Less than 6 months
Forward contracts - long-term customer financings	Up to 2 years
Forward contracts - investments	Less than 2 years

We do not enter into foreign exchange forward or option contracts for trading purposes.

Table of Contents

Item 4. Controls and Procedures

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

Changes in internal control over financial reporting. There was no change in our internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) during our second quarter of fiscal 2009 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

Brazilian authorities are investigating our Brazilian subsidiary and certain of its current and former employees, as well as a Brazilian importer of our products, and its affiliates and employees, relating to the allegation of evading import taxes and other alleged improper transactions involving the subsidiary and the importer. We are conducting a thorough review of the matter. In December 2008, Brazilian authorities asserted claims against us for calendar year 2003 and we believe claims may also be asserted for calendar year 2004 through calendar year 2007. We believe the asserted claims are without merit and intend to defend the claims vigorously. We are unable to determine the likelihood of an unfavorable outcome on any potential further claims against us. While we believe there is no legal basis for our alleged liability, due to the complexities and uncertainty surrounding the judicial process in Brazil, and the nature of the claims asserting joint liability with the importer, we are unable to reasonably estimate a range of loss, if any. In addition, we are investigating the allegations regarding improper transactions. We have proactively communicated with United States authorities to provide information and report on our findings, and the United States authorities are currently investigating such allegations.

In addition, we are subject to legal proceedings, claims, and litigation arising in the ordinary course of business, including intellectual property litigation. While the outcome of these matters is currently not determinable, we do not expect that the ultimate costs to resolve these matters will have a material adverse effect on our consolidated financial position, results of operations, or cash flows. For additional information regarding intellectual property litigation, see Part II, Item 1A. Risk Factors. We may be found to infringe on intellectual property rights of others herein.

Table of Contents

ITEM 1A. Risk Factors

Set forth below and elsewhere in this report and in other documents we file with the SEC are descriptions of the risks and uncertainties that could cause our actual results to differ materially from the results contemplated by the forward-looking statements contained in this report. The descriptions below include any material changes to and supersede the description of the risk factors affecting our business previously disclosed in Part I, Item 1A. Risk Factors of our Annual Report on Form 10-K for the fiscal year ended July 26, 2008.

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

Our operating results have been in the past, and will continue to be, subject to quarterly and annual fluctuations as a result of numerous factors, some of which may contribute to more pronounced fluctuations in an uncertain global economic environment. These factors include:

Fluctuations in demand for our products and services, especially with respect to telecommunications service providers and Internet businesses, in part due to changes in the global economic environment

Changes in sales and implementation cycles for our products and reduced visibility into our customers' spending plans and associated revenue

Our ability to maintain appropriate inventory levels and purchase commitments

Price and product competition in the communications and networking industries, which can change rapidly due to technological innovation and different business models from various geographic regions

The overall movement toward industry consolidation among both our competitors and our customers

The introduction and market acceptance of new technologies and products and our success in new markets, including emerging and advanced technologies, as well as the adoption of new standards

Variations in sales channels, product costs, or mix of products sold

The timing, size, and mix of orders from customers

Manufacturing and customer lead times

Fluctuations in our gross margins, and the factors that contribute to such fluctuations, as described below

Our ability to achieve targeted cost reductions, including the ongoing resource realignment and expense reduction that is described under Resource Management and Realignment in Part I, Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

Edgar Filing: CISCO SYSTEMS INC - Form 10-Q

The ability of our customers, channel partners, contract manufacturers and suppliers to obtain financing or to fund capital expenditures, especially during a period of global credit market disruption or in the event of customer, channel partner, contract manufacturer or supplier financial problems

Share-based compensation expense and the timing and amount of employer payroll tax to be paid on our employees' gains on stock options exercised

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

How well we execute on our strategy and operating plans

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

Changes in accounting rules, such as increased use of fair value measures and the potential requirement that U.S. registrants prepare financial statements in accordance with International Financial Reporting Standards (IFRS)

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

Table of Contents

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

Challenging economic conditions worldwide have from time to time contributed, and are currently contributing, to slowdowns in the communications and networking industries at large, as well as to specific segments and markets in which we operate, resulting in:

Reduced demand for our products as a result of continued constraints on IT-related capital spending by our customers, particularly service providers, and other customer markets as well

Increased price competition for our products, not only from our competitors but also as a consequence of customers disposing of unutilized products

Risk of excess and obsolete inventories

Excess facilities and manufacturing capacity

Higher overhead costs as a percentage of revenue and higher interest expense

The turmoil in the global credit markets, the recent instability in the geopolitical environment in many parts of the world and other disruptions, such as changes in energy costs, may continue to put pressure on global economic conditions. Our operating results in one or more segments may also be affected by uncertain or changing economic conditions particularly germane to that segment or to particular customer markets within that segment. The economic challenges we initially saw in the United States have spread throughout the world. If global economic and market conditions, or economic conditions in the United States or other key markets, remain uncertain, persist, or deteriorate further, we may experience material impacts on our business, operating results, and financial condition.

DURING THE CURRENT GLOBAL ECONOMIC DOWNTURN AND WHILE THE RELATED MARKET UNCERTAINTY PERSISTS, WE INTEND TO INVEST IN MARKET ADJACENCIES AND ALSO INVEST IN THE UNITED STATES AND SELECT EMERGING COUNTRIES, AND IF THE RETURN ON THESE INVESTMENTS IS LOWER OR DEVELOPS MORE SLOWLY THAN WE EXPECT, OUR OPERATING RESULTS MAY BE HARMED

We plan to realign resources to focus on certain market adjacencies, such as data center virtualization, video/visual networking, collaboration architectures, and globalization, primarily in targeted geographic locations. Moreover, since we believe that the United States will be the first major country to recover from the global economic slowdown, we plan to make a significant portion of these investments in the United States so that we can be positioned to benefit from this future recovery while other countries or markets may not be recovering. Additionally, we believe countries such as China and India are positioned to minimize the effect of the global challenges on their own economies, creating opportunities for us as other countries or markets may not be recovering. The return on our investments in such market adjacencies and in such geographic markets may be lower, or may develop more slowly, than we expect. If we do not achieve the benefits anticipated from these investments, or if the achievement of these benefits is delayed, our operating results may be adversely affected.

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

As a result of a variety of factors discussed in this report, our revenue for a particular quarter is difficult to predict, especially in light of the current global economic downturn and related market uncertainty. Our net sales may grow at a slower rate than in past periods or may decline. Our ability to meet financial expectations could also be adversely affected if the nonlinear sales pattern seen in some of our past quarters recurs in future periods. We have experienced periods of time during which shipments have exceeded net bookings or manufacturing issues have delayed shipments, leading to nonlinearity in shipping patterns. In addition to making it difficult to predict revenue for a particular period, nonlinearity in shipping can increase costs, because irregular shipment patterns result in periods of underutilized capacity and periods in which overtime expenses may be incurred, as well as in potential additional inventory management-related costs. In addition, to the extent that manufacturing issues and any related component shortages result in delayed shipments in the future, and particularly in periods in which we and

Edgar Filing: CISCO SYSTEMS INC - Form 10-Q

our contract manufacturers are operating at higher levels of capacity, it is possible that revenue for a quarter could be adversely affected if such matters occur and are not remediated within the same quarter.

The timing of large orders can also have a significant effect on our business and operating results from quarter to quarter, primarily in our Emerging Markets theater and other emerging countries. From time to time, we receive large orders that have a significant effect on our operating results in the period in which the order is recognized as revenue. The timing of such orders is difficult to predict, and the timing of revenue recognition from such orders may affect period to period changes in net sales. As a result, our operating results could vary materially from quarter to quarter based on the receipt of such orders and their ultimate recognition as revenue.

Table of Contents

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

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

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

WE EXPECT GROSS MARGIN TO VARY OVER TIME, AND OUR LEVEL OF PRODUCT GROSS MARGIN MAY NOT BE SUSTAINABLE

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

Changes in customer, geographic, or product mix, including mix of configurations within each product group

Introduction of new products, including products with price-performance advantages

Our ability to reduce production costs

Entry into new markets, including markets with different pricing and cost structures, through acquisitions or internal development

Sales discounts

Increases in material or labor costs

Excess inventory and inventory holding charges

Obsolescence charges

Changes in shipment volume

The timing of revenue recognition and revenue deferrals

Increased cost, loss of cost savings or dilution of savings due to changes in component pricing or charges incurred due to inventory holding periods if parts ordering does not correctly anticipate product demand or if the financial health of either contract

manufacturers or suppliers deteriorates

Lower than expected benefits from value engineering

Increased price competition, including competitors from Asia, especially from China

Changes in distribution channels

Increased warranty costs

How well we execute on our strategy and operating plans

Changes in service gross margin may result from various factors such as changes in the mix between technical support services and advanced services, as well as the timing of technical support service contract initiations and renewals and the addition of personnel and other resources to support higher levels of service business in future periods.

Table of Contents

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

Sales to the service provider market have been characterized by large and sporadic purchases, especially relating to our router sales and sales of certain of our advanced technologies, in addition to longer sales cycles. In the past, we have experienced significant weakness in sales to service providers over certain extended periods of time as market conditions have fluctuated. Sales activity in this industry depends upon the stage of completion of expanding network infrastructures; the availability of funding; and the extent to which service providers are affected by regulatory, economic, and business conditions in the country of operations. Weakness in orders from this industry, including as a result of any slowdown in capital expenditures by service providers (which may be more prevalent in the current global economic downturn), could have a material adverse effect on our business, operating results, and financial condition. For example, we recently have seen a slowdown in service provider capital expenditures, which may continue in future quarters. Orders from this industry could decline for many reasons other than the competitiveness of our products and services within their respective markets. For example, in the past, many of our service provider customers have been materially and adversely affected by slowdowns in the general economy, by overcapacity, by changes in the service provider market, by regulatory developments, and by constraints on capital availability, resulting in business failures and substantial reductions in spending and expansion plans. These conditions have materially harmed our business and operating results in the past, and some of these or other conditions in the service provider market could affect our business and operating results in any future period. Finally, service provider customers typically have longer implementation cycles; require a broader range of services, including design services; demand that vendors take on a larger share of risks; often require acceptance provisions, which can lead to a delay in revenue recognition; and expect financing from vendors. All these factors can add further risk to business conducted with service providers.

DISRUPTION OF OR CHANGES IN OUR DISTRIBUTION MODEL COULD HARM OUR SALES AND MARGINS

If we fail to manage distribution of our products and services properly, or if our distributors' financial condition or operations weaken, our revenue and gross margins could be adversely affected.

A substantial portion of our products and services is sold through our channel partners, and the remainder is sold through direct sales. Our channel partners include systems integrators, service providers, other resellers, distributors, and retail partners. Systems integrators and service providers typically sell directly to end users and often provide system installation, technical support, professional services, and other support services in addition to network equipment sales. Systems integrators also typically integrate our products into an overall solution, and a number of service providers are also systems integrators. Distributors stock inventory and typically sell to systems integrators, service providers, and other resellers. In addition, home networking products are generally sold through distributors and retail partners. We refer to sales through distributors and retail partners as our two-tier system of sales to the end customer. Revenue from distributors and retail partners is recognized based on a sell-through method using information provided by them. These distributors and retail partners are generally given business terms that allow them to return a portion of inventory, receive credits for changes in selling prices, and participate in various cooperative marketing programs. If sales through indirect channels increase, this may lead to greater difficulty in forecasting the mix of our products and, to a degree, the timing of orders from our customers.

Historically, we have seen fluctuations in our gross margins based on changes in the balance of our distribution channels. Although variability to date has not been significant, there can be no assurance that changes in the balance of our distribution model in future periods would not have an adverse effect on our gross margins and profitability.

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

We compete with some of our channel partners through our direct sales, which may lead these channel partners to use other suppliers that do not directly sell their own products

Some of our channel partners may demand that we absorb a greater share of the risks that their customers may ask them to bear

Some of our channel partners may have insufficient financial resources and may not be able to withstand changes and challenges in business conditions

Revenue from indirect sales could suffer if our distributors' financial condition or operations weaken. In addition, we depend on our channel partners globally to comply with applicable regulatory requirements. To the extent that they fail to do so, that could have a material adverse effect on our business, operating results, and financial condition.

Table of Contents

OUR INVENTORY MANAGEMENT RELATING TO OUR SALES TO OUR TWO-TIER DISTRIBUTION CHANNEL IS COMPLEX, AND EXCESS INVENTORY MAY HARM OUR GROSS MARGINS

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

SUPPLY CHAIN ISSUES, INCLUDING FINANCIAL PROBLEMS OF CONTRACT MANUFACTURERS OR COMPONENT SUPPLIERS, OR A SHORTAGE OF ADEQUATE COMPONENT SUPPLY OR MANUFACTURING CAPACITY THAT INCREASED OUR COSTS OR CAUSED A DELAY IN OUR ABILITY TO FULFILL ORDERS, COULD HAVE AN ADVERSE IMPACT ON OUR BUSINESS AND OPERATING RESULTS, AND OUR FAILURE TO ESTIMATE CUSTOMER DEMAND PROPERLY MAY RESULT IN EXCESS OR OBSOLETE COMPONENT SUPPLY, WHICH COULD ADVERSELY AFFECT OUR GROSS MARGINS

The fact that we do not own or operate the bulk of our manufacturing facilities and that we are reliant on our extended supply chain could have an adverse impact on the supply of our products and on our business and operating results:

Any financial problems of either contract manufacturers or component suppliers could either limit supply or increase costs

Reservation of manufacturing capacity at our contract manufacturers by other companies, inside or outside of our industry, could either limit supply or increase costs

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

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

Table of Contents

We believe that we may be faced with the following challenges in the future:

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

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

We face competition for certain components that are supply-constrained, from existing competitors, and companies in other markets. Manufacturing capacity and component supply constraints could be significant issues for us. We purchase components from a variety of suppliers and use several contract manufacturers to provide manufacturing services for our products. During the normal course of business, in order to improve manufacturing lead-time performance and to help ensure adequate component supply, we enter into agreements with contract manufacturers and suppliers that either allow them to procure inventory based upon criteria as defined by us or that establish the parameters defining our requirements. In certain instances, these agreements allow us the option to cancel, reschedule, and adjust our requirements based on our business needs prior to firm orders being placed. If we fail to anticipate customer demand properly, an oversupply of parts could result in excess or obsolete components that could adversely affect our gross margins. For additional information regarding our purchase commitments with contract manufacturers and suppliers, see Note 11 to the Consolidated Financial Statements contained in this report.

Our key manufacturing facility for Scientific-Atlanta's products is located in Juarez, Mexico, and we may be materially and adversely affected by any prolonged disruption in the operation of this facility.

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

The markets in which we compete are characterized by rapid change, converging technologies, and a migration to networking and communications solutions that offer relative advantages. These market factors represent a competitive threat to us. We compete with numerous vendors in each product category. The overall number of our competitors providing niche product solutions may increase. Also, the identity and composition of competitors may change as we increase our activity in our advanced technology markets. As we continue to expand globally, we may see new competition in different geographic regions. In particular, we have experienced price-focused competition from competitors in Asia, especially from China, and we anticipate this will continue. Our competitors include: Alcatel-Lucent; ARRIS Group, Inc.; Aruba Networks, Inc.; Avaya Inc.; Belden Inc.; Brocade Communications Systems, Inc.; Check Point Software Technologies Ltd.; D-Link Corporation; LM Ericsson Telephone Company; Extreme Networks, Inc.; F5 Networks, Inc.; Force10 Networks, Inc.; Fortinet Inc.; Hewlett-Packard Company; Huawei Technologies Co., Ltd; International Business Machines Corporation; Juniper Networks, Inc.; Meru Networks, Inc.; Microsoft Corporation; Motorola, Inc.; NETGEAR, Inc.; Nortel Networks Corporation; Riverbed Technology, Inc.; and Symantec Corporation; among others.

Some of these companies compete across many of our product lines, while others are primarily focused in a specific product area.

Barriers to entry are relatively low, and new ventures to create products that do or could compete with our products are regularly formed. In addition, some of our competitors may have greater resources, including technical and engineering resources, than we do. As we expand into new markets, we will face competition not only from our existing competitors but also from other competitors, including existing companies with strong technological, marketing, and sales positions in those markets. We also sometimes face competition from resellers and distributors of our products. Companies with whom we have strategic alliances in some areas may be competitors in other areas.

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

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

Product performance

Price

The ability to introduce new products, including products with price-performance advantages

The ability to reduce production costs

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

Table of Contents

Conformance to standards

Market presence

The ability to provide financing

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

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

The markets for our products are characterized by rapidly changing technology, evolving industry standards, new product introductions, and evolving methods of building and operating networks. Our operating results depend on our ability to develop and introduce new products into existing and emerging markets and to reduce the production costs of existing products. We believe the industry is evolving to enable personal and business process collaboration enabled by networked Web 2.0, the technologies that enable user collaboration, as part of the second major phase of the Internet. As such, many of our strategic initiatives and investments are aimed at meeting the requirements that a network capable of multiple party, collaborative interaction would demand, and the investments we have made and our architectural approach are designed to enable networked Web 2.0 and the increased use of the network as the platform for all forms of communications and IT. The process of developing new technology is complex and uncertain, and if we fail to accurately predict customers' changing needs and emerging technological trends our business could be harmed. We must commit significant resources, including the investments we intend to make in market adjacencies and in the United States and select emerging countries mentioned above, to developing new products before knowing whether our investments will result in products the market will accept. In particular, if our model of the evolution of networking to collaborative systems does not emerge as we believe it will, or if the industry does not evolve as we believe it will, many of our strategic initiatives and investments may be of no or limited value. Furthermore, we may not execute successfully on that vision because of errors in product planning or timing, technical hurdles that we fail to overcome in a timely fashion, or a lack of appropriate resources. This could result in competitors providing those solutions before we do and loss of market share, net sales, and earnings. The success of new products depends on several factors, including proper new product definition, component costs, timely completion and introduction of these products, differentiation of new products from those of our competitors, and market acceptance of these products. There can be no assurance that we will successfully identify new product opportunities, develop and bring new products to market in a timely manner, or achieve market acceptance of our products or that products and technologies developed by others will not render our products or technologies obsolete or noncompetitive. Specifically, the products and technologies that we identify as emerging technologies, such as Cisco TelePresence systems, or advanced technologies may not prove to have the market success we anticipate, and we may not successfully identify and invest in other emerging or advanced technologies.

OVER THE LONG TERM WE INTEND TO INCREASE OUR INVESTMENT IN ENGINEERING, SALES, SERVICE AND MANUFACTURING ACTIVITIES, AND THESE INVESTMENTS MAY ACHIEVE DELAYED, OR LOWER THAN EXPECTED BENEFITS WHICH COULD HARM OUR OPERATING RESULTS

While we intend to focus on managing our costs and expenses over the short term, over the long term, we intend to continue to add personnel and other resources to our engineering, sales, service, and manufacturing functions as we focus on developing emerging technologies, the next wave of advanced technologies, growing the commercial market segment, capitalizing on our emerging market opportunities, enhancing our evolving support model and increasing our market share gains. We are likely to recognize the costs associated with these investments earlier than some of the anticipated benefits, and the return on these investments may be lower, or may develop more slowly, than we expect. If we do not achieve the benefits anticipated from these investments, or if the achievement of these benefits is delayed, our operating results may be adversely affected.

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

A substantial portion of our business and revenue depends on growth and evolution of the Internet, including the continued development of networked Web 2.0 as part of the second major phase of the Internet, and on the deployment of our products by customers who depend on such continued growth and evolution. To the extent that an economic slowdown and reduction in capital spending adversely affect spending on

Edgar Filing: CISCO SYSTEMS INC - Form 10-Q

Internet infrastructure, as we are currently seeing, we could experience material harm to our business, operating results, and financial condition.

Table of Contents

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

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

In response to changes in industry and market conditions, we may be required to strategically realign our resources and consider restructuring, disposing of, or otherwise exiting businesses. Any decision to limit investment in or dispose of or otherwise exit businesses may result in the recording of special charges, such as inventory and technology-related write-offs, workforce reduction costs, charges relating to consolidation of excess facilities, or claims from third parties who were resellers or users of discontinued products. Our estimates with respect to the useful life or ultimate recoverability of our carrying basis of assets, including purchased intangible assets, could change as a result of such assessments and decisions. Further, our estimates relating to the liabilities for excess facilities are affected by changes in real estate market conditions. Additionally, we are required to perform goodwill impairment tests on an annual basis and between annual tests in certain circumstances, and future goodwill impairment tests may result in a charge to earnings.

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

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

Difficulties in integrating the operations, systems, technologies, products, and personnel of the acquired companies, particularly companies with large and widespread operations and/or complex products, such as Scientific-Atlanta and WebEx

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

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

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

Initial dependence on unfamiliar supply chains or relatively small supply partners

Insufficient revenue to offset increased expenses associated with acquisitions

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

Acquisitions may also cause us to:

Edgar Filing: CISCO SYSTEMS INC - Form 10-Q

Issue common stock that would dilute our current shareholders' percentage ownership

Use a substantial portion of our cash resources, as we did in connection with our June 2007 acquisition of WebEx, or incur debt, as we did in February 2006 when we issued and sold \$6.5 billion in senior unsecured notes to fund our acquisition of Scientific-Atlanta

Significantly increase our interest expense, leverage and debt service requirements if we incur additional debt to pay for an acquisition

Assume liabilities

Record goodwill and nonamortizable intangible assets that are subject to impairment testing on a regular basis and potential periodic impairment charges

Incur amortization expenses related to certain intangible assets

Table of Contents

Incur tax expenses related to the effect of acquisitions on our intercompany R&D cost sharing arrangement and legal structure

Incur large and immediate write-offs and restructuring and other related expenses

Become subject to intellectual property or other litigation

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

From time to time, we have made acquisitions that resulted in in-process research and development expenses being charged in an individual quarter. These charges may occur in any particular quarter, resulting in variability in our quarterly earnings. In addition, our effective tax rate for future periods is uncertain and could be impacted by mergers and acquisitions. Risks related to new product development also apply to acquisitions. Please see the risk factors above, including the risk factor entitled "We depend upon the development of new products and enhancements to existing products, and if we fail to predict and respond to emerging technological trends and customers' changing needs, our operating results and market share may suffer" for additional information.

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

As we focus on new market opportunities—for example, storage; wireless; security; transporting data, voice, and video traffic across the same network; and other advanced technologies and emerging technologies—we will increasingly compete with large telecommunications equipment suppliers as well as startup companies. Several of our competitors may have greater resources, including technical and engineering resources, than we do. Additionally, as customers in these markets complete infrastructure deployments, they may require greater levels of service, support, and financing than we have provided in the past, especially in the Emerging Markets theater. Demand for these types of service, support, or financing contracts may increase in the future. There can be no assurance that we can provide products, service, support, and financing to effectively compete for these market opportunities.

Further, provision of greater levels of services, support and financing by us may result in a delay in the timing of revenue recognition. In addition, entry into other markets, including our entry into the consumer market, has subjected and will subject us to additional risks, particularly to those markets, including the effects of general market conditions and reduced consumer confidence.

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

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

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

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

Table of Contents

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

We conduct significant sales and customer support operations in countries outside of the United States; maintain a manufacturing facility for a substantial portion of our video systems products in Juarez, Mexico; and also depend on non-U.S. operations of our contract manufacturers and our distribution partners. Recently our Emerging Markets theater has been a relatively fast growing theater, and we have announced plans to expand our commitments and growth expectations in this theater. As such, our growth depends in part on our continuing to increase sales into this theater. We also intend to expand our level of business activity in two large emerging countries, India and China, and our growth in the Asia Pacific theater will also depend in part upon our continuing to increase sales in these countries. Our future results could be materially adversely affected by a variety of factors relating to our operations outside the United States, any or all of which could have a material adverse effect on our operating results and financial condition, including, among others, the following:

The worldwide impact of the current global economic downturn and related market uncertainty

Foreign currency exchange rates

Political or social unrest

Economic instability or weakness or natural disasters in a specific country or region; environmental and trade protection measures and other legal and regulatory requirements, some of which may affect our ability to import our products to, export our products from, or sell our products in various countries

Political considerations that affect service provider and government spending patterns

Health or similar issues, such as a pandemic or epidemic

Difficulties in staffing and managing international operations

Adverse tax consequences, including imposition of withholding or other taxes on payments by subsidiaries

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

Most of our sales are on an open credit basis, with typical payment terms of 30 days in the United States and, because of local customs or conditions, longer in some markets outside the United States. We monitor individual customer payment capability in granting such open credit arrangements, seek to limit such open credit to amounts we believe the customers can pay, and maintain reserves we believe are adequate to cover exposure for doubtful accounts. Beyond our open credit arrangements, we have also experienced demands for customer financing and facilitation of leasing arrangements. We expect demand for customer financing to continue, and recently we have seen an increase in this demand as the credit markets have been impacted by the global economic downturn and related market uncertainty. We believe customer financing is a competitive factor in obtaining business, particularly in serving customers involved in significant infrastructure projects. Our loan financing arrangements may include not only financing the acquisition of our products and services but also providing additional funds for other costs associated with network installation and integration of our products and services.

Our exposure to the credit risks relating to our financing activities described above may increase if our customers are adversely affected by the current global economic downturn, or if there is a continuation or worsening of the downturn. Although we have programs in place that are designed to monitor and mitigate the associated risk, including monitoring of particular risks in certain geographic areas, there can be no

assurance that such programs will be effective in reducing our credit risks.

In the past, there have been significant bankruptcies among customers both on open credit and with loan or lease financing arrangements, particularly among Internet businesses and service providers, causing us to incur economic or financial losses. There can be no assurance that additional losses will not be incurred. Although these losses have not been material to date, future losses, if incurred, could harm our business and have a material adverse effect on our operating results and financial condition. A portion of our sales is derived through our distributors and retail partners. These distributors and retail partners are generally given business terms that allow them to return a portion of inventory, receive credits for changes in selling prices, and participate in various cooperative marketing programs. We maintain estimated accruals and allowances for such business terms. However, distributors tend to have more limited financial resources than other resellers and end-user customers and therefore represent potential sources of increased credit risk, because they may be more likely to lack the reserve resources to meet payment obligations. Additionally, to the degree that the ongoing turmoil in the credit markets makes it more difficult for some customers to obtain financing, those customers' ability to pay could be adversely impacted, which in turn could have a material adverse impact on our business, operating results, and financial condition.

Table of Contents

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

Because a significant portion of our business is conducted outside the United States, we face exposure to adverse movements in foreign currency exchange rates. These exposures may change over time as business practices evolve, and they could have a material adverse impact on our financial results and cash flows. Historically, our primary exposures have related to nondollar-denominated sales in Japan, Canada, and Australia and certain nondollar-denominated operating expenses and service cost of sales in Europe, Latin America, and Asia, where we sell primarily in U.S. dollars. Additionally, we have exposures to emerging market currencies, which can have extreme currency volatility. An increase in the value of the dollar could increase the real cost to our customers of our products in those markets outside the United States where we sell in dollars, and a weakened dollar could increase the cost of local operating expenses and procurement of raw materials to the extent that we must purchase components in foreign currencies.

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

OUR PROPRIETARY RIGHTS MAY PROVE DIFFICULT TO ENFORCE

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

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

Third parties, including customers, have in the past and may in the future assert claims or initiate litigation related to exclusive patent, copyright, trademark, and other intellectual property rights to technologies and related standards that are relevant to us. These assertions have increased over time as a result of our growth and the general increase in the pace of patent claims assertions, particularly in the United States. Because of the existence of a large number of patents in the networking field, the secrecy of some pending patents, and the rapid rate of issuance of new patents, it is not economically practical or even possible to determine in advance whether a product or any of its components infringes or will infringe on the patent rights of others. The asserted claims and/or initiated litigation can include claims against us or our manufacturers, suppliers, or customers, alleging infringement of their proprietary rights with respect to our existing or future products or components of those products. Regardless of the merit of these claims, they can be time-consuming, result in costly litigation and diversion of technical and management personnel, or require us to develop a non-infringing technology or enter into license agreements. Where claims are made by customers, resistance even to unmeritorious claims could damage customer relationships. There can be no assurance that licenses will be available on acceptable terms and conditions, if at all, or that our indemnification by our suppliers will be adequate to cover our costs if a claim were brought directly against us or our customers. Furthermore, because of the potential for high court awards that are not necessarily predictable, it is not unusual to find even arguably unmeritorious claims settled for significant amounts. If any infringement or other intellectual property claim made against us by any third party is successful, if we are required to indemnify a customer with respect to a claim against the customer, or if we fail to develop non-infringing technology or license the proprietary rights on commercially reasonable terms and conditions, our business, operating results, and financial condition could be materially and adversely affected.

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

Table of Contents

WE RELY ON THE AVAILABILITY OF THIRD-PARTY LICENSES

Many of our products are designed to include software or other intellectual property licensed from third parties. It may be necessary in the future to seek or renew licenses relating to various aspects of these products. There can be no assurance that the necessary licenses would be available on acceptable terms, if at all. The inability to obtain certain licenses or other rights or to obtain such licenses or rights on favorable terms, or the need to engage in litigation regarding these matters, could have a material adverse effect on our business, operating results, and financial condition. Moreover, the inclusion in our products of software or other intellectual property licensed from third parties on a nonexclusive basis could limit our ability to protect our proprietary rights in our products.

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

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

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

Changes in telecommunications requirements, or regulatory requirements in other industries in which we operate, in the United States or other countries could affect the sales of our products. In particular, we believe that there may be future changes in U.S. telecommunications regulations that could slow the expansion of the service providers' network infrastructures and materially adversely affect our business, operating results, and financial condition.

Future changes in tariffs by regulatory agencies or application of tariff requirements to currently untariffed services could affect the sales of our products for certain classes of customers. Additionally, in the United States, our products must comply with various Federal Communications Commission requirements and regulations. In countries outside of the United States, our products must meet various requirements of local telecommunications authorities. Changes in tariffs or failure by us to obtain timely approval of products could have a material adverse effect on our business, operating results, and financial condition.

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

Our success has always depended in large part on our ability to attract and retain highly skilled technical, managerial, sales, and marketing personnel. Competition for these personnel is intense, especially in the Silicon Valley area of Northern California. Stock incentive plans are designed to reward employees for their long-term contributions and provide incentives for them to remain with us. Volatility or lack of positive performance in our stock price or equity incentive awards, or changes to our overall compensation program, including our stock incentive program, resulting from the management of share dilution and share-based compensation expense or otherwise, may also adversely affect our ability to retain key employees. As a result of one or more of these factors, we may increase our hiring in geographic areas outside the United States, which could subject us to additional geopolitical and exchange rate risk. The loss of services of any of our key personnel; the inability to retain and attract qualified personnel in the future; or delays in hiring required personnel, particularly engineering and sales personnel, could make it difficult to meet key objectives, such as timely and effective product introductions. In addition, companies in our industry whose employees accept positions with competitors frequently claim that competitors have engaged in improper hiring practices. We have received these claims in the past and may receive additional claims to this effect in the future.

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

We are a party to lawsuits in the normal course of our business. Litigation can be expensive, lengthy, and disruptive to normal business operations. Moreover, the results of complex legal proceedings are difficult to predict. In addition, Brazilian authorities are investigating our Brazilian subsidiary and certain of its current and former employees, as well as a Brazilian importer of our products, and its affiliates and employees, relating to the allegation of evading import taxes and other alleged improper transactions involving the subsidiary and the importer. We are conducting a thorough review of the matter. In December 2008, Brazilian authorities asserted claims against us for calendar year 2003 and we believe claims may also be asserted for calendar year 2004 through calendar year 2007. We believe the asserted claims are without merit and intend to defend the claims vigorously. In addition, we are investigating the allegations regarding improper transactions. We have

Edgar Filing: CISCO SYSTEMS INC - Form 10-Q

proactively communicated with United States authorities to provide information and report on our findings, and the United States authorities are currently investigating such allegations. An unfavorable resolution of lawsuits or governmental investigations could have a material adverse effect on our business, operating results, or financial condition. For additional information regarding certain of the matters in which we are involved, see Item 1, Legal Proceedings, contained in Part II of this report.

Table of Contents**CHANGES IN OUR PROVISION FOR INCOME TAXES OR ADVERSE OUTCOMES RESULTING FROM EXAMINATION OF OUR INCOME TAX RETURNS COULD ADVERSELY AFFECT OUR RESULTS**

Our provision for income taxes is subject to volatility and could be adversely affected by earnings being lower than anticipated in countries that have lower tax rates and higher than anticipated in countries that have higher tax rates; by changes in the valuation of our deferred tax assets and liabilities; by expiration of or lapses in the R&D tax credit laws; by transfer pricing adjustments including the effect of acquisitions on our intercompany R&D cost sharing arrangement and legal structure; by tax effects of nondeductible compensation; by tax costs related to intercompany realignments; or by changes in tax laws, regulations, accounting principles, including accounting for uncertain tax positions or interpretations thereof. Significant judgment is required to determine the recognition and measurement attribute prescribed in Financial Interpretation No. 48, Accounting for Uncertainty in Income Taxes—an interpretation of FASB Statement No. 109 (FIN 48). In addition, FIN 48 applies to all income tax positions, including the potential recovery of previously paid taxes, which if settled unfavorably could adversely impact our provision for income taxes or additional paid-in capital. Further, as a result of certain of our ongoing employment and capital investment actions and commitments, our income in certain countries is subject to reduced tax rates and in some cases is wholly exempt from tax. Our failure to meet these commitments could adversely impact our provision for income taxes. In addition, we are subject to the continuous examination of our income tax returns by the Internal Revenue Service and other tax authorities. We regularly assess the likelihood of adverse outcomes resulting from these examinations to determine the adequacy of our provision for income taxes. There can be no assurance that the outcomes from these continuous examinations will not have an adverse effect on our operating results and financial condition.

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

Our corporate headquarters, including certain of our research and development operations are located in the Silicon Valley area of Northern California, a region known for seismic activity. Additionally, a certain number of our facilities are located near rivers that have experienced flooding in the past. A significant natural disaster, such as an earthquake, a hurricane, or a flood, could have a material adverse impact on our business, operating results, and financial condition.

MAN-MADE PROBLEMS SUCH AS COMPUTER VIRUSES OR TERRORISM MAY DISRUPT OUR OPERATIONS AND HARM OUR OPERATING RESULTS

Despite our implementation of network security measures our servers are vulnerable to computer viruses, break-ins, and similar disruptions from unauthorized tampering with our computer systems. Any such event could have a material adverse effect on our business, operating results, and financial condition. Efforts to limit the ability of malicious third parties to disrupt the operations of the Internet or undermine our own security efforts may meet with resistance. In addition, the continued threat of terrorism and heightened security and military action in response to this threat, or any future acts of terrorism, may cause further disruptions to the economies of the United States and other countries and create further uncertainties or otherwise materially harm our business, operating results, and financial condition. Likewise, events such as widespread blackouts could have similar negative impacts. To the extent that such disruptions or uncertainties result in delays or cancellations of customer orders or the manufacture or shipment of our products, our business, operating results, and financial condition could be materially and adversely affected.

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

We maintain an investment portfolio of various holdings, types, and maturities. These securities are generally classified as available-for-sale and, consequently, are recorded on our Consolidated Balance Sheets at fair value with unrealized gains or losses reported as a component of accumulated other comprehensive income (loss), net of tax. Our portfolio includes fixed income securities and equity investments in publicly traded companies, the values of which are subject to market price volatility to the extent unhedged. If such investments suffer market price declines, as we experienced with some of our investments during the first quarter of fiscal 2009, we may recognize in earnings the decline in the fair value of our investments below their cost basis when the decline is judged to be other-than-temporary. For information regarding the sensitivity of and risks associated with the market value of portfolio investments and interest rates, refer to the section titled Quantitative and Qualitative Disclosures About Market Risk included in this report and in our Annual Report on Form 10-K for the year ended July 26, 2008. Our investments in private companies are subject to risk of loss of investment capital. These investments are inherently risky because the markets for the technologies or products they have under development are typically in the early stages and may never materialize. We could lose our entire investment in these companies.

Table of Contents

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

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

OUR STOCK PRICE MAY BE VOLATILE

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

THERE CAN BE NO ASSURANCE THAT OUR OPERATING RESULTS AND FINANCIAL CONDITION WILL NOT BE ADVERSELY AFFECTED BY OUR INCURRENCE OF SENIOR UNSECURED DEBT

We have issued senior unsecured notes in an aggregate principal amount of \$6.5 billion, of which \$500 million will mature on February 20, 2009 and the balance will mature at specific dates in 2011 and 2016. In addition, we have recently priced, and expect to complete the sale of, an aggregate of \$4.0 billion of senior unsecured notes that mature at specific dates in 2019 and 2039. A portion of the proceeds of the recently priced notes will be used to repay the notes that will mature on February 20, 2009. The notes that mature in 2011, 2016, 2019 and 2039 bear fixed-rate interest payable semi-annually. The fair value of the long-term debt is subject to market interest rate volatility. The instruments governing the notes contain certain covenants applicable to us and our subsidiaries that may adversely affect our ability to incur certain liens or engage in certain types of sale and leaseback transactions. There can be no assurance that our incurrence of this debt will be a better means of providing liquidity to us than would our use of our existing cash resources, including cash currently held offshore. Further, we cannot be assured that our maintenance of this indebtedness will not adversely affect our operating results or financial condition. In addition, changes by any rating agency to our credit rating can negatively impact the value and liquidity of both our debt and equity securities.

Table of Contents**Item 2. Unregistered Sales of Equity Securities and Use of Proceeds**

(a) None.

(b) None.

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

Period	Total Number of Shares Purchased ⁽¹⁾	Average Price Paid per Share ⁽¹⁾	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs ⁽²⁾	Approximate Dollar Value of Shares That May Yet Be Purchased Under the Plans or Programs ⁽²⁾
October 26, 2008 to November 22, 2008	15	\$ 16.80	15	\$ 7,171
November 23, 2008 to December 20, 2008	9	\$ 16.08	9	\$ 7,032
December 21, 2008 to January 24, 2009	13	\$ 16.15	13	\$ 6,821
Total	37	\$ 16.40	37	

⁽¹⁾ Includes approximately 200,000 shares repurchased to satisfy tax withholding obligations that arose on the vesting of shares of restricted stock and restricted stock units.

⁽²⁾ On September 13, 2001, we announced that our Board of Directors had authorized a stock repurchase program. As of January 24, 2009, our Board of Directors had authorized the repurchase of up to \$62 billion of common stock under this program. During the second quarter of fiscal 2009, we repurchased and retired 37 million shares of our common stock at a weighted-average price of \$16.40 per share for an aggregate purchase price of \$600 million. As of January 24, 2009, we had repurchased and retired 2.7 billion shares of our common stock at a weighted-average price of \$20.57 per share for an aggregate purchase price of \$55.2 billion since inception of the stock repurchase program, and the remaining authorized amount for stock repurchases under this program was \$6.8 billion with no termination date.

Item 3. Defaults Upon Senior Securities

None.

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

We held our Annual Meeting of Shareholders on November 13, 2008. At the meeting, our shareholders voted on the following four proposals and cast their votes as follows:

Proposal 1: To elect twelve members of our Board of Directors:

Nominee	For	Against	Abstain
Carol A. Bartz	4,769,269,910	239,522,463	10,973,553
M. Michele Burns	4,966,141,684	42,347,310	11,276,932
Michael D. Capellas	4,932,184,188	73,166,526	14,415,212
Larry R. Carter	4,971,064,784	37,267,795	11,433,347
John T. Chambers	4,943,257,355	67,439,476	9,069,095
Brian L. Halla	4,956,827,162	48,499,708	14,439,056
Dr. John L. Hennessy	4,569,360,161	431,578,172	18,827,593
Richard M. Kovacevich	4,948,267,699	60,112,571	11,385,656

Edgar Filing: CISCO SYSTEMS INC - Form 10-Q

Roderick C. McGeary	4,939,316,886	65,534,395	14,914,645
Michael K. Powell	4,968,373,652	39,807,490	11,584,784
Steven M. West	4,900,250,477	107,663,734	11,851,715
Jerry Yang	2,836,980,506	2,091,627,914	91,157,506

Proposal 2: To ratify the appointment of PricewaterhouseCoopers LLP as our independent registered public accounting firm for the fiscal year ending July 25, 2009:

For	Against	Abstain	Broker Non-votes
4,968,706,054	44,383,631	6,676,241	0

Table of Contents

Proposal 3: A shareholder proposal to amend our corporate Bylaws to establish a Board Committee on Human Rights:

For	Against	Abstain	Broker Non-votes
273,040,434	3,025,807,147	673,812,122	1,047,106,223

Proposal 4: A shareholder proposal that the Board of Directors publish a report to shareholders within six months providing a summarized listing and assessment of concrete steps we could reasonably take to reduce the likelihood that our business practices might enable or encourage the violation of human rights:

For	Against	Abstain	Broker Non-votes
1,106,281,462	2,309,232,061	557,048,305	1,047,204,098

Item 5. Other Information

None.

Item 6. Exhibits

The following documents are filed as Exhibits to this report:

- 31.1 Rule 13a-14(a)/15d-14(a) Certification of Principal Executive Officer
- 31.2 Rule 13a-14(a)/15d-14(a) Certification of Principal Financial Officer
- 32.1 Section 1350 Certification of Principal Executive Officer
- 32.2 Section 1350 Certification of Principal Financial Officer

Table of Contents

SIGNATURE

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

Date: February 17, 2009

Cisco Systems, Inc.

By /s/ Frank A. Calderoni
Frank A. Calderoni

Executive Vice President and

Chief Financial Officer

(Principal Financial Officer and duly authorized signatory)

Table of Contents

EXHIBIT INDEX

- 31.1 Rule 13a-14(a)/15d-14(a) Certification of Principal Executive Officer
- 31.2 Rule 13a-14(a)/15d-14(a) Certification of Principal Financial Officer
- 32.1 Section 1350 Certification of Principal Executive Officer
- 32.2 Section 1350 Certification of Principal Financial Officer