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 July 26, 2003

OR

o **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934.**

For the transition period from to

Commission file number: 000-25601

Brocade Communications Systems, Inc.

(Exact name of Registrant as specified in its charter)

Delaware	**77-0409517**
(State or other jurisdiction of incorporation)	*(I.R.S. employer identification no.)*

1745 Technology Drive

San Jose, CA 95110
(408) 333-8000
(Address, including zip code, of Registrant's principal executive offices and 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 o

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Act). Yes ☑ No o

The number of shares outstanding of the Registrant's Common Stock on August 23, 2003 was 257,624,206 shares.

TABLE OF CONTENTS

BROCADE COMMUNICATIONS SYSTEMS, INC.

FORM 10-Q

QUARTER ENDED JULY 26, 2003

INDEX

PART I — FINANCIAL INFORMATION

Item 1. ***Financial Statements***

BROCADE COMMUNICATIONS SYSTEMS, INC.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

	Three Months Ended		Nine Months Ended	
	July 26, 2003	July 27, 2002	July 26, 2003	July 27, 2002
	(In thousands, except per share amounts) (Unaudited)			
Net revenues	$133,458	$151,234	$ 387,520	$409,262
Cost of revenues	61,226	60,299	178,511	162,950
Gross margin	72,232	90,935	209,009	246,312
Operating expenses:				
Research and development	37,158	33,209	105,576	95,523
Sales and marketing	27,526	30,338	90,249	82,722
General and administrative	5,539	4,756	15,805	14,139
Amortization of deferred stock compensation	213	243	494	727
Restructuring costs	(15)	—	20,991	—
In-process research and development	—	—	134,898	—
Total operating expenses	70,421	68,546	368,013	193,111
Income (loss) from operations	1,811	22,389	(159,004)	53,201
Interest and other income, net	4,290	6,827	14,720	16,823
Interest expense	(3,417)	(3,387)	(10,129)	(8,057)
Income (loss) before provision for income taxes	2,684	25,829	(154,413)	61,967
Income tax (benefit) provision	773	7,481	(3,417)	17,970
Net income (loss)	$ 1,911	$ 18,348	$(150,996)	$ 43,997
Net income (loss) per share — Basic	$ 0.01	$ 0.08	$ (0.61)	$ 0.19
Net income (loss) per share — Diluted	$ 0.01	$ 0.08	$ (0.61)	$ 0.18
Shares used in per share calculation — Basic	255,873	233,017	248,486	230,819
Shares used in per share calculation — Diluted	259,444	240,106	248,486	244,672

The accompanying notes are an integral part of these Condensed Consolidated Financial Statements.

BROCADE COMMUNICATIONS SYSTEMS, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS

	July 26, 2003	October 26, 2002
	(In thousands, except par value) (Unaudited)	
Assets		
Current assets:		
Cash and cash equivalents	$ 487,580	$ 516,535
Short-term investments	71,039	50,988
Total cash, cash equivalents and short-term investments	558,619	567,523
Marketable equity securities	—	226
Accounts receivable, net of allowances of $3,672 and $3,763, respectively	76,866	97,707
Inventories, net	4,529	5,402
Deferred tax assets, net	28,418	28,418
Prepaid expenses and other current assets	12,593	16,429
Total current assets	681,025	715,705
Long-term investments	350,443	320,865
Property and equipment, net	129,113	143,625
Deferred tax assets, net	221,489	221,878
Convertible subordinated debt issuance costs	8,424	10,274
Other assets	3,794	9,316
Total assets	$1,394,288	$1,421,663
Liabilities and Stockholders' Equity		
Current liabilities:		
Accounts payable	$ 46,613	$ 57,538
Accrued employee compensation	26,344	23,930
Deferred revenue	20,183	22,430
Current liabilities associated with lease losses	8,260	8,204
Other accrued liabilities	39,939	49,364
Total current liabilities	141,339	161,466
Non-current liabilities associated with lease losses	18,277	22,602
Convertible subordinated debt	550,000	550,000
Commitments and contingencies (Note 9)		
Stockholders' equity:		
Preferred stock, $0.001 par value, 5,000 shares authorized:		
No shares issued and outstanding	—	—
Common stock, $0.001 par value, 800,000 shares authorized:		
Issued and outstanding: 257,620 and 234,652 shares at July 26, 2003 and October 26, 2002, respectively	258	235
Additional paid-in capital	725,455	577,171
Deferred stock compensation	(1,252)	(69)
Accumulated other comprehensive income	7,027	6,078
Accumulated earnings (deficit)	(46,816)	104,180
Total stockholders' equity	684,672	687,595
Total liabilities and stockholders' equity	$1,394,288	$1,421,663

The accompanying notes are an integral part of these Condensed Consolidated Financial Statements.

BROCADE COMMUNICATIONS SYSTEMS, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

	Nine Months Ended	
	July 26, 2003	July 27, 2002
	(In thousands) (Unaudited)	
Cash flows from operating activities:		
Net income (loss)	$(150,996)	$ 43,997
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Tax benefits from employee stock option transactions	—	26,200
Deferred taxes	—	(20,293)
Depreciation and amortization	34,801	22,195
Loss on disposal of property and equipment	4,206	539
Amortization of debt issuance costs	1,850	1,484
Net gains on investments and marketable equity securities	(518)	—
Amortization of deferred stock compensation	494	727
Provision for doubtful accounts receivable and sales returns	2,288	1,700
Non-cash restructuring charges	8,088	—
In-process research and development	134,898	—
Changes in operating assets and liabilities:		
Accounts receivable	18,553	(20,657)
Inventories	873	3,243
Prepaid expenses and other assets	6,892	(8,967)
Accounts payable	(11,698)	33,210
Accrued employee compensation	1,510	(2,582)
Deferred revenue	(2,435)	5,702
Other accrued liabilities	(15,171)	8,986
Liabilities associated with lease losses	(7,109)	(5,580)
Net cash provided by operating activities	26,526	89,904
Cash flows from investing activities:		
Purchases of short-term investments	(40,804)	—
Purchases of long-term investments	(60,755)	(640,777)
Proceeds from sales and maturities of investments	67,275	74,098
Proceeds from sale of marketable equity securities	2,332	—
Purchases of property and equipment	(25,261)	(65,179)
Acquired cash and cash equivalents from acquisition of Rhapsody	2,453	—
Net cash used in investing activities	(54,760)	(631,858)
Cash flows from financing activities:		
Proceeds from issuance of common stock, net	11,496	49,995
Proceeds from issuance of convertible subordinated debt	—	537,625
Payments on assumed capital lease and debt obligations in connection with the acquisition of Rhapsody	(12,583)	—
Net cash provided by financing activities	(1,087)	587,620
Net effect of exchange rate fluctuations on cash and cash equivalents	366	—
Net increase (decrease) in cash and cash equivalents	(28,955)	45,666
Cash and cash equivalents, beginning of period	516,535	150,118
Cash and cash equivalents, end of period	$ 487,580	$ 195,784
Supplemental disclosure of cash flow information:		
Common stock issued for acquisition of Rhapsody, net of acquisition costs	$ 137,134	$ —
Net assets acquired from acquisition of Rhapsody	$ 3,556	$ —

The accompanying notes are an integral part of these Condensed Consolidated Financial Statements.

BROCADE COMMUNICATIONS SYSTEMS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

1. Organization and Operations of Brocade

Brocade Communications Systems, Inc. (Brocade or the Company) designs, develops, markets, sells, and supports data storage networking products and services, offering a line of storage networking products that enables companies to implement highly available, scalable, manageable, and secure environments for data storage applications. The Brocade SilkWorm® family of storage area networking switches is designed to help companies reduce the cost and complexity of managing business information within a data storage environment. Brocade products and services are marketed, sold, and supported worldwide to end-users through distribution partners, including original equipment manufacturers (OEMs), value-added distributors, systems integrators, and value-added resellers.

Brocade was incorporated on May 14, 1999 as a Delaware corporation, succeeding operations that began on August 24, 1995. The Company’s headquarters is located in San Jose, California.

Brocade, SilkWorm, and the Brocade logo are trademarks or registered trademarks of Brocade Communications Systems, Inc. in the United States and/or in other countries. All other brands, products, or service names are or may be trademarks or service marks of, and are used to identify, products or services of their respective owners.

2. Summary of Significant Accounting Policies

Basis of Presentation

The accompanying financial data as of July 26, 2003, and for the three and nine months ended July 26, 2003 and July 27, 2002, have 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 of America have been condensed or omitted pursuant to such rules and regulations. The October 26, 2002 Condensed Consolidated Balance Sheet was derived from audited Consolidated Financial Statements, but does not include all disclosures required by generally accepted accounting principles in the United States of America. However, the Company believes that the disclosures are adequate to make the information presented not misleading. These Condensed Consolidated Financial Statements should be read in conjunction with the Consolidated Financial Statements and notes thereto included in the Company’s Annual Report on Form 10-K for the fiscal year ended October 26, 2002.

In the opinion of management, all adjustments (which include only normal recurring adjustments, except as otherwise indicated) necessary to present a fair statement of financial position as of July 26, 2003, results of operations for the three and nine months ended July 26, 2003 and July 27, 2002, and cash flows for the nine months ended July 26, 2003 and July 27, 2002, have been made. The results of operations for the three and nine months ended July 26, 2003 are not necessarily indicative of the operating results for the full fiscal year or any future periods.

Cash and Cash Equivalents

The Company considers all highly liquid investments with an original or remaining maturity of three months or less at the date of purchase to be cash equivalents. Cash and cash equivalents are primarily maintained at four major financial institutions.

Investments

Investment securities with original or remaining maturities of more than three months but less than one year are considered short-term investments. Investment securities with original or remaining maturities of one year or more are considered long-term investments. Short-term and long-term investments consist primarily of debt securities issued by United States government agencies. Short-term and long-term investments are maintained at three major financial institutions, are classified as available-for-sale, and are recorded on the accompanying Condensed Consolidated Balance Sheets at fair value. Unrealized holding gains and losses are included as a separate component of accumulated other comprehensive income on the accompanying Condensed Consolidated Balance Sheets, net of any related tax effect. Realized gains and losses are calculated based on the specific identification method and are included in interest and other income, net on the Condensed Consolidated Statements of Operations.

From time to time the Company makes minority equity investments in non-publicly traded companies. These investments are included in other assets on the accompanying Condensed Consolidated Balance Sheets, and are accounted for under the cost method. The Company holds less than 20 percent of the voting equity of such companies, and neither has nor seeks control or significant influence over the respective company’s operating and financial policies. The Company monitors its investments for impairment on a quarterly basis and makes appropriate reductions in carrying values when such impairments are determined to be other-than-temporary. Impairment charges are included in interest and other income, net on the Condensed Consolidated Statements of Operations. Factors used in determining an impairment include, but are not limited to, the current business environment including competition and uncertainty of financial condition; going concern considerations such as the rate at which the investee company utilizes cash to finance overhead, and the investee company’s ability to obtain additional private financing to fulfill its stated business plan; the need for changes to the investee company’s existing business model due to changing business environments and its ability to successfully implement necessary changes; and comparable valuations. If an investment is determined to be impaired, a determination is made as to whether such impairment is other-than-temporary. As of July 26, 2003 and October 26, 2002, the carrying values of the Company’s minority equity investments in non-publicly traded companies were zero and $2.2 million, respectively.

Notes Receivable from Non-Executive Employees

The Company has historically provided loans to various non-executive employees principally related to the respective employees’ relocation to the San Francisco Bay area. The loans are generally evidenced by secured promissory notes to the Company and bear interest at prevailing rates. Notes receivable from employees are included in prepaid expenses and other current assets, and other assets in the accompanying Condensed Consolidated Balance Sheets depending upon their remaining term. As of July 26, 2003 and October 26, 2002, the Company had outstanding loans to various employees totaling $3.6 million and $9.0 million, respectively.

Concentrations

Financial instruments that potentially subject the Company to concentrations of credit risk consist primarily of cash equivalents, short-term and long-term investments, and accounts receivable. Cash, cash equivalents, and short-term and long-term investments are primarily maintained at five major financial institutions in the United States. Deposits held with banks may be redeemed upon demand and may exceed the amount of insurance provided on such deposits. The Company primarily invests in United States government agency debt securities and limits the amount of credit exposure to any one institution.

A majority of the Company’s trade receivable balance is derived from sales to OEM partners in the computer storage and server industry. As of July 26, 2003, and October 26, 2002, 78 percent and 73 percent of accounts receivable were concentrated with five customers, respectively. The Company performs ongoing credit evaluations of its customers and generally does not require collateral on accounts receivable balances. The Company has established reserves for credit losses and sales returns and other allowances. The Company has not experienced material credit losses in any of the periods presented.

BROCADE COMMUNICATIONS SYSTEMS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

For the three and nine months ended July 26, 2003, three customers each represented greater than ten percent of the Company's total revenues for combined totals of 66 percent and 68 percent of total revenues, respectively. For the three and nine months ended July 27, 2002, four customers each represented greater than ten percent of the Company's total revenues for combined totals of 76 percent and 73 percent of total revenues, respectively. The level of sales to any single customer may vary and the loss of any single customer, or a decrease in the level of sales to any single customer, could seriously harm the Company's financial condition and results of operations.

The Company currently relies on single and limited supply sources for several key components used in the manufacture of its products. Additionally, the Company relies on two contract manufacturers for the production of its products. The inability of any single and limited source suppliers or the inability of either contract manufacturer to fulfill supply and production requirements, respectively, could have a material adverse effect on the Company's future operating results.

The Company's business is concentrated in the storage area networking industry. Accordingly, the Company's future success depends upon the buying patterns of customers in the storage area networking industry, their response to current and future IT investment trends, and the continued demand by such customers for the Company's products. The Company's continued success will depend upon its ability to enhance its existing products and to develop and introduce, on a timely basis, new cost-effective products and features that keep pace with technological developments and emerging industry standards.

Revenue Recognition

Product revenue. Product revenue is recognized when persuasive evidence of an arrangement exists, delivery has occurred, the fee is fixed or determinable, and collection is probable. However, revenue recognition is deferred for shipments to new customers and for shipments to existing customers when significant support services are required to successfully integrate Brocade products into the customer's products. These revenues, and related costs, are deferred and recognized when the customer has successfully integrated Brocade products into its product offerings and Brocade has met any support obligations. In addition, revenue from sales to master resellers is recognized upon reported sell-through. The Company reduces revenue for estimated sales returns and other allowances at the time of shipment. Sales returns and other allowances are estimated based upon historical experience.

Service revenue. Service revenue consists of training, warranty, and maintenance arrangements, including post-contract customer support (PCS) services. PCS services are offered under renewable, annual fee-based contracts or as part of multiple element arrangements and typically include upgrades and enhancements to the Company's operating system software, and telephone support. For multiple element arrangements, the Company allocates revenue to each element based upon vendor-specific objective evidence (VSOE) of the fair value of the element or application of the residual method. VSOE of the fair value for an element is based upon the price charged when the element is sold separately. Service revenue, including revenue allocated to undelivered elements, is deferred and recognized ratably over the contractual period. Service contracts are typically one to three years in length. Training revenue is recognized upon completion of the training. Service revenue was not material in any of the periods presented.

Warranty Expense. The Company provides warranties on its products ranging from one to three years. Estimated future warranty costs are accrued at the time of shipment and charged to cost of revenues based upon historical experience.

Stock-Based Compensation

The Company has several stock-based compensation plans that are described in the Company's Annual Report on Form 10-K for the fiscal year ended October 26, 2002, which was filed with the SEC on January 22,

BROCADE COMMUNICATIONS SYSTEMS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

2003. The Company accounts for stock-based awards using the intrinsic value method of accounting in accordance with Accounting Principles Board Opinion No. 25, “Accounting for Stock Issued to Employees” (APB 25). Under the intrinsic value method of accounting, no compensation expense is recognized in the Company’s Condensed Consolidated Statements of Operations because the exercise price of the Company’s employee stock options equals the market price of the underlying common stock on the date of grant.

Statement of Financial Accounting Standards No. 123, “Accounting for Stock-Based Compensation,” (SFAS 123), established a fair value based method of accounting for stock-based awards. Under the provisions of SFAS 123, companies that elect to account for stock-based awards in accordance with the provisions of APB 25 are required to disclose the pro forma net income (loss) that would have resulted from the use of the fair value based method under SFAS 123.

Statement of Financial Accounting Standards No. 148, “Accounting for Stock-Based Compensation — Transition and Disclosure an Amendment of FASB Statement No. 123” (SFAS 148), amended the disclosure requirements of SFAS 123 to require more prominent disclosures in both annual and interim financial statements regarding the method of accounting for stock-based employee compensation and the effect of the method used on reported results. The pro forma information resulting from the use of the fair value based method under SFAS 123 is as follows (in thousands except per share amounts):

	Three Months Ended		Nine Months Ended	
	July 26, 2003	July 27, 2002	July 26, 2003	July 27, 2002
Net income (loss) — as reported	$ 1,911	$ 18,348	$(150,996)	$ 43,997
Total stock-based compensation expense determined under fair value based method, net of tax	(69,863)	(118,774)	(113,113)	(380,845)
Pro forma net income (loss)	$(67,952)	$(100,426)	$(264,109)	$(336,848)
Basic earnings (loss) per share:				
As reported	$ 0.01	$ 0.08	$ (0.61)	$ 0.19
Pro forma	$ (0.27)	$ (0.43)	$ (1.06)	$ (1.46)
Diluted earnings (loss) per share:				
As reported	$ 0.01	$ 0.08	$ (0.61)	$ 0.18
Pro forma	$ (0.27)	$ (0.43)	$ (1.06)	$ (1.46)

The assumptions used for the three and nine months ended July 26, 2003 and July 27, 2002, are as follows:

	Three Months Ended		Nine Months Ended	
Stock Options	July 26, 2003	July 27, 2002	July 26, 2003	July 27, 2002
Expected dividend yield	0.0%	0.0%	0.0%	0.0%
Risk-free interest rate	1.2 – 4.4%	1.5 – 4.3%	1.1 – 3.8%	1.5 – 4.3%
Expected volatility	68.7%	97.1%	77.3%	97.1%
Expected life from vest date (in years)	0.5	0.5	0.5	0.5

Employee Stock Purchase Plan	Three Months Ended July 26, 2003	Three Months Ended July 27, 2002	Nine Months Ended July 26, 2003	Nine Months Ended July 27, 2002
Expected dividend yield	0.0%	0.0%	0.0%	0.0%
Risk-free interest rate	0.9%	1.4%	1.0%	1.4%
Expected volatility	63.5%	93.7%	62.1%	93.7%
Expected life from vest date (in years)	0.5	0.5	0.5	0.5

Computation of Net Income (Loss) per Share

Basic net income (loss) per share is computed using the weighted-average number of common shares outstanding during the period, less shares subject to repurchase. Diluted net income (loss) per share is computed using the weighted-average number of common shares and dilutive potential common shares outstanding during the period. Dilutive potential common shares result from the assumed exercise of outstanding stock options, by application of the treasury stock method, that have a dilutive effect on earnings per share, and from the assumed conversion of outstanding convertible debt if it has a dilutive effect on earnings per share.

Comprehensive Income (Loss)

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

	Three Months Ended July 26, 2003	Three Months Ended July 27, 2002	Nine Months Ended July 26, 2003	Nine Months Ended July 27, 2002
Net income (loss)	$1,911	$18,348	$(150,996)	$43,997
Other comprehensive income (loss):				
Change in net unrealized gains (losses)	(684)	9,241	583	9,613
Cumulative translation adjustments	188	—	366	—
Total comprehensive income (loss)	$1,415	$27,589	$(150,047)	$53,610

Reclassifications

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

Recent Accounting Pronouncements

In June 2002, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards No. 146, “Accounting for Costs Associated with Exit or Disposal Activities” (SFAS 146). SFAS 146 requires the recording of costs associated with exit or disposal activities at their fair values only when a liability has been incurred. Under previous guidance, certain exit costs were accrued upon management’s commitment to an exit plan, which is generally before an actual liability has been incurred. The requirements of SFAS 146 were effective prospectively for exit or disposal activities initiated after December 31, 2002. The adoption of SFAS 146 did not have a material effect on the Company’s financial position, results of operations, or cash flows.

In November 2002, the FASB issued FASB Interpretation No. 45, “Guarantor’s Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others — an Interpretation of FASB Statements No. 5, 57, and 107 and Rescission of FASB Interpretation No. 34” (FIN 45). FIN 45 elaborates on the disclosures to be made by a guarantor in its interim and annual financial statements about its obligations under certain guarantees that it has issued. It also requires a guarantor to recognize, at the inception of a guarantee, a liability for the fair value of the obligation undertaken in issuing the guarantee. In general, FIN 45 applies to contracts or indemnification agreements that contingently require the guarantor to make payments to the guaranteed party based on changes in an underlying obligation that is related to an asset, liability or an equity security of the guaranteed party. The recognition provisions of FIN 45 are effective for guarantees issued or modified after December 31, 2002. The disclosure requirements of FIN 45 are effective for financial statements of interim or annual periods ending after December 15, 2002. The Company has determined that the requirements of FIN 45 apply to its accrued warranty and standard indemnification clauses contained within its various customer contracts (see Note 9).

In December 2002, the FASB issued Statement of Financial Accounting Standards No. 148, “Accounting for Stock-Based Compensation — Transition and Disclosure an Amendment of FASB Statement No. 123” (SFAS 148). SFAS 148 amends SFAS 123 “Accounting for Stock-Based Compensation,” to provide alternative methods of transition for a voluntary change to the fair value based method of accounting for stock-based employee compensation. In addition, SFAS 148 amends the disclosure requirements of SFAS 123 to require prominent disclosures in both annual and interim financial statements about the method of accounting for stock-based employee compensation and the effect of the method used on reported results. SFAS 148 is effective for fiscal years beginning after December 15, 2002. The interim disclosure provisions are effective for financial reports containing financial statements for interim periods beginning after December 15, 2002. The adoption of the interim disclosure provisions of SFAS 148 did not affect the Company’s financial position, results of operations, or cash flows.

In January 2003, the FASB issued FASB Interpretation No. 46, “Consolidation of Variable Interest Entities” (FIN 46). FIN 46 requires that if an entity has a controlling financial interest in a variable interest entity, the assets, liabilities and results of activities of the variable interest entity should be included in the consolidated financial statements of the entity. For arrangements entered into after January 31, 2003, FIN 46 was effective immediately. For arrangements entered into prior to January 31, 2003, FIN 46 is effective for the first interim or annual period beginning after June 15, 2003. The Company does not have any variable interest entities.

In May 2003, the FASB issued Statement of Financial Accounting Standards No. 150, “Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity” (SFAS 150). SFAS 150 establishes standards for how an issuer classifies and measures certain financial instruments with characteristics of both liabilities and equity. SFAS 150 is effective for financial instruments entered into or modified after May 31, 2003, and otherwise is effective at the beginning of the first interim period beginning after June 15, 2003. The Company does not expect the adoption of SFAS 150 to have a material effect on the Company’s financial position, results of operations, or cash flows.

3. Acquisition of Rhapsody Networks, Inc.

On January 27, 2003, the Company completed its acquisition of Rhapsody Networks, Inc. (Rhapsody), a provider of next-generation intelligent switching platforms. In exchange for all of the outstanding securities of Rhapsody, the Company issued 19.8 million shares of its common stock and assumed warrants to purchase 0.4 million shares of Brocade common stock and options to purchase 0.3 million shares of Brocade common stock. In addition, the Company will issue up to an additional 2.9 million shares of its common stock if the Rhapsody business successfully completes specified product milestones by November 30, 2003. The additional shares, if issued, will represent additional purchase price and will be accounted for in the same manner as described below.

The total purchase price was $138.5 million, consisting of Brocade common stock valued at $129.3 million; restricted common stock, assumed warrants, and assumed options valued at $7.9 million, reduced by the intrinsic value of unvested restricted stock and stock options of $1.7 million; and direct acquisition costs of

$3.0 million. The value of the common stock issued was determined based on the average of the five-day trading period ended November 7, 2002, or $6.95 per share. The fair value of the restricted common stock, assumed warrants, and assumed options was determined using the Black-Scholes option-pricing model. The deferred stock compensation of $1.7 million will be amortized over the remaining service period on a straight-line basis.

As of the acquisition date, Rhapsody was a development stage company with no recognized revenue and a core technology that had not yet reached technological feasibility. Technological feasibility is established when an enterprise has completed all planning, designing, coding, and testing activities necessary to establish that the technology can be utilized to meet design specifications, including functions, features, and technical performance requirements. Substantial additional resources are still required to bring the Rhapsody core technology to technological feasibility. To date, the Company has incurred $11.6 million in expenses related to bringing the Rhapsody core technology to technological feasibility, and the Company expects to incur additional expenses in the future, approximately $5.0 million to $6.0 million of which the Company expects to incur over the next three months. The Company currently believes that revenues related to this technology will commence during fiscal year 2004. Based upon the factors noted above, the Company concluded that for accounting purposes it was not purchasing a business with an existing revenue stream, but rather a group of assets centered on a core technology that the Company believes will ultimately be developed into a saleable product. As a result, the acquisition of Rhapsody was accounted for as an asset purchase.

The purchase price was allocated to the assets acquired, liabilities assumed, and acquired in-process research and development (in-process R&D) based on their respective fair values. The excess of purchase price over the fair value of net assets received was allocated to acquired in-process R&D and acquired non-monetary assets on a pro-rata basis.

The following table summarizes the allocation of purchase price for the acquisition of Rhapsody (in thousands):

	Fair Value of Assets and Liabilities	Allocation of Excess Purchase Price	Allocated Fair Value of Assets and Liabilities
Current assets	$ 20,766	$ —	$ 20,766
Property and equipment	1,764	822	2,586
Other assets	240	—	240
Total assets acquired	22,770	822	23,592
Current liabilities	(4,613)	—	(4,613)
Capital lease and debt obligations	(12,583)	—	(12,583)
Liabilities associated with facility lease loss	(2,840)	—	(2,840)
Total liabilities assumed	(20,036)	—	(20,036)
Acquired in-process R&D	92,015	42,883	134,898
Excess purchase price	43,705	(43,705)	—
Total purchase price	$138,454	$ —	$138,454

The value assigned to acquired in-process R&D was based on a valuation prepared by an independent third-party appraiser. The value was estimated based on the income approach using discount rates ranging from 35 percent to 45 percent. The income approach estimates the present value of the anticipated cash flows attributable to the respective assets under development once they have reached technological feasibility. The anticipated cash flows were based upon estimated prospective financial information, which was determined by the third-party appraiser to be reasonable and appropriate for use in reaching the value assigned to acquired in-process R&D. No intangible assets were identified. The amount allocated to in-process R&D was expensed in the period of acquisition since the in-process R&D had not yet reached technological feasibility and had no alternative future use.

4. Restructuring Costs

Fiscal 2003 Second Quarter Restructuring

During the quarter ended April 26, 2003, the Company reevaluated certain aspects of its business model and completed a program to restructure certain business operations, reorganize certain aspects of the Company, and reduce the Company's operating expense structure. The restructuring program included a workforce reduction of approximately nine percent, primarily in the sales, marketing, and engineering organizations. In addition, as a result of the restructuring, certain assets associated with reorganized or eliminated functions were determined to be impaired.

The following table summarizes the restructuring costs incurred and charged to restructuring expense, costs paid or otherwise settled, and remaining unpaid or otherwise unsettled accrued liabilities (in thousands) as of July 26, 2003:

	Severance and Benefits	Contract Terminations and Other	Equipment Impairment	Total
Restructuring costs incurred	$ 4,165	$1,478	$ 5,245	$10,888
Cash payments	(3,858)	(782)	—	(4,640)
Non-cash charges	(25)	—	(5,245)	(5,270)
Remaining accrued liabilities at July 26, 2003	$ 282	$ 696	$ —	$ 978

Severance and benefits charges of $4.2 million consisted of severance and related employee termination costs, including outplacement services, associated with the reduction of the Company's workforce. Equipment impairment charges of $5.2 million primarily consisted of excess equipment that is no longer being used as a result of the restructuring program. Contract termination and other charges of $1.5 million were primarily related to the cancellation of certain contracts in connection with the restructuring of certain business functions.

Remaining accrued liabilities related to the Company's fiscal 2003 second quarter restructuring program are included in other accrued liabilities on the accompanying Condensed Consolidated Balance Sheets. No material changes in estimates were made to the fiscal 2003 second quarter restructuring accrual during the three months ended July 26, 2003. The Company expects to pay or otherwise substantially settle the remaining accrued liabilities over the next six to nine months.

Fiscal 2003 First Quarter Restructuring

During the quarter ended January 25, 2003, the Company completed a restructuring program to reduce the Company's expense structure. The restructuring program included a company-wide workforce reduction of approximately 12 percent, consolidation of excess facilities, and the restructuring of certain business functions. This restructuring program affected all of the Company's functional areas.

The following table summarizes the restructuring costs incurred and charged to restructuring expense, costs paid or otherwise settled, and remaining unpaid or otherwise unsettled accrued liabilities (in thousands) as of July 26, 2003:

	Severance and Benefits	Contract Terminations	Equipment Impairment	Total
Restructuring costs incurred	$ 8,549	$ 947	$ 622	$10,118
Cash payments	(6,094)	(930)	—	(7,024)
Non-cash charges	(2,196)	—	(622)	(2,818)
Adjustments	(15)	—	—	(15)
Remaining accrued liabilities at July 26, 2003	$ 244	$ 17	$ —	$ 261

Severance and benefits charges of $8.5 million consisted of severance and related employee termination costs related to the reduction of the Company's workforce, including outplacement services and the write-off of unrecoverable employee loans of certain terminated employees. Contract termination charges of $0.9 million were primarily related to the cancellation of certain contracts in connection with the restructuring of certain business functions and the consolidation of excess facilities. Equipment impairment charges of $0.6 million were related to excess computer equipment resulting from the workforce reduction, consolidation of excess facilities, and the restructuring of certain business functions.

Remaining accrued liabilities related to the Company's fiscal 2003 first quarter restructuring program are included in other accrued liabilities on the accompanying Condensed Consolidated Balance Sheets. No material changes in estimates were made to the fiscal 2003 first quarter restructuring accrual during the three months ended July 26, 2003. The Company expects to pay or otherwise settle the remaining accrued liabilities during the remainder of fiscal year 2003.

5. Balance Sheet Details

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

	July 26, 2003	October 26, 2002
Inventories, net:		
Raw materials	$ 962	$ 645
Finished goods	3,567	4,757
Total	$ 4,529	$ 5,402
Property and equipment, net:		
Computer equipment and software	$ 68,710	$ 64,220
Engineering and other equipment	101,461	96,904
Furniture and fixtures	3,781	3,647
Leasehold improvements	33,753	31,259
	207,705	196,030
Less: Accumulated depreciation and amortization	(78,592)	(52,405)
Total	$129,113	$143,625

Leasehold improvements as of July 26, 2003 and October 26, 2002, are shown net of estimated asset impairments related to facilities lease losses (see Note 7).

6. Investments and Equity Securities

The following tables summarize the Company's investments and equity securities (in thousands):

	Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
July 26, 2003				
U.S. government obligations	$398,932	$11,565	$ —	$410,497
State and municipal obligations	3,850	—	—	3,850
Corporate notes	7,132	7	(4)	7,135
Equity securities	694	63	—	757
Total	$410,608	$11,635	$ (4)	$422,239
Reported as:				
Short-term investments				$ 71,039
Other current assets				757
Long-term investments				350,443
Total				$422,239
October 26, 2002				
U.S. government obligations	$361,074	$10,779	$ —	$371,853
Marketable equity securities	347	—	(121)	226
Total	$361,421	$10,779	$(121)	$372,079
Reported as:				
Short-term investments				$ 50,988
Marketable equity securities				226
Long-term investments				320,865
Total				$372,079

For the three and nine months ended July 26, 2003, a loss of $0.2 million was realized on the sale of marketable equity securities and included in interest and other income, net on the Condensed Consolidated Statements of Operations. No gains or losses were realized on the sale of investments or marketable equity securities during the three and nine months ended July 27, 2002. As of July 26, 2003, and October 26, 2002, net unrealized holding gains of $11.6 million and $10.7 million, respectively, were included in accumulated other comprehensive income in the accompanying Condensed Consolidated Balance Sheets, net of any related tax effect.

The following table summarizes the maturities of the Company's investments in debt securities as of July 26, 2003 (in thousands):

	Amortized Cost	Fair Value
Less than one year	$ 70,878	$ 71,039
Due in 1 – 2 years	339,036	350,443
Due in 2 – 3 years	—	—
Total	$409,914	$421,482

7. Liabilities Associated with Facilities Lease Losses

During the quarter ended October 27, 2001, the Company recorded a charge of $39.8 million related to estimated facilities lease losses, net of expected sublease income, and a charge of $5.7 million in connection with the estimated impairment of certain related leasehold improvements. These charges represented the low-end of an estimated range that may be adjusted upon the occurrence of future triggering events. Triggering events may include, but are not limited to, changes in estimated time to sublease the facilities, sublease terms, sublease rates, expected future operating costs, and expected future use of the facilities.

During the three months ended July 27, 2002, the Company completed a transaction to sublease a portion of these vacant facilities. Accordingly, based on then current market data, the Company revised certain estimates and assumptions, including those related to estimated sublease rates, estimated time to sublease the facilities, expected future operating costs, and expected future use of the facilities. The Company reevaluates its estimates and assumptions on a quarterly basis and makes adjustments to the reserve balance if necessary. No material adjustments were made to the facilities lease losses reserve for the three or nine months ended July 26, 2003.

Should there be changes in real estate market conditions or should it take longer than expected to find a suitable tenant to sublease the remaining vacant facilities, adjustments to the facilities lease losses reserve may be necessary in future periods based upon then current actual events and circumstances.

The following table summarizes the activity related to the facilities lease losses reserve, net of expected sublease income (in thousands):

	Facilities Lease Losses
Reserve balances at October 26, 2002	$30,806
Cash payments on facilities leases	(6,569)
Non-cash charges	(540)
Lease loss liability assumed in connection with the acquisition of Rhapsody (see Note 3)	2,840
Reserve balances at July 26, 2003	$26,537

Cash payments for facilities leases related to the above noted facilities lease losses will be paid over the respective lease terms through fiscal year 2006.

8. Convertible Subordinated Debt

On December 21, 2001, and January 10, 2002, the Company sold, in private placements pursuant to Section 4(2) of the Securities Act of 1933, as amended, $550 million in aggregate principal amount, two percent convertible subordinated notes due 2007. The initial purchasers purchased the notes from the Company at a discount of 2.25 percent of the aggregate principal amount. Holders of the notes may, in whole or in part, convert the notes into shares of the Company's common stock at a conversion rate of 22.8571 shares per $1,000 principal amount of notes (aggregate of approximately 12.6 million shares) at any time prior to maturity on January 1, 2007. At any time on or after January 5, 2005, the Company may redeem the notes in whole or in part at the following prices expressed as a percentage of the principal amount:

Redemption Period	Price
Beginning on January 5, 2005 and ending on December 31, 2005	100.80%
Beginning on January 1, 2006 and ending on December 31, 2006	100.40%
On January 1, 2007	100.00%

The Company is required to pay interest on January 1 and July 1 of each year, beginning July 1, 2002. Debt issuance costs of $12.4 million are being amortized over the term of the notes. The amortization of debt issuance costs will accelerate upon early redemption, repurchase, or conversion of the notes. The net proceeds remain available for general corporate purposes, including working capital and capital expenditures.

The notes are not listed on any securities exchange or included in any automated quotation system; however, the notes are eligible for trading on the Portal[SM] Market. On July 25, 2003, the average bid and ask price on the Portal Market of the notes was 82.50, resulting in an aggregate fair value of approximately $453.8 million.

9. Commitments and Contingencies

Leases

The Company leases its facilities and certain equipment under various operating lease agreements that expire through November 2013. In connection with its facilities lease agreements, the Company has signed unconditional, irrevocable letters of credit totaling $18.7 million as security for the leases. Future minimum lease payments under all non-cancelable operating leases as of July 26, 2003 were $249.2 million. In addition to base rent, many of the facilities lease agreements require that the Company pay a proportional share of the respective facilities' operating expenses.

As of July 26, 2003, the Company had recorded $26.5 million in facilities lease loss reserves related to future lease commitments, net of expected sublease income (see Note 7).

Product Warranties

The Company provides warranties on its products ranging from one to three years. Estimated future warranty costs are accrued at the time of shipment and charged to cost of revenues based upon historical experience. The Company's accrued liability for estimated future warranty costs is included in other accrued liabilities on the accompanying Condensed Consolidated Balance Sheets. The following table summarizes the activity related to the Company's accrued liability for estimated future warranty costs during the nine months ended July 26, 2003 (in thousands):

	Accrued Warranty
Balance at October 26, 2002	$ 3,966
Liabilities accrued	1,188
Claims paid	(530)
Changes in liability for pre-existing warranties	(1,207)
Balance at July 26, 2003	$ 3,417

In addition, the Company has standard indemnification clauses contained within its various customer contracts whereby the Company indemnifies the parties to whom it sells its products with respect to the Company's product infringing upon any patents, trademarks, copyrights, or trade secrets, as well as against bodily injury or damage to real or tangible personal property caused by a defective Company product. As of July 26, 2003, there have been no known events or circumstances that have resulted in an indemnification related liability to the Company.

Manufacturing and Purchase Commitments

The Company has manufacturing agreements with Solectron Corporation (Solectron) and Hon Hai Precision Industry Co. (Foxconn) under which the Company provides twelve-month product forecasts and places purchase orders in advance of the scheduled delivery of products to the Company's customers. The required lead-time for placing orders with both Solectron and Foxconn depends on the specific product. As of July 26, 2003, the Company's aggregate commitment to Solectron and Foxconn for inventory components used in the manufacture of Brocade products was $47.3 million, net of purchase commitment reserves of $2.5 million, which the Company expects to utilize during future normal ongoing operations. The Company's purchase orders placed with Solectron and Foxconn are cancelable, however if cancelled, the agreement with Solectron requires the Company to purchase from Solectron certain inventory components not returnable, usable by, or sold to other Solectron customers within 365 days.

Legal Proceedings

From time to time, claims are made against the Company in the ordinary course of its business, which could result in litigation. Claims and associated litigation are subject to inherent uncertainties and unfavorable outcomes could occur, such as monetary damages, fines, penalties or injunctions prohibiting the Company from selling one or more products or engaging in other activities. The occurrence of an unfavorable outcome in any specific period could have a material adverse affect on the Company's results of operations for that period or future periods.

On May 23, 2003, a suit captioned *Vixel Corporation v. Brocade Communications Systems, Inc.* was filed in the United States District Court for the Northern District of California. The complaint alleges that Brocade products infringe United States Patents Nos. 6,118,776; 6,470,007; and 6,185,203 relating to switching and Fibre Channel technologies. The complaint seeks unspecified compensatory and exemplary damages and to permanently enjoin Brocade from infringing the patents in the future. A scheduling conference is scheduled for November 15, 2003. The Company believes that it has meritorious defenses to the claims and intends to defend the action vigorously. At this time the Company is not able to determine what effect, if any, this action will have on its business or financial position and results of operations.

On January 10, 2003, a suit captioned *Raytheon Company v. Brocade Communications Systems, Inc. et al.* was filed against Brocade and various other companies in the United States District Court for the Eastern District of Texas. The complaint alleges that Brocade products infringe United States Patent No. 5,412,791, entitled "Mass Data Storage Library." On February 6, 2003, Raytheon filed an amended complaint stating their original claim with more particularity. The complaint seeks unspecified compensatory and exemplary damages and to permanently enjoin Brocade from infringing the patent in the future. On May 9, 2003, the Company filed an answer and counterclaims, asserting, among other things, invalidity of all of Raytheon's claims. A scheduling conference was held on May 20, 2003, and trial has been scheduled for June 2004. The Company believes that it has meritorious defenses to the claims and intends to defend the action vigorously. At this time the Company is not able to determine what effect, if any, this action will have on its business or financial position and results of operations.

On February 14, 2002, a suit captioned *McDATA Corp. v. Brocade Communications Systems, Inc.* was filed against the Company in the United States District Court for the District of Colorado. The complaint alleged that the Brocade SilkWorm 3800 Enterprise Fibre Channel Fabric Switch and Brocade SilkWorm 12000 Core Fabric Switch infringe United States Patent No. 6,233,236, entitled "Method and Apparatus for Measuring Traffic Within a Switch." The complaint seeks unspecified compensatory and exemplary damages and to permanently enjoin the Company from infringing the patent in the future. On March 4, 2002, McDATA Corporation (McDATA) filed an amended complaint in which it additionally alleged that the Brocade SilkWorm 3200 Entry Fabric Switch infringed this patent. In connection with this suit, on March 4, 2002, McDATA filed a motion for a preliminary injunction against the Company with regard to the patent. On April 8, 2002, the Company filed an answer and counterclaims asserting, among other things, no infringement, and that the patent is invalid, unenforceable and covered by an existing covenant not to sue between the parties. A hearing on McDATA's motion for preliminary injunction was held during the week of July 15, 2002. In an order dated December 6, 2002, the Court denied McDATA's motion for a preliminary injunction. On December 23, 2002, McDATA filed a demand for arbitration to move this matter from the United States District Court for the District of Colorado to arbitration. The matter was referred to arbitration. A scheduling conference was held on August 20, 2003, and arbitration has been scheduled for November 10, 2003. The Company believes that it has meritorious defenses to the claims and intends to defend the action vigorously. The Company believes that the ultimate disposition of this matter will not have a material adverse effect on its business or financial position and results of operations.

On July 20, 2001, the first of a number of putative class actions was filed in the United States District Court for the Southern District of New York against the Company, certain of its officers and directors, and certain of the underwriters for the Company's initial public offering. Those cases were consolidated under the caption *Chae v. Brocade Communications Systems, Inc. et al*. The complaints generally alleged that various underwriters engaged in improper and undisclosed activities related to the allocation of shares in the Company's initial public offering of securities. On March 1, 2002, the Court entered an order dismissing without prejudice all claims against the Company and its officers and directors named in the consolidated proceeding. On April 19, 2002, a consolidated amended class action captioned *In Re Brocade Communications Systems, Inc. Initial Public Offering Securities Litigation* was filed which makes claims against the Brocade parties that are substantially similar to those alleged in the earlier case. The complaint seeks unspecified damages on behalf of a purported class of purchasers of common stock from May 24, 1999 to December 6, 2000. In October 2002, the individual defendants were dismissed without prejudice from the action. On February 19, 2003, the Court entered an order dismissing all of the plaintiffs' claims against the Company. No appeal has been filed.

10. Common Stock

On December 9, 2002, the Company announced that its Board of Directors approved a voluntary stock option exchange program (the Exchange Program) for employees. Under the Exchange Program, employees were offered the opportunity to exchange an aggregate of approximately 67.3 million outstanding stock options with exercise prices equal to or greater than $12.00 per share for new stock options to be granted at an exchange ratio determined by the date the exchanged stock options were granted. Participating employees other than the Chief Executive Officer (CEO) would receive new stock options in exchange for their eligible outstanding stock options at an exchange ratio of either 1 for 1, 1 for 2, or 1 for 3, depending on the grant date of the exchanged stock option. The CEO would receive new stock options in exchange for eligible outstanding stock options at an exchange ratio of 1 for 10.

In accordance with the Exchange Program, on January 9, 2003, the Company cancelled 58.7 million outstanding stock options and issued promises to grant new stock options to participating employees. On July 10, 2003, the first business day that was six months and one day after the cancellation of the exchanged options, the Company granted to participating employees 26.6 million new stock options at an exercise price of $6.54 per share. The exercise price per share of the new stock options was equal to the fair market value of the Company's common stock at the close of regular trading on July 10, 2003. The 26.6 million new stock options represent approximately 10 percent of the Company's total shares of common stock outstanding as of July 26, 2003, and could have a dilutive effect on the Company's future earnings per share to the extent that the future market price of the Company's common stock exceeds $6.54 per share. No financial or accounting effect to the Company's financial position, results of operations, or cash flows for the three and nine months ended July 26, 2003 was associated with this transaction.

11. Segment Information

The Company is organized and operates as one operating segment: the design, development, marketing and selling of infrastructure for storage area networks (SANs). The CEO is the Company's Chief Operating

Decision Maker (CODM), as defined by SFAS 131, “Disclosures about Segments of an Enterprise and Related Information.” The CODM allocates resources and assesses the performance of the Company based on revenues and overall profitability.

Revenues are attributed to geographic areas based on the location of the customer to which product is shipped. Domestic revenues include sales to certain OEM customers who take possession of Brocade products domestically and then distribute those products to their international customers. Domestic and international revenues were 66 percent and 34 percent of total revenues, respectively, for the three months ended July 26, 2003, and 67 percent and 33 percent of total revenues, respectively, for the nine months ended July 26, 2003. Domestic and international revenues were 75 percent and 25 percent of total revenues, respectively, for the three months ended July 27, 2002, and 71 percent and 29 percent of total revenues, respectively, for the nine months ended July 27, 2002. To date, service revenue has not exceeded 10 percent of total revenues. Long-lived assets located in foreign countries were not material as of July 26, 2003 and October 26, 2002.

For the three and nine months ended July 26, 2003, three customers each represented greater than ten percent of the Company’s total revenues for combined totals of 66 percent and 68 percent of total revenues, respectively. For the three and nine months ended July 27, 2002, four customers each represented greater than ten percent of the Company’s total revenues for combined totals of 76 percent and 73 percent of total revenues, respectively. The level of sales to any single customer may vary and the loss of any single customer, or a decrease in the level of sales to any single customer, could seriously harm the Company’s financial condition and results of operations.

12. Interest and Other Income, Net

Interest and other income, net consisted of the following (in thousands):

	Three Months Ended		Nine Months Ended	
	July 26, 2003	July 27, 2002	July 26, 2003	July 27, 2002
Interest income	$4,651	$6,972	$14,708	$17,094
Gain (loss) on investment, net	(12)	—	518	—
Other income (expense), net	(349)	(145)	(506)	(271)
Total	$4,290	$6,827	$14,720	$16,823

Net gain on investments for the nine months ended July 26, 2003, includes a gain of $2.5 million recorded during the three months ended January 25, 2003, that resulted from the acquisition of a non-publicly traded company in which Brocade had a minority equity investment. This gain was partially offset by an impairment charge of $2.2 million recorded during the three months ended January 25, 2003, that resulted from an other-than-temporary decline in the estimated fair value of a minority equity investment in a different non-publicly traded company.

13. Net Income (Loss) Per Share

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

	Three Months Ended		Nine Months Ended	
	July 26, 2003	July 27, 2002	July 26, 2003	July 27, 2002
Net income (loss)	$ 1,911	$ 18,348	$(150,996)	$ 43,997
Basic and diluted net income (loss) per share:				
Weighted-average shares of common stock outstanding	256,674	233,760	249,158	232,573
Less: Weighted-average shares of common stock subject to repurchase	(801)	(743)	(672)	(1,754)
Weighted-average shares used in computing basic net income (loss) per share	255,873	233,017	248,486	230,819
Dilutive effect of potential common shares	3,571	7,089	—	13,853
Weighted-average shares used in computing diluted net income (loss) per share	259,444	240,106	248,486	244,672
Basic net income (loss) per share	$ 0.01	$ 0.08	$ (0.61)	$ 0.19
Diluted net income (loss) per share	$ 0.01	$ 0.08	$ (0.61)	$ 0.18

For the three months ended July 26, 2003 and July 27, 2002, potential common shares in the form of stock options to purchase 9.1 million shares of common stock and 65.1 million shares of common stock, respectively, were antidilutive and therefore not included in the computation of diluted earnings per share. For the nine months ended July 26, 2003 and July 27, 2002, potential common shares in the form of stock options to purchase 30.0 million shares of common stock and 43.9 million shares of common stock, respectively, were antidilutive and therefore not included in the computation of diluted earnings per share.

In addition, for each of the three months ended July 26, 2003 and July 27, 2002, 12.6 million potential common shares resulting from the potential conversion of the Company's convertible subordinated debt were antidilutive and therefore not included in the computation of diluted earnings per share. For the nine months ended July 26, 2003 and July 27, 2002, 12.6 million potential common shares and 10.0 million potential common shares, respectively, resulting from the potential conversion of the Company's convertible subordinated debt were antidilutive and therefore not included in the computation of diluted earnings per share.

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

This Quarterly Report on Form 10-Q (Quarterly Report) contains forward-looking statements. These forward-looking statements include predictions regarding our future:

- revenues and profits;
- customer concentration;
- research and development expenses;
- sales and marketing expenses;
- general and administrative expenses;
- pricing and cost reduction activities;
- technological feasibility of Rhapsody core technology;
- effective tax rate;
- cash flows from employee participation in employee stock programs;
- liquidity and sufficiency of existing cash, cash equivalents, and short-term investments for near-term requirements;
- realization of deferred tax assets;
- purchase commitments; and
- the effect of recent accounting pronouncements on our financial condition and results of operations.

You can identify these and other forward-looking statements by the use of words such as “may,” “will,” “should,” “expects,” “plans,” “anticipates,” “believes,” “estimates,” “predicts,” “intends,” “potential,” “continue,” or the negative of such terms, or other comparable terminology. Forward-looking statements also include the assumptions underlying or relating to any of the foregoing statements.

Our actual results could differ materially from those anticipated in these forward-looking statements as a result of various factors, including those set forth below under the heading “Risk Factors.” All forward-looking statements included in this document are based on information available to us on the date hereof. We assume no obligation to update any forward-looking statements.

The following information should be read in conjunction with the Condensed Consolidated Financial Statements and notes thereto included in Item 1 of this Quarterly Report, and with Management's Discussion and Analysis of Financial Condition and Results of Operations and the Consolidated Financial Statements and notes thereto contained in our Annual Report on Form 10-K for the fiscal year ended October 26, 2002, which was filed with the SEC on January 22, 2003.

Results of Operations

The following table sets forth certain financial data for the periods indicated as a percentage of total net revenues:

	Three Months Ended		Nine Months Ended	
	July 26, 2003	July 27, 2002	July 26, 2003	July 27, 2002
Net revenues	100.0%	100.0%	100.0%	100.0%
Cost of revenues	45.9	39.9	46.1	39.8
Gross margin	54.1	60.1	53.9	60.2
Operating expenses:				
Research and development	27.8	22.0	27.2	23.3
Sales and marketing	20.6	20.0	23.3	20.2
General and administrative	4.1	3.1	4.1	3.5
Amortization of deferred stock compensation	0.2	0.2	0.1	0.2
Restructuring costs	—	—	5.4	—
In-process research and development	—	—	34.8	—
Total operating expenses	52.7	45.3	94.9	47.2
Income (loss) from operations	1.4	14.8	(41.0)	13.0
Interest and other income, net	3.2	4.5	3.8	4.1
Interest expense	(2.6)	(2.2)	(2.6)	(1.9)
Income (loss) before provision for income taxes	2.0	17.1	(39.8)	15.2
Income tax (benefit) provision	0.6	5.0	(0.9)	4.4
Net income (loss)	1.4%	12.1%	(38.9)%	10.8%

Revenues. Our revenues are derived primarily from sales of our SilkWorm family of products. Net revenues for the three months ended July 26, 2003 were $133.5 million, compared to $151.2 million for the three months ended July 27, 2002. Net revenues for the nine months ended July 26, 2003 were $387.5 million, compared to $409.3 million for the nine months ended July 27, 2002. Revenues were negatively affected by declines in average selling prices as a result of increased competition, partially offset by increases in volume. Revenues for the nine months ended July 26, 2003 were also negatively affected by reductions in the supply of our product maintained by our primary OEM customers.

Domestic and international revenues were 66 percent and 34 percent of total revenues, respectively, for the three months ended July 26, 2003, compared to 75 percent and 25 percent of total revenues, respectively, for the three months ended July 27, 2002. Domestic and international revenues were 67 percent and 33 percent of total revenues, respectively, for the nine months ended July 26, 2003, compared to 71 percent and 29 percent, respectively, for the nine months ended July 27, 2002. Revenues are attributed to geographic areas based on the location of the customer to which our products are shipped. International revenues primarily consisted of sales to customers in Western Europe and the greater Asia Pacific region. Included in domestic revenues are sales to certain OEM customers who take possession of our products domestically and then distribute those products to their international customers. Our mix of international and domestic revenue can therefore vary depending on the relative mix of sales to certain OEM customers.

A significant portion of our revenues is concentrated among a relatively small number of customers. For the three and nine months ended July 26, 2003, three customers each represented greater than ten percent of our total revenues for combined totals of 66 percent and 68 percent of total revenues, respectively. For the three and nine months ended July 27, 2002, four customers each represented greater than ten percent of our total revenues for combined totals of 76 percent and 73 percent of total revenues, respectively. We expect that a significant portion of our future revenues will continue to come from sales of products to a relatively small number of customers. Therefore, the loss of any one significant customer, or a decrease in the level of sales to any one significant customer, could seriously harm our financial condition and results of operations.

Gross margin. Gross margin for the three months ended July 26, 2003 was 54.1 percent, compared to 60.1 percent for the three months ended July 27, 2002. Gross margin for the nine months ended July 26, 2003 was 53.9 percent, compared to 60.2 percent for the nine months ended July 27, 2002. The reductions in gross margins were primarily related to an increase in manufacturing operations costs and declines in the average selling prices of our products, partially offset by reductions in product costs.

Research and development expenses. Research and development (R&D) expenses were $37.2 million for the three months ended July 26, 2003, compared to $33.2 million for the three months ended July 27, 2002. R&D expenses were $105.6 million for the nine months ended July 26, 2003, compared to $95.5 million for the nine months ended July 27, 2002. R&D expenses consist primarily of salaries and related expenses for personnel engaged in engineering and R&D activities; fees paid to consultants and outside service providers; nonrecurring engineering charges; prototyping expenses related to the design, development, testing and enhancement of our products; depreciation related to engineering and other test equipment; and IT and facilities expenses. The increases in R&D expenses were primarily the result of incremental spending associated with our acquisition of Rhapsody. We currently anticipate that R&D expenses for the three months ended October 25, 2003, will increase on an absolute dollars basis from the $37.2 million incurred during the three months ended July 26, 2003.

Sales and marketing expenses. Sales and marketing expenses were $27.5 million for the three months ended July 26, 2003, compared to $30.3 million for the three months ended July 27, 2002. Sales and marketing expenses consist primarily of salaries, commissions and related expenses for personnel engaged in marketing and sales; costs associated with promotional and travel expenses; and IT and facilities expenses. The decrease in sales and marketing expenses was primarily due to decreased salary expense resulting from the workforce reduction that occurred during the three months ended April 26, 2003, and decreased travel and marketing program expenses resulting from various cost-cutting actions. Sales and marketing expenses were $90.2 million for the nine months ended July 26, 2003, compared to $82.7 million for the nine months ended July 27, 2002. The increase in sales and marketing expenses was primarily due to the expansion of our sales and marketing organizations partially offset by restructuring and other cost-cutting actions. We currently anticipate that sales and marketing expenses for the three months ended October 25, 2003, will decrease slightly, subject to our ability to execute on planned cost reduction activities, on an absolute dollar basis from the $27.5 million incurred during the three months ended July 26, 2003.

General and administrative expenses. General and administrative (G&A) expenses were $5.5 million for the three months ended July 26, 2003, compared to $4.8 million for the three months ended July 27, 2002. G&A expenses were $15.8 million for the nine months ended July 26, 2003, compared to $14.1 million for the nine months ended July 27, 2002. G&A expenses consist primarily of salaries and related expenses for corporate executives, finance, human resources and investor relations, as well as recruiting expenses, professional fees, corporate legal expenses, other corporate expenses, and IT and facilities expenses. The increase in G&A expenses was primarily due to an increase in G&A related personnel. We currently anticipate that G&A expenses for the three months ended October 25, 2003 will decrease slightly, subject to our ability to execute on planned cost reduction activities, on an absolute dollar basis from the $5.5 million incurred during the three months ended July 26, 2003.

Restructuring costs. Restructuring costs for the nine months ended July 26, 2003, were $21.0 million. Restructuring costs consist of $10.9 million related to a program to restructure and reorganize certain business operations during the three months ended April 26, 2003, and $10.1 million related to a company-wide restructuring program during the three months ended January 25, 2003 (see Note 4 “Restructuring Costs” of the Notes to Condensed Consolidated Financial Statements).

Amortization of deferred stock compensation. Amortization of deferred stock compensation was $0.2 million for each of the three months ended July 26, 2003 and July 27, 2002. Amortization of deferred stock compensation was $0.5 million for the nine months ended July 26, 2003, compared to $0.7 million for the nine months ended July 27, 2002. During the three months ended April 26, 2003, we recorded $1.7 million of deferred stock compensation in connection with our acquisition of Rhapsody. The $1.7 million of deferred stock compensation represented the intrinsic value of unvested restricted common stock and assumed stock options, and is being amortized over the respective remaining service periods on a straight-line basis (see Note 3 "Acquisition of Rhapsody Networks, Inc." of the Notes to Condensed Consolidated Financial Statements).

In-process research and development. On January 27, 2003, we completed our acquisition of Rhapsody, a provider of next-generation intelligent switching platforms. In exchange for all of the outstanding securities of Rhapsody, we issued 19.8 million shares of our common stock and assumed warrants and stock options to purchase 0.7 million shares of our common stock. In addition, we will issue up to an additional 2.9 million shares of our common stock if the Rhapsody business successfully completes specified product milestones by November 30, 2003.

As of the acquisition date, Rhapsody was a development stage company that had no recognized revenue and a core technology that required substantial additional resources to bring it to technological feasibility. To date, we have incurred $11.6 million in expenses related to bringing the Rhapsody core technology to technological feasibility, and we expect to incur additional expenses in the future, approximately $5.0 million to $6.0 million of which we expect to incur over the next three months. We currently believe that revenues related to this technology will commence during fiscal year 2004. As a result, the acquisition was accounted for as an asset purchase and the total purchase price of $138.5 million was allocated to the assets acquired, liabilities assumed, and acquired in-process R&D based on their respective fair values. The excess of purchase price over the fair value of net assets received was allocated to acquired in-process R&D and acquired non-monetary assets on a pro-rata basis. Acquired in-process R&D of $134.9 million was expensed during the three months ended April 26, 2003 because it had not yet reached technological feasibility and had no alternative future use. No acquired in-process R&D was recorded in any of the other periods presented (see Note 3 "Acquisition of Rhapsody Networks, Inc.," of the Notes to Condensed Consolidated Financial Statements).

Interest and other income, net. Net interest and other income was $4.3 million for the three months ended July 26, 2003, compared to $6.8 million for the three months ended July 27, 2002. Net interest and other income was $14.7 million for the nine months ended July 26, 2003, compared to $16.8 million for the nine months ended July 27, 2002. The decreases were primarily the result of lower interest rates.

Interest expense. Interest expense was $3.4 million for each of the three months ended July 26, 2003 and July 27, 2002, respectively. Interest expense was $10.1 million for the nine months ended July 26, 2003, compared to $8.1 million for the nine months ended July 27, 2002. Interest expense primarily represents the interest cost associated with our convertible subordinated notes issued during the three months ended January 26, 2002.

Income tax (benefit) provision. Our effective tax rate for the three months ended July 26, 2003 was a provision of 28.8 percent, compared with a provision of 29.0 percent for the three months ended July 27, 2002. Our effective tax rate for the nine months ended July 26, 2003, was a benefit of 2.2 percent, compared with a provision of 29.0 percent for the nine months ended July 27, 2002. Our effective tax rate for the nine months ended July 26, 2003, was affected by non-deductible expenses, primarily in-process R&D, incurred in connection with our acquisition of Rhapsody.

We currently anticipate an effective tax rate of 29 percent for the three months ended October 25, 2003. Our ability to maintain this effective tax rate requires that international revenues and earnings as a percentage of total revenues and earnings be consistent with historical levels. To the extent that international revenues and earnings differ from those historically achieved, a factor largely influenced by the buying behavior of our OEM partners, or unfavorable changes in tax laws and regulations occur, our effective tax rate could change.

Liquidity and Capital Resources

Cash, cash equivalents, short-term and long-term investments were $909.1 million as of July 26, 2003. For the nine months ended July 26, 2003, we generated $26.5 million in cash from operating activities, primarily related to non-cash losses and a decrease in accounts receivable, partially offset by decreases in accounts payable and other accrued liabilities. Days sales outstanding in receivables for the three months ended July 26, 2003 was 52 days.

Net cash used in investing activities for the nine months ended July 26, 2003 totaled $54.8 million and was primarily the result of $34.3 million in net purchases of short- and long-term investments, and $25.3 million invested in capital equipment. Net cash used in financing activities totaled $1.1 million. Net cash used in financing activities resulted from payments of $12.6 million for assumed capital lease and debt obligations in connection with our acquisition of Rhapsody, partially offset by proceeds from the issuance of common stock related to employee participation in employee stock plans of $11.5 million.

Net proceeds from the issuance of common stock related to employee participation in employee stock programs have historically been a significant component of our liquidity. The extent to which our employees participate in these programs generally increases or decreases based upon changes in the market price of our common stock. As a result, our cash flows resulting from the issuance of common stock related to employee participation in employee stock programs will vary. We do not expect to generate significant cash flows from the issuance of common stock related to employee participation in employee stock programs during fiscal year 2003 as a result of our voluntary stock option exchange program.

We have manufacturing agreements with Solectron and Foxconn under which we provide twelve-month product forecasts and place purchase orders in advance of the scheduled delivery of products to our customers. The required lead-time for placing orders with both Solectron and Foxconn depends on the specific product. As of July 26, 2003, our aggregate commitment to Solectron and Foxconn for inventory components used in the manufacture of our products was $47.3 million, net of purchase commitment reserves of $2.5 million, which we expect to utilize during future normal ongoing operations. Our purchase orders placed with Solectron and Foxconn are cancelable, however if cancelled, the agreement with Solectron requires us to purchase from Solectron certain inventory components not returnable, usable by, or sold to other Solectron customers within 365 days.

On December 21, 2001, and January 10, 2002, we sold $550 million in aggregate principal amount of two percent convertible subordinated notes due 2007 (see note 8, “Convertible Subordinated Debt” of the Notes to Condensed Consolidated Financial Statements). Holders of the notes may, in whole or in part, convert the notes into shares of our common stock at a conversion rate of 22.8571 shares per $1,000 principal amount of notes (aggregate of approximately 12.6 million shares) at any time prior to maturity on January 1, 2007. At any time on or after January 5, 2005, we may redeem the notes in whole or in part at the following prices expressed as a percentage of the principal amount:

Redemption Period	Price
Beginning on January 5, 2005 and ending on December 31, 2005	100.80%
Beginning on January 1, 2006 and ending on December 31, 2006	100.40%
On January 1, 2007	100.00%

We are required to pay interest on January 1 and July 1 of each year, beginning July 1, 2002. We may, from time to time, consider repurchasing portions of the outstanding notes. Debt issuance costs of $12.4 million are being amortized over the term of the notes. The amortization of debt issuance costs will accelerate upon early redemption, repurchase, or conversion of the notes. The net proceeds remain available for general corporate purposes, including working capital and capital expenditures.

The following table summarizes our contractual obligations (including interest expense) and commitments as of July 26, 2003 (in thousands):

	Total	Less than 1 year	1 – 3 years	After 3 years
Contractual Obligations:				
Convertible subordinated notes, including interest	$588,500	$11,000	$22,000	$555,500
Non-cancelable operating leases	249,229	32,196	56,066	160,967
Unconditional purchase obligations, gross	49,835	49,835	—	—
Total contractual cash obligations	$887,564	$93,031	$78,066	$716,467
Other Commitments:				
Standby letters of credit	$ 18,749	$ n/a	$ n/a	$ n/a

We believe that our existing cash, cash equivalents, short-term and long-term investments, and cash expected to be generated from future operations will be sufficient to meet our capital requirements at least through the next 12 months. Our future capital requirements will depend on many factors, including: our revenues; the timing and extent of spending to support product development efforts; the timing of introductions of new products and enhancements to existing products; and the market acceptance of our products.

Related Party Transactions

Larry W. Sonsini, a director of Brocade, is a member of Wilson Sonsini Goodrich & Rosati, Professional Corporation (WSGR), our principal outside legal counsel. Aggregate fees billed to us by WSGR for legal services rendered, including general corporate counseling, litigation services, merger and acquisition related services, and services related to our convertible debt offering, during the nine months ended July 26, 2003 and July 27, 2002, were $1.1 million and $2.5 million, respectively.

During the normal course of business we purchase certain equipment from vendors who are also customers of Brocade and with whom we have contractual arrangements. The equipment we purchase is primarily used for testing purposes in our development labs or otherwise consumed internally. We believe that all such transactions are on an arms-length basis and subject to terms no more favorable than those with unrelated parties.

Use of Estimates and Critical Accounting Policies

Our discussion and analysis of financial condition and results of operations is based upon our Condensed Consolidated Financial Statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America. The preparation of these Condensed Consolidated Financial Statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities. We evaluate our estimates and judgments on an on-going basis, including those related to sales returns, bad debts, excess inventory and purchase commitments, investments, warranty obligations, lease losses, income taxes, and contingencies and litigation. We base our estimates on historical experience and assumptions that we believe to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates.

The methods, estimates, and judgments we use in applying our most critical accounting policies have a significant effect on the results that we report in our Condensed Consolidated Financial Statements. The SEC considers an entity’s most critical accounting policies to be those policies that are both most important to the portrayal of a company’s financial condition and results of operations, and those that require management’s most difficult, subjective or complex judgments, often as a result of the need to make estimates about matters that are inherently uncertain at the time of estimation. We believe the following critical accounting policies, among others, require significant judgments and estimates used in the preparation of our Condensed Consolidated Financial Statements:

- Revenue recognition, warranty reserves, and allowances for sales returns and doubtful accounts;
- Inventory and purchase commitment reserves;
- Lease losses; and
- Accounting for income taxes.

Product revenue is generally recognized when persuasive evidence of an arrangement exists, delivery has occurred, fee is fixed or determinable, and collection is probable. However, revenue recognition is deferred for shipments to new customers and for shipments to existing customers when significant support services are required to successfully integrate our products into our customers' products. These revenues, and related costs, are deferred and recognized when the customer has successfully integrated our products into its product offerings, and we have met any support obligations. In addition, revenue from sales to master resellers is recognized upon reported sell-through. We reduce revenue for estimated sales returns and other allowances at the time of shipment. Sales returns and other allowances are estimated based upon historical experience.

Service revenue, which to date has not been material, consists of training, warranty, and maintenance arrangements, including post-contract customer support (PCS) services. PCS services are offered under renewable, annual fee-based contracts or as part of multiple element arrangements and typically include upgrades and enhancements to our operating system software, and telephone support. For multiple element arrangements, we allocate revenue to each element based upon vendor-specific objective evidence (VSOE) of the fair value of the element or application of the residual method. VSOE of the fair value for an element is based upon the price charged when the element is sold separately. Service revenue, including revenue allocated to undelivered elements, is deferred and recognized ratably over the contractual period. Service contracts are typically one to three years in length. Training revenue is recognized upon completion of the training.

We provide warranties on our products ranging from one to three years. Estimated future warranty costs are accrued at the time of shipment and charged to cost of revenues based upon historical experience.

We maintain allowances for doubtful accounts for estimated losses resulting from the inability of our customers to make required payments. We analyze accounts receivable and historical bad debts, customer concentrations, customer creditworthiness, current economic trends and changes in customer payment terms and practices when evaluating the adequacy of the allowance for doubtful accounts. If the financial condition of our customers was to deteriorate, resulting in an impairment of their ability to make payments, additional allowances and charges against earnings may be required. To date, actual experience has been consistent with our estimates.

We write down inventory and record purchase commitment reserves for estimated excess and obsolete inventory equal to the difference between the cost of inventory and the estimated fair value based upon assumptions about future demand, product transition cycles, and market conditions. Although we strive to ensure the accuracy of our forecasts of future product demand, any significant unanticipated changes in demand or technological developments could have a significant effect on the value of our inventory and commitments, and our reported results. If actual market conditions are less favorable than those projected, additional inventory write-downs, purchase commitment reserves, and charges against earnings might be required. To date actual experience has been consistent with our estimates.

During the three months ended October 27, 2001, as a result of continuing unfavorable economic conditions and a reduction in IT spending rates, we performed a comprehensive analysis of our real estate facilities requirements and identified vacant excess facility space, which was subsequently offered for sublease. Based upon the results of this analysis, during the three months ended October 27, 2001, we recorded a charge of $39.8 million related to estimated facilities lease losses, net of expected sublease income, and a charge of $5.7 million in connection with the estimated impairment of certain related leasehold improvements. In determining the net facilities lease losses and related asset impairment charges, various assumptions were made, including the time period over which the facilities will be vacant, expected sublease terms, expected sublease rates, anticipated future operating expenses, and expected future use of the facilities. The charges represented the low-end of an estimated range that may be adjusted upon the occurrence of future triggering events. Triggering events may include, but are not limited to, changes in estimated time to sublease the facilities, sublease terms, sublease rates, expected future operating costs, and expected future use of the facilities.

During the three months ended July 27, 2002, we completed a transaction to sublease a portion of these vacant facilities. Accordingly, based on then current market data, we revised certain estimates and assumptions, including those related to estimated sublease rates, estimated time to sublease the facilities, expected future operating costs, and expected future use of the facilities. We reevaluate our estimates and assumptions on a quarterly basis and make adjustments to the reserve balance if necessary. No material adjustments were made to the facilities lease losses reserve for the three and nine months ended July 26, 2003. Should there be changes in real estate market conditions or should it take longer than expected to find a suitable tenant to sublease the remaining vacant facilities, adjustments to the facilities lease losses reserve may be necessary in future periods based upon then current actual events and circumstances.

The determination of our tax provision is subject to judgments and estimates due to operations in several tax jurisdictions outside the United States. Sales to our international customers are generally taxed at rates that are lower than United States rates, resulting in a reduction of our effective tax rate. The ability to maintain our current effective tax rate is contingent upon existing tax laws in both the United States and in the respective countries in which our international subsidiaries are located. Future changes in domestic or international tax laws could affect the continued realization of the tax benefits we are currently receiving and expect to receive from international sales of our products. In addition, a decrease in the percentage of our total revenue from international customers or in the mix of international revenue among particular tax jurisdictions could change our overall effective tax rate. Also, our current effective tax rate assumes that United States income taxes are not provided for undistributed earnings of certain non-United States subsidiaries. These earnings could become subject to United States federal and state income taxes and foreign withholding taxes, as applicable, should they be either deemed or actually remitted from our international subsidiaries to the United States.

The carrying value of our net deferred tax assets, which is made up primarily of income tax deductions and credits resulting from stock option exercises, assumes that we will be able to generate sufficient future income to fully utilize these tax deductions and credits. If we do not generate sufficient future income, the realization of these deferred tax assets may be impaired resulting in additional income tax expense. We evaluate the expected realization of our deferred tax assets and assess the need for valuation allowances quarterly.

Recent Accounting Pronouncements

In June 2002, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards No. 146, “Accounting for Costs Associated with Exit or Disposal Activities” (SFAS 146). SFAS 146 requires the recording of costs associated with exit or disposal activities at their fair values only when a liability has been incurred. Under previous guidance, certain exit costs were accrued upon management’s commitment to an exit plan, which is generally before an actual liability has been incurred. The requirements of SFAS 146 were effective prospectively for exit or disposal activities initiated after December 31, 2002. The adoption of SFAS 146 did not have a material effect on our financial position, results of operations, or cash flows.

In November 2002, the FASB issued FASB Interpretation No. 45, “Guarantor’s Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others — an Interpretation of FASB Statements No. 5, 57, and 107 and Rescission of FASB Interpretation No. 34” (FIN 45). FIN 45 elaborates on the disclosures to be made by a guarantor in its interim and annual financial statements about its obligations under certain guarantees that it has issued. It also requires a guarantor to recognize, at the inception of a guarantee, a liability for the fair value of the obligation undertaken in issuing the guarantee. In general, FIN 45 applies to contracts or indemnification agreements that contingently require the guarantor to make payments to the guaranteed party based on changes in an underlying obligation that is related to an asset, liability or an equity security of the guaranteed party. The recognition provisions of FIN 45 are effective for guarantees issued or modified after December 31, 2002. The disclosure requirements of FIN 45 are effective for financial statements of interim or annual periods ending after December 15, 2002. We have determined that the requirements of FIN 45 apply to our accrued warranty and standard indemnification clauses contained within our various customer contracts (see Note 9, "Commitments and Contingencies" of the Notes to Condensed Consolidated Financial Statements).

In December 2002, the FASB issued Statement of Financial Accounting Standards No. 148, "Accounting for Stock-Based Compensation — Transition and Disclosure an Amendment of FASB Statement No. 123" (SFAS 148). SFAS 148 amends SFAS 123 "Accounting for Stock-Based Compensation," to provide alternative methods of transition for a voluntary change to the fair value based method of accounting for stock-based employee compensation. In addition, SFAS 148 amends the disclosure requirements of SFAS 123 to require prominent disclosures in both annual and interim financial statements about the method of accounting for stock-based employee compensation and the effect of the method used on reported results. SFAS 148 is effective for fiscal years beginning after December 15, 2002. The interim disclosure provisions are effective for financial reports containing financial statements for interim periods beginning after December 15, 2002. The adoption of the interim disclosure provisions of SFAS 148 did not affect our financial position, results of operations, or cash flows.

In January 2003, the FASB issued FASB Interpretation No. 46, "Consolidation of Variable Interest Entities" (FIN 46). FIN 46 requires that if an entity has a controlling financial interest in a variable interest entity, the assets, liabilities and results of activities of the variable interest entity should be included in the consolidated financial statements of the entity. For arrangements entered into after January 31, 2003, FIN 46 was effective immediately. For arrangements entered into prior to January 31, 2003, FIN 46 is effective for the first interim or annual period beginning after June 15, 2003. We do not have any variable interest entities.

In May 2003, the FASB issued Statement of Financial Accounting Standards No. 150, "Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity" (SFAS 150). SFAS 150 establishes standards for how an issuer classifies and measures certain financial instruments with characteristics of both liabilities and equity. SFAS 150 is effective for financial instruments entered into or modified after May 31, 2003, and otherwise is effective at the beginning of the first interim period beginning after June 15, 2003. The Company does not expect the adoption of SFAS 150 to have a material effect on the Company's financial position, results of operations, or cash flows.

Risk Factors

Our quarterly revenues and operating results may fluctuate in future periods for a number of reasons, which could adversely affect the trading price of our stock.

Our quarterly revenues and operating results may vary significantly in the future due to a number of factors, any of which may cause our stock price to fluctuate. The primary factors that may affect the predictability of our quarterly results include the following:

- changes in general economic conditions and specific economic conditions in the information technology industry. In particular, continuing economic uncertainty has resulted in a general reduction in IT spending. This reduction in IT spending has lead to a decline in our growth rates;
- the timing of customer orders and product implementations, particularly large orders from and product implementations of our OEM partners;
- disruptions or downturns in general economic activity resulting from terrorist activity and armed conflict;
- announcements, introductions, and transitions of new products by us and our competitors;
- the ability of new competitors to enter the market and effectively compete against us;
- deferrals of customer orders in anticipation of new products, services, or product enhancements introduced by us or our competitors;

- our ability to obtain sufficient supplies of sole- or limited-sourced components, including ASICs, microprocessors, certain connectors, certain logic chips, and programmable logic devices;
- increases in prices of components used in the manufacture of our products;
- our ability to attain and maintain production volumes and quality levels;
- variations in the mix of our products sold and the mix of distribution channels through which they are sold;
- litigation; and
- legislation and regulatory developments.

Accordingly, the results of any prior periods should not be relied upon as an indication of future performance. If our revenues or operating results are below the expectations of stock market analysts or investors, our stock price may decline.

Our revenues may be affected by changes in IT spending levels.

Unfavorable economic conditions and reduced global IT spending rates have adversely affected our operating results and led to a decline in our growth rates. We are unable to predict when IT spending rates will improve, if at all. If there are further reductions in either domestic or international IT spending rates, or if IT spending rates do not improve, our revenues, operating results and financial condition may be adversely affected.

Our storage networking products are sold as part of storage systems and subsystems. As a result, the demand for our storage networking products has historically been affected by changes in storage requirements associated with growth related to new applications and an increase in transaction levels. Although in the past we have experienced historical growth in our business as enterprise-class customers have adopted SAN technology, demand for SAN products in the enterprise-class sector continues to be adversely affected as a result of the weakened economy and because larger businesses are focusing on more efficiently using their existing IT infrastructure rather than making new equipment purchases. Increases in a customer’s ability to utilize existing storage infrastructure and the continued weakened economy may cause a decline in the demand for SAN products. This may harm our financial condition and results of operations.

Increased market competition may lead to reduced sales of our products, reduced margins, reduced profits, and reduced market share.

The market for SAN solutions is competitive and subject to rapid technological change. Increased competition could result in greater pricing pressures, reduced sales, reduced margins, reduced profits, and reduced market share. Currently, we believe that we face competition from providers of Fibre Channel switching products for interconnecting servers and storage. These competitors include Cisco Systems, Computer Network Technology Corporation (CNT), Qlogic Corporation, McDATA Corporation, and Vixel Corporation.

The SAN market is likely to become even more competitive as new products are introduced by existing competitors and as new competitors enter the market. Our OEM partners could potentially become new competitors by developing and introducing products competitive with our product offerings. These new competitive products could be based on existing technologies or new technologies that may or may not be compatible with our SAN technology. In addition, our OEM partners, who also have relationships with some of our current competitors, could choose to sell our competitors’ products instead of our products, or offer preferred pricing or promotions on our competitors’ products.

Some of our competitors have longer operating histories and significantly greater human and financial resources than us. These competitors could adopt more aggressive pricing policies and devote greater resources to the development, promotion, and sale of their products than we can. As a result, they may be able to respond more quickly to changes in customer or market requirements. We may not have the financial resources, technical expertise or marketing, manufacturing, distribution, and support capabilities to compete successfully against current or future competitors. This could materially harm our business.

We depend on OEM partners. The loss of any of these OEM partners could significantly reduce our revenues and negatively affect our financial results.

We depend on large, recurring purchases from a limited number of large OEM partners. Our agreements with our OEM partners are typically cancelable, non-exclusive, and have no minimum purchase requirements. For the three months ended July 26, 2003, three customers each represented greater than ten percent of our total revenues for a combined total of 66 percent. We anticipate that our revenues and operating results will continue to depend on sales to a relatively small number of customers. The loss of any one significant customer, or a decrease in the level of sales to any one significant customer, could seriously harm our financial condition and results of operations.

The prices of our products and gross margins have recently declined at a higher than historical rate and are likely to continue to decline, which would reduce our revenues and profitability.

The average unit prices and gross margins of some of our products have recently declined at a higher than historical rate, and are likely to continue to decline in the future as a result of changes in product mix, competitive pricing pressures, increased sales discounts, new product introductions by us or our competitors, or other factors. If we are unable to offset these factors by increasing sales volumes, our total revenues may decline. In addition, to maintain our gross margins we must maintain or increase current shipment volumes, develop and introduce new products and product enhancements, and we must continue to reduce the manufacturing cost of our products. Failure to reduce the manufacturing cost of our products in response to declines in unit selling prices would result in a further decline in our gross margins. Moreover, most of our expenses are fixed in the short-term or incurred in advance of receipt of corresponding revenue. As a result, we may not be able to decrease our spending to offset any unexpected shortfall in revenues. If this occurs, we could incur losses, our operating results and gross margins may be below our expectations and the expectations of investors and stock market analysts, and our stock price could be negatively affected.

We may not be able to maintain profitability.

In fiscal year 2003, we do not expect to maintain profitability and may not be able to maintain profitability at all in the future. We expect to incur significant costs and expenses for product development, sales and marketing, customer support, and expansion of corporate infrastructure. We make investment decisions based upon anticipated revenues and margins. If these anticipated revenues and margins do not materialize, our future profitability could be adversely affected. For example, we expect our acquisition of Rhapsody to adversely affect our earnings per share at least through our fiscal year 2004.

We recently completed programs to restructure certain business operations that included workforce reductions and the impairment of certain assets no longer being used as a result of the restructuring programs. We may not be able to achieve our planned reduction in spending related to these restructuring programs if we incur unforeseen expenses in future quarters or if we are unable to reduce expenses without jeopardizing further development, marketing, and sales of our products. Additionally, it is possible that these reductions in spending may not be sufficient to achieve their intended goals. If we are unable to achieve our planned reduction in spending or if our current reductions in spending are insufficient, we may be required to undertake additional restructuring activities that may involve our personnel, real estate, fixed assets, marketing programs and research and development programs.

These actions involve numerous risks, including unanticipated costs, diversion of management’s attention from our core business and adverse effects on existing business relationships with suppliers, customers, and employees. In addition, it is difficult to forecast future operating results based on historical results. We plan our operating expenses based in part on future revenue projections. Our ability to accurately forecast quarterly revenue is limited for the reasons discussed above in “Our quarterly revenues and operating results may fluctuate in future periods for a number of reasons, which could adversely affect the trading price of our stock.” Moreover, most of our expenses are fixed in the short-term or incurred in advance of receipt of corresponding revenue. As a result, we may not be able to decrease our spending to offset any unexpected shortfall in revenues. If this occurs, we could incur losses, and our operating results and gross margins may be below our expectations and those of investors and stock market analysts.

Our Board of Directors approved a voluntary stock option exchange program for employees. Under the stock option exchange program, employees were offered the opportunity to exchange an aggregate of approximately 67.3 million outstanding stock options with exercise prices equal to or greater than $12.00 per share for new stock options to be granted at an exchange ratio determined by the date the exchanged stock options were granted. In accordance with this program, on January 9, 2003, we cancelled 58.7 million outstanding stock options and issued promises to grant new stock options to participating employees. On July 10, 2003, the first business day that was six months and one day after the cancellation of the exchanged options, we granted to participating employees 26.6 million new stock options at an exercise price of $6.54 per share. The 26.6 million new stock options represent approximately 10 percent of our total shares of common stock outstanding as of July 26, 2003, and could have a dilutive effect on our future earnings per share to the extent that the future market price of our common stock exceeds $6.54 per share.

As we introduce new products, we must manage the transition between our new products and our older products.

As new or enhanced products are introduced, we must successfully manage the transition from older products in order to minimize disruption in customers' ordering patterns, avoid excessive levels of older product inventories, and ensure that sufficient supplies of new products can be delivered to meet customer demands. When we introduce new products and product enhancements, we face numerous risks relating to product transitions, including the inability to accurately forecast demand, possible product and software defects, and a potentially different sales and support environment due to the complexity of these new systems. Our failure to manage the transition to newer products in the future or to develop and successfully introduce new products and product enhancements, such as products associated with the Rhapsody acquisition, could adversely affect our business and financial results.

Our success depends on our ability to develop new and enhanced products that achieve widespread market acceptance.

We currently derive the majority of our revenues from sales of our SilkWorm family of products. We expect that revenue from this product family will continue to account for a substantial portion of our revenues for the foreseeable future. Therefore, widespread market acceptance of these products is critical to our future success. Some of our products have been recently introduced. For example, during the second quarter of fiscal 2003, we introduced a new operating system software release for our products. The demand and market acceptance of this new operating system software release is uncertain. Factors that may affect market acceptance include performance, price, and total cost of ownership; features and functionality; availability and price of competing products and technologies; and the success and development of our OEM partners and other distribution channels. Many of these factors are beyond our control.

Our future success depends upon our ability to address the rapidly changing needs of our customers by developing and introducing high-quality, cost-effective products and product enhancements on a timely basis, and by keeping pace with technological developments and emerging industry standards. We expect to launch new products and product enhancements during the next year that will further expand the market opportunity for our products. We expect that our future revenue growth will be dependent on the success of our current line of products, new product enhancements, and the continued development of new products. In the past we have experienced delays in product development; such delays could occur in the future. In addition, if we are unable to achieve market acceptance of our new products, our business and results of operations could be harmed.

International political instability and concerns about other international crises may increase our cost of doing business and disrupt our business.

International political instability, evidenced by the occurrence and threat of terrorist attacks, enhanced national security measures, and military action and armed conflicts in the Middle East, Africa and Asia, may halt or hinder our ability to do business and may increase our costs. In addition, concerns about other international crises, such as the SARS virus, may have an adverse effect upon the world economy and could adversely affect our business operations or the operations of our OEM partners, contract manufacturers and suppliers. This political instability and concerns about other international crises may, for example:

- negatively affect the reliability and cost of transportation,
- negatively affect the desire and ability of our employees and customers to travel,
- disrupt the production capabilities of our OEM partners, contract manufacturers and suppliers,
- adversely affect our ability to obtain adequate insurance at reasonable rates, and
- require us to take extra security precautions for our operations.

In addition, to the extent that air transportation is delayed or disrupted, the operations of our contract manufacturers and suppliers may be disrupted, particularly if shipments of components and raw materials are delayed.

Failure to manage distribution channels and relationships could significantly reduce our revenues.

Our success will depend on our continuing ability to develop and manage relationships with large distribution partners, including OEM partners, value-added distributors, systems integrators, and value-added resellers, and on the sales efforts and success of these distribution partners. Our OEM partners must evaluate and qualify our products for a limited time period before they begin to market and sell them. Assisting these distribution partners through the evaluation process requires significant sales, marketing, and management efforts on our part, particularly if our products are being qualified with multiple distribution partners at the same time. In addition, once our products have been qualified, our customer agreements have no minimum purchase commitments. We may not be able to effectively maintain or expand our distribution channels, manage distribution relationships successfully, or market our products through distribution partners. Our failure to manage successfully our distribution relationships or the failure of our distribution partners to sell our products could reduce our revenues.

Failure to manage our business effectively could seriously harm our business, financial condition, and prospects.

Our ability to successfully implement our business plan, develop and offer products, and manage our business in a rapidly evolving market requires a comprehensive and effective planning and management process. We continue to change the scope of our operations domestically and internationally, including managing our headcount appropriately. In addition, our acquisition of Rhapsody and its integration into Brocade could present additional management challenges. Changes in our business, headcount, organizational structure and relationships with customers and other third parties has placed, and will continue to place, a significant strain on management systems and resources. Our failure to continue to improve upon our operational, managerial, and financial controls, reporting systems, and procedures, and our failure to continue to train and manage our workforce worldwide, could seriously harm our business and financial results.

Failure to adequately anticipate future OEM and end-user product needs could negatively affect the demand for our products and reduce our revenues.

We market and sell our products through distribution partners, including OEM partners, value-added distributors, system integrators, and value-added resellers. Therefore, we must continually assess, anticipate, and respond to the needs of these distribution partners and ensure that our products integrate with their solutions. We must also continually assess, anticipate, and respond to the needs of our distribution partners’ customers, who are the end-users of our products. If we fail to respond to the needs of these groups, our business and operating results could be harmed.

Because of our indirect distribution model, our contact with the actual end-users of our products is limited. Although we make every effort to communicate with, understand, and anticipate the current and future needs of the end-users of our products, to a large extent we rely on our distribution partners for visibility into those end-user requirements. Our failure to adequately assess and anticipate future end-user needs could negatively affect the demand for our products and reduce our revenues.

Uncertainties involving sales and demand forecasts for our products could negatively affect our business.

We have limited ability to forecast the demand for our products. In preparing sales and demand forecasts, we rely largely on input from our distribution partners. If our distribution partners are unable to accurately forecast demand, or if we fail to effectively communicate with our distribution partners about end-user demand or other time sensitive information, sales and demand forecasts may not reflect the most accurate, up-to-date information. Because we make business decisions based on our sales and demand forecasts, if these forecasts are inaccurate, our business and financial results could be negatively affected. Furthermore, we may not be able to identify these forecast differences until late in our fiscal quarter. Consequently, we may not be able to make adjustments to our business model without negatively affecting our business and results of operations.

We plan to continue to increase our international sales activities, which will subject us to additional business risks.

We plan to continue to expand our international sales activities. Expansion of international operations will involve inherent risks that we may not be able to control, including:

- supporting multiple languages;
- recruiting sales and technical support personnel with the skills to support our products;
- increased complexity and costs of managing international operations;
- commercial laws and business practices that favor local competition;
- multiple, potentially conflicting, and changing governmental laws and regulations, including differing labor and employment laws;
- longer sales cycles;
- difficulties in collecting accounts receivable;
- reduced or limited protections of intellectual property rights;
- more complicated distribution arrangements; and
- political and economic instability.

To date, none of our international revenues and costs of revenues have been denominated in foreign currencies. As a result, an increase in the value of the United States dollar relative to foreign currencies could make our products more expensive and, thus, less competitive in foreign markets. In the future, a portion of our international revenues may be denominated in foreign currencies, including the Euro, which will subject us to risks associated with fluctuations in those foreign currencies. Additionally, we receive significant tax benefits from sales to our international customers. These benefits are contingent upon existing tax laws in both the United States and in the respective countries in which our international customers are located.

Future changes in domestic or international tax laws could affect the continued realization of the tax benefits that we currently receive and expect to receive from sales to our international customers. In addition, a decrease in the percentage of our total revenue from international customers, or in the mix of international revenue among particular tax jurisdictions, could increase our overall effective tax rate.

Our business may be subject to seasonal fluctuations in the future.

Some of our large customers experience seasonality in their businesses. As our business and products become more mature it is possible that we could begin to experience seasonality similar to that experienced by our large customers. It is difficult for us to evaluate the degree to which the seasonality of our large customers may affect our business in the future because the overall growth of our business may have lessened the affect of this customer seasonality on our business in the past.

The loss of our third-party contract manufacturers or the failure to accurately forecast demand for our products or successfully manage the production of our products could negatively affect our ability to manufacture and sell our products.

We currently depend on two third-party contract manufacturers, Solectron and Foxconn, to manufacture our products. If we should fail to effectively manage the production of our products through Solectron and Foxconn, or if Solectron or Foxconn experience delays, disruptions, capacity constraints, or quality control problems in their manufacturing operations, shipment of our products to our customers could be delayed and our competitive position and reputation could be harmed. Qualifying a new contract manufacturer and commencing volume production is a lengthy and expensive process and if we are required or choose to change contract manufacturers, we may lose revenue and injure our customer relationships.

We provide to our contract manufacturers product forecasts and place purchase orders with our contract manufacturers in advance of the scheduled delivery of products to our customers. Although our purchase orders placed with our contract manufacturers are cancelable, if cancelled, we could be required to purchase certain unused material not returnable, usable by, or sold to other customers. Accordingly, if we inaccurately forecast demand for our products, we may be unable to obtain adequate manufacturing capacity from our contract manufacturers to meet customers' delivery requirements, or we may accumulate excess inventories. If we are unable to obtain adequate manufacturing capacity from our contract manufacturers or if we accumulate excess inventories, our business and results of operations may be negatively affected.

As part of our business strategy, we may seek to transition a greater portion of our product manufacturing to third parties that are located overseas. If we are not successful in our strategy to further transition our manufacturing to overseas markets, our ability to manufacture and sell our products could be substantially impaired.

We are dependent on sole source and limited source suppliers for certain key components.

We currently purchase several key components used in the manufacture of our products from single or limited sources. We purchase ASICs from a single source, and we purchase microprocessors, certain connectors, certain logic chips, and programmable logic devices from limited sources. In addition, we license certain third-party software that is incorporated into our operating system software and other software products. If we are unable to buy or license these components on a timely basis, we may not be able to deliver our products to our customers in a timely manner.

We use a rolling six-month forecast based on anticipated product orders to determine component requirements. If we overestimate component requirements, we may have excess inventory, which would increase our costs. If we underestimate component requirements, we may have inadequate inventory, which could interrupt the manufacturing process and result in lost or deferred revenue. In addition, lead times for components vary significantly and depend on factors such as the specific supplier, contract terms, and demand for a component at a given time. We also may experience shortages of certain components from time to time, which also could delay the manufacturing and sales processes.

Undetected software or hardware errors could increase our costs and reduce our revenues.

Networking products frequently contain undetected software or hardware errors, or "bugs," when first introduced or as new versions are released. Our products are becoming increasingly complex, and errors may be found from time to time in our new or enhanced products. In addition, our products are combined with products from other vendors. As a result, when problems occur, it may be difficult to identify the source of the problem. These problems may cause us to incur significant warranty and repair costs, divert the attention of engineering personnel from product development efforts and cause significant customer relations problems. Moreover, the occurrence of hardware and software errors, whether caused by another vendor's SAN products, or ours, could delay or prevent the development of the SAN market.

If we lose key personnel or are unable to hire additional qualified personnel, we may not be successful.

Our success depends to a significant degree upon the continued contributions of key management, engineering, and sales and marketing personnel, many of whom would be difficult to replace. We do not have life insurance on any of our key personnel. Our compensation packages include equity-based incentives. To the extent that our stock price remains at depressed levels, our ability to continue to offer competitive compensation packages could be affected.

We believe our future success will also depend in large part upon our ability to attract and retain highly skilled managerial, engineering, sales and marketing, finance, and operations personnel, and on the ability of management to operate effectively, both individually and as a group. We have experienced difficulty in hiring qualified ASIC, software, system and test, sales and marketing, key management, and customer support personnel. We may not be successful in attracting and retaining these individuals in the future. The loss of the services of any of our key employees, the inability to attract or retain qualified personnel in the future, or delays in hiring required personnel, particularly engineers and sales personnel, could delay the development and introduction of, and negatively affect our ability to sell, our products.

In addition, companies in the computer storage and server industry whose employees accept positions with competitors frequently claim that their competitors have engaged in unfair hiring practices. We may receive such claims in the future as we seek to hire qualified personnel. Such claims, if received, could result in material litigation. As a result, we could incur substantial costs in defending against these claims, regardless of their merits.

We may be unable to protect our intellectual property, which would negatively affect our ability to compete.

We rely on a combination of patent, copyright, trademark, and trade secret laws, confidentiality agreements, and other contractual restrictions on disclosure to protect our intellectual property rights. We also enter into confidentiality or license agreements with our employees, consultants, and corporate partners, and control access to and distribution of our technology, software, documentation, and other confidential information. These measures may not preclude competitors from independently developing products with functionality or features similar to our products. Despite efforts to protect our proprietary rights, unauthorized parties may attempt to copy or otherwise obtain and use our products or technology. Monitoring unauthorized use of our products is difficult, and we cannot be certain that the steps we take to prevent unauthorized use of our technology, particularly in foreign countries where the laws may not protect proprietary rights as fully as in the United States, will be effective.

Others may bring infringement claims, which could be time-consuming and expensive to defend, against us.

In recent years, there has been significant litigation in the United States involving patents and other intellectual property rights. For example, on February 14, 2002, a suit captioned *McDATA Corp. v. Brocade Communications Systems, Inc*. was filed against us in the United States District Court for the District of Colorado. The complaint alleged that the Brocade SilkWorm 3800 Enterprise Fibre Channel Fabric Switch and Brocade SilkWorm 12000 Core Fabric Switch infringe United States Patent No. 6,233,236, entitled “Method and Apparatus for Measuring Traffic Within a Switch.” The complaint seeks unspecified compensatory and exemplary damages and to permanently enjoin Brocade from infringing the patent in the future (see Item 4 — Legal Proceedings for additional information regarding this dispute).

We may be a party to litigation in the future to protect our intellectual property or as a result of an alleged infringement of the intellectual property of others. These claims and any resulting lawsuit, including the McDATA lawsuit, could subject us to significant liability for damages and invalidation of proprietary rights. These lawsuits, regardless of their success, would likely be time-consuming and expensive to resolve and would divert management’s time and attention. Any potential intellectual property litigation, including the McDATA litigation, also could force us to do one or more of the following:

- stop selling, incorporating or using products or services that use the challenged intellectual property;
- obtain from the owner of the infringed intellectual property a license to the relevant intellectual property, which may require us to license our intellectual property to such owner, or may not be available on reasonable terms or at all; and
- redesign those products or services that use technology that is the subject of an infringement claim.

If we are forced to take any of the foregoing actions, we may be unable to manufacture, use, sell, import and export our products, which would reduce our revenues.

Our business may be harmed by class-action litigation due to stock price volatility.

In the past, securities class-action litigation often has been brought against a company following periods of volatility in the market price of its securities. We have been a party in a securities class action litigation, which resulted in the court dismissing all claims against us. In the future, we may be the target of other securities litigation. Securities litigation could result in substantial costs and divert management’s attention and resources.

We may engage in future acquisitions that dilute our stockholders and cause us to use cash, incur debt, or assume contingent liabilities.

We recently completed our acquisition of Rhapsody. As part of our strategy, we expect to continue to review opportunities to buy other businesses or technologies that would complement our current products, expand the breadth of our markets or enhance our technical capabilities, or that may otherwise offer growth opportunities. We may buy other businesses, products, or technologies in the future. In the event of any future purchases, we could:

- issue stock that would dilute our current stockholders’ percentage ownership;
- use cash, which may result in a reduction of our liquidity;
- incur debt; or
- assume liabilities.

These purchases also involve numerous risks, including:

- problems combining the purchased operations, technologies, personnel or products;
- unanticipated costs;
- diversion of management’s attention from our core business;
- adverse effects on existing business relationships with suppliers and customers;
- risks associated with entering into markets in which we have no, or limited, prior experience; and
- potential loss of key employees of acquired organizations.

We may not be able to successfully integrate any businesses, products, technologies, or personnel that we might acquire, or to realize expected benefits of acquisitions that we may undertake in the future.

Our products must comply with evolving industry standards and government regulations.

Industry standards for SAN products are continuing to emerge, evolve, and achieve acceptance. To remain competitive, we must continue to introduce new products and product enhancements that meet these industry standards. All components of the SAN must interoperate together. Industry standards are in place to specify guidelines for interoperability and communication based on standard specifications. Our products encompass only a part of the entire SAN solution utilized by the end-user, and we depend on the companies that provide other components of the SAN solution, many of whom are significantly larger than we are, to support the industry standards as they evolve. The failure of these providers to support these industry standards could adversely affect the market acceptance of our products.

In addition, in the United States, our products comply with various regulations and standards defined by the Federal Communications Commission and Underwriters Laboratories. Internationally, products that we develop will be required to comply with standards established by authorities in various countries. Failure to comply with existing or evolving industry standards or to obtain timely domestic or foreign regulatory approvals or certificates could materially harm our business.

Provisions in our charter documents, customer agreements, Delaware law, our convertible subordinated notes, and our stockholder rights plan could prevent or delay a change in control of Brocade, which could hinder stockholders' ability to receive a premium for our stock.

Provisions of our certificate of incorporation and bylaws may discourage, delay or prevent a merger or acquisition that a stockholder may consider favorable. These provisions include:

- authorizing the issuance of preferred stock without stockholder approval;
- providing for a classified board of directors with staggered, three-year terms;
- prohibiting cumulative voting in the election of directors;
- limiting the persons who may call special meetings of stockholders;
- prohibiting stockholder actions by written consent; and
- requiring super-majority voting to effect amendments to the foregoing provisions of our certificate of incorporation and bylaws.

Certain provisions of Delaware law also may discourage, delay, or prevent someone from acquiring or merging with us, and our agreements with certain of our customers require that we give prior notice of a change of control and grant certain manufacturing rights following a change of control. In addition, we currently have in place a stockholder rights plan. Furthermore, any of these things could prevent or delay a change in control of Brocade, which could hinder stockholders' ability to receive a premium for our stock.

Also, if we incur a "fundamental change" as defined in our convertible subordinated notes, we could be required to repurchase all of our outstanding notes. A "fundamental change" is generally defined as any transfer or event in which all or substantially all of our common stock is exchanged for, converted into or acquired for, or constitutes solely the right to receive consideration which is not all or substantially all common stock that is listed on a United States national securities exchange or the Nasdaq National Market or similar automated quotation system.

We expect to experience volatility in our stock price, which could negatively affect stockholders' investments.

The market price of our common stock has experienced significant volatility in the past and may continue to fluctuate significantly in response to the following factors, some of which are beyond our control:

- macroeconomic conditions;
- actual or anticipated fluctuations in our operating results;
- changes in financial estimates and ratings by securities analysts;
- changes in market valuations of other technology companies;
- announcements of financial results by us or other technology companies;
- announcements by us, our competitors, customers, or similar businesses of significant technical innovations, contracts, acquisitions, strategic partnerships, joint ventures or capital commitments;
- losses of major OEM partners;
- additions or departures of key personnel;
- sales by us of common stock or convertible securities;
- incurring additional debt; and
- other risk factors detailed in this section.

In addition, the stock market has experienced extreme volatility that often has been unrelated to the performance of particular companies. These market fluctuations may cause our stock price to fall regardless of how the business performs.

Business interruptions could adversely affect our business.

Our operations are vulnerable to interruption by fire, earthquake, power loss, telecommunications failure, and other events beyond our control. A substantial portion of our facilities, including our corporate headquarters, is located near major earthquake faults. In the event of a major earthquake, we could experience business interruptions, destruction of facilities and loss of life. We neither carry earthquake insurance nor have we set aside funds or reserves to cover such earthquake-related losses. Our operations are also subject to business interruptions that may occur as a result of a change or upgrade in our information technology systems, consolidation of our business operations, or a transition to new facilities in the United States of America or abroad. Although we carry business interruption insurance to mitigate the effect of potential business interruptions, should a business interruption occur, our business could be seriously harmed.

New tax legislation targeting companies operating in certain foreign jurisdictions could, if enacted into law, adversely affect our business.

Legislation relating to the tax treatment of United States companies that operate in certain foreign jurisdictions and have undertaken certain types of expatriation transactions is being considered by the United States Congress. While we do not believe that this legislation, as currently proposed, would adversely affect us, the exact scope of the legislation and whether it will ultimately be enacted is unclear at this time. Therefore, it is possible that legislation in this area, if enacted, could increase our future tax burden or otherwise affect our business.

Item 3. *Quantitative and Qualitative Disclosures About Market Risks*

We are exposed to market risk related to changes in interest rates and equity security prices.

Interest Rate Risk

Our exposure to market risk due to changes in the general level of United States interest rates relates primarily to our cash equivalents and short-term and long-term investment portfolios. Our cash, cash equivalents, and short-term and long-term investments are primarily maintained at five major financial institutions in the United States. As of July 26, 2003, we did not hold any derivative instruments. The primary objective of our investment activities is the preservation of principal while maximizing investment income and minimizing risk.

The following table presents the hypothetical changes in fair values of our investments in debt securities as of July 26, 2003 that are sensitive to changes in interest rates (in thousands):

	Valuation of Securities Given an Interest Rate Decrease of X Basis Points			Fair Value As of July 26, 2003	Valuation of Securities Given an Interest Rate Increase of X Basis Points		
Issuer	**(150 BPS)**	**(100 BPS)**	**(50 BPS)**		**50 BPS**	**100 BPS**	**150 BPS**
U.S. government obligations	$418,326	$415,867	$413,652	$410,497	$407,801	$405,162	$402,549
State & municipal obligations	3,852	3,852	3,851	3,850	3,849	3,848	3,848
Corporate notes	7,179	7,165	7,150	7,135	7,119	7,104	7,088
Total	$429,357	$426,884	$424,653	$421,482	$418,769	$416,114	$413,485

These instruments are not leveraged and are classified as available-for-sale. The modeling technique used measures the change in fair values arising from selected potential changes in interest rates. Market changes reflect immediate hypothetical parallel shifts in the yield curve of plus or minus 50 basis points (BPS), 100 BPS, and 150 BPS, which are representative of the historical movements in the Federal Funds Rate.

The following table (in thousands) presents our cash equivalents and short-term and long-term investments subject to interest rate risk and their related weighted average interest rates as of July 26, 2003. Carrying value approximates fair value.

	Amount	Average Interest Rate
Cash and cash equivalents	$487,580	1.1%
Short-term investments	71,039	1.5%
Long-term investments	350,443	3.7%
Total	$909,062	2.1%

Our convertible subordinated debt is subject to a fixed interest rate and the notes are based on a fixed conversion ratio into common stock. Therefore, we are not exposed to changes in interest rates related to our long-term debt instruments. The notes are not listed on any securities exchange or included in any automated quotation system; however, the notes are eligible for trading on the Portal^{SM} Market. On July 25, 2003, the average bid and ask price on the Portal Market of our convertible subordinated notes due 2007 was 82.50, resulting in an aggregate fair value of approximately $453.8 million. Our common stock is quoted on the Nasdaq National Market under the symbol “BRCD.” On July 25, 2003, the last reported sale price of our common stock on the Nasdaq National Market was $5.55 per share.

Equity Security Price Risk

Our exposure to market risk due to equity security price fluctuations primarily relates to investments in equity securities. These investments are principally in companies in the volatile high-technology sector. We do not attempt to reduce or eliminate the market exposure on these securities. Adverse changes in equity prices of 25 percent, 50 percent, and 75 percent would result in decreases of approximately $0.2 million, $0.4 million, and $0.6 million in the fair value of equity securities as of July 26, 2003, respectively.

Item 4. ***Controls and Procedures***

(a) *Evaluation of disclosure controls and procedures:* Our management evaluated, with the participation of our Chief Executive Officer and Chief Financial Officer, the effectiveness of our disclosure controls and procedures as of the end of the period covered by this Quarterly Report on Form 10-Q. Based on this evaluation, our Chief Executive Officer and Chief 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 (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. It should be noted that the design of any system of controls is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions, regardless of how remote.

(b) *Changes in internal control over financial reporting:* There was no change in our internal control over financial reporting that occurred during the period covered by this Quarterly Report on Form 10-Q 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***

From time to time, claims are made against us in the ordinary course of our business, which could result in litigation. Claims and associated litigation are subject to inherent uncertainties and unfavorable outcomes could occur, such as monetary damages, fines, penalties or injunctions prohibiting us from selling one or more products or engaging in other activities. The occurrence of an unfavorable outcome in any specific period could have a material adverse affect on our results of operations for that period or future periods.

On May 23, 2003, a suit captioned *Vixel Corporation v. Brocade Communications Systems, Inc*. was filed in the United States District Court for the Northern District of California. The complaint alleges that Brocade products infringe United States Patents Nos. 6,118,776; 6,470,007; and 6,185,203 relating to switching and Fibre Channel technologies. The complaint seeks unspecified compensatory and exemplary damages and to permanently enjoin Brocade from infringing the patents in the future. A scheduling conference is scheduled for November 15, 2003. We believe that we have meritorious defenses to the claim and intend to defend the action vigorously. At this time we are not able to determine what effect, if any, this action will have on our business or financial position and results of operations.

On January 10, 2003, a suit captioned *Raytheon Company v. Brocade Communications Systems, Inc. et al*. was filed against Brocade and various other companies in the United States District Court for the Eastern District of Texas. The complaint alleges that Brocade products infringe United States Patent No. 5,412,791, entitled “Mass Data Storage Library.” On February 6, 2003, Raytheon filed an amended complaint stating their original claim with more particularity. The complaint seeks unspecified compensatory and exemplary damages and to permanently enjoin Brocade from infringing the patent in the future. On May 9, 2003, we filed an answer and counterclaims, asserting, among other things, invalidity of all of Raytheon’s claims. A scheduling conference was held on May 20, 2003, and trial has been scheduled for June 2004. We believe that we have meritorious defenses to the claims and intend to defend the action vigorously. At this time, we are not able to determine what effect, if any, this action will have on our business or financial position and results of operations.

On February 14, 2002, a suit captioned *McDATA Corp. v. Brocade Communications Systems, Inc.* was filed against us in the United States District Court for the District of Colorado. The complaint alleged that the Brocade SilkWorm 3800 Enterprise Fibre Channel Fabric Switch and Brocade SilkWorm 12000 Core Fabric Switch infringe United States Patent No. 6,233,236, entitled “Method and Apparatus for Measuring Traffic Within a Switch.” The complaint seeks unspecified compensatory and exemplary damages and to permanently enjoin Brocade from infringing the patent in the future. On March 4, 2002, McDATA filed an amended complaint, in which it additionally alleged that the Brocade SilkWorm 3200 Entry Fabric Switch infringed this patent. In connection with this suit, on March 4, 2002, McDATA filed a motion for a preliminary injunction against Brocade with regard to the patent. On April 8, 2002, we filed an answer and counterclaims asserting, among other things, no infringement, and that the patent is invalid, unenforceable and covered by an existing covenant not to sue between the parties. A hearing on McDATA’s motion for preliminary injunction was held during the week of July 15, 2002. In an order dated December 6, 2002, the Court denied McDATA’s motion for a preliminary injunction. On December 23, 2002, McDATA filed a demand for arbitration to move this matter from the United States District Court for the District of Colorado to arbitration. The matter was referred to arbitration. A scheduling conference was held on August 20, 2003, and arbitration has been scheduled for November 10, 2003. We believe that we have meritorious defenses to the claims and intend to defend the action vigorously. We believe that the ultimate disposition of this matter will not have a material adverse effect on our business or financial position and results of operations.

On July 20, 2001, the first of a number of putative class actions was filed in the United States District Court for the Southern District of New York against Brocade, certain of its officers and directors, and certain of the underwriters for its initial public offering. Those cases were consolidated under the caption *Chae v. Brocade Communications Systems, Inc. et al*. The complaints generally alleged that various underwriters engaged in improper and undisclosed activities related to the allocation of shares in our initial public offering of securities. On March 1, 2002, the Court entered an order dismissing without prejudice all claims against Brocade and its officers and directors named in the consolidated proceeding. On April 19, 2002, a consolidated amended class action captioned *In Re Brocade Communications Systems, Inc. Initial Public Offering Securities Litigation* was filed which makes claims against the Brocade parties that are substantially similar to those alleged in the earlier case. The complaint seeks unspecified damages on behalf of a purported class of purchasers of common stock from May 24, 1999 to December 6, 2000. In October 2002, the individual defendants were dismissed without prejudice from the action. On February 19, 2003, the Court entered an order dismissing all of the plaintiffs' claims against the Company. No appeal has been filed.

Item 6. ***Exhibits and Reports on Form 8-K***

(a) Exhibits.

Exhibit Number	Description of Document
2.1(14)	Agreement and Plan of Reorganization by and among Brocade, Rhapsody Networks, Inc., and certain other parties dated November 5, 2002.
2.2(14)	First Amendment to Agreement and Plan of Reorganization by and among Brocade, Rhapsody Networks, Inc., and certain other parties dated January 5, 2003.
3.1(8)	Amended and Restated Certificate of Incorporation.
3.2(1)	Bylaws of the Registrant.
3.3(10)	Certificate of Designation of Rights, Preferences and Privileges of Series A Participating Preferred Stock of Brocade Communications Systems, Inc.
4.1(1)	Form of Registrant's Common Stock certificate.
4.2(10)	Preferred Stock Rights Agreement dated as of February 7, 2002 between Brocade and Wells Fargo Bank MN, N.A.
4.3(9)	Indenture, dated as of December 21, 2001, between Brocade and State Street Bank and Trust Company of California, N.A.
4.4(9)	Form of Note (included in Exhibit 4.3).
4.5(9)	Registration Rights Agreement, dated as of December 21, 2001, by and among Brocade and Morgan Stanley & Co. Incorporated, Goldman, Sachs & Co., Salomon Smith Barney Inc. and Merrill Lynch Pierce Fenner and Smith Incorporated.
10.1(1)	Form of Indemnification Agreement entered into between Brocade and each of its directors and executive officers.
10.2(1)*	1995 Equity Incentive Plan and forms of agreements thereunder.
10.3(1)*	1998 Equity Incentive Plan and forms of agreements thereunder.
10.4(1)*	1998 Executive Equity Incentive Plan and forms of agreements thereunder.
10.5(7)*	Amended and Restated 1999 Director Option Plan as of April 17, 2001, and form of agreement thereunder.
10.6(2)*	1999 Employee Stock Purchase Plan.
10.7(2)*	1999 Stock Plan and forms of agreements thereunder.
10.8(13)*	1999 Nonstatutory Stock Option Plan and forms of agreements thereunder, as amended.
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10.10(1)#	Acknowledgement between Wind River Systems, Inc. and Brocade dated April 22, 1999.
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10.14 (5)	First Amendment to Lease between Spieker Properties and Brocade dated February 16, 2000.
10.15(5)	Second Amendment to Lease between Spieker Properties and Brocade dated August 11, 2000.
10.16(4)	Credit Agreement between Comerica Bank-California and Brocade dated January 5, 2000.
10.17(5)	First Amendment to Credit Agreement between Comerica Bank-California and Brocade dated March 21, 2000.
10.18(5)	Second Amendment to Credit Agreement between Comerica Bank-California and Brocade dated September 20, 2000.

Exhibit Number	Description of Document
10.19(5)	Master Lease Agreement between Spieker Properties and Brocade dated July 26, 2000.
10.20(5)#	Purchase Agreement between Compaq Computer Corporation and Brocade dated February 1, 2000.
10.21(5)*	Promissory Note between David A. Smith and Brocade dated April 27, 2000.
10.22(5)#	Purchase Agreement between EMC Corporation and Brocade dated January 25, 2000 (EMC Purchase Agreement).
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10.24(14)	Extension Agreement between EMC Corporation and Brocade dated November 13, 2002.
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10.32(6)	Lease Agreement between MV Golden State San Jose, LLC and Brocade dated December 1, 2000.
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10.34(11)#	Amendment No. 6 to Statement of Work No. 1 between International Business Machines Corporation and Brocade.
10.35(12)+	Amendment No. 7 to Statement of Work No. 1 between International Business Machines Corporation and Brocade.
10.36(14)+	Amendment No. 8 to Statement of Work No. 1 between International Business Machines Corporation and Brocade.
10.37(14)+	Amendment No. 9 to Statement of Work No. 1 between International Business Machines Corporation and Brocade.
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10.39(11)	Amendment No. 2 to Statement of Work No. 2 between International Business Machines Corporation and Brocade.
10.40(12)+	OEM Purchase Agreement between Brocade and Hewlett-Packard Company dated January 28, 2000 (2000 OEM Purchase Agreement).
10.41(12)+	Amendment to 2000 OEM Purchase Agreement between Brocade and Hewlett-Packard Company dated April 20, 2001.
10.42(12)	Letter Amendment to 2000 OEM Purchase Agreement between Brocade and Hewlett-Packard Company dated January 25, 2002.
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10.50(15)	Amendment Number One to HHPI Manufacturing and Purchase Agreement between Brocade and Hon Hai Precision Industry Co., Ltd. dated April 5, 2003.
10.51(15)+	Manufacturing and Purchase Agreement between Brocade Communications Switzerland SarL and Hon Hai Precision Industry Co., Ltd. dated May 1, 2003.
10.52(15)+	Manufacturing and Purchase Agreement between Brocade and Solectron Corporation dated February 21, 2003 (Solectron Manufacturing and Purchase Agreement).
10.53(15)	Amendment No. 1 to Solectron Manufacturing and Purchase Agreement between Brocade and Solectron Corporation dated March 21, 2003.
10.54(15)+	Manufacturing and Purchase Agreement between Brocade Communications Switzerland SarL and Solectron Corporation dated March 21, 2003.
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31.1	Rule 13a-14(a)/15d-14(a) Certification by the Chief Executive Officer.
31.2	Rule 13a-14(a)/15d-14(a) Certification by the Chief Financial Officer.
32.1	Certification by the Chief Executive Officer and Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

* Indicates management contract or compensatory plan or arrangement required to be filed as an exhibit pursuant to Item 14(c) of Form 10-K.

\# Confidential treatment granted as to certain portions, which portions were omitted and filed separately with the Securities and Exchange Commission.

\+ Confidential treatment requested as to certain portions, which portions were omitted and filed separately with the Securities and Exchange Commission.

(1) Incorporated by reference from Brocade’s Registration Statement on Form S-1 (Reg. No. 333-74711), as amended.

(2) Incorporated by reference from Brocade’s Registration Statement on Form S-8 (Reg. No. 333-95653) filed on January 28, 2000.

(3) Incorporated by reference from Brocade’s Annual Report on Form 10-K for the fiscal year ended October 31, 1999, as amended.

(4) Incorporated by reference from Brocade’s Quarterly Report on Form 10-Q for the fiscal quarter ended January 29, 2000.

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(15) Incorporated by reference from Brocade's Quarterly Report on Form 10-Q for the fiscal quarter ended April 26, 2003.

(b) Reports on Form 8-K.

We filed a current report on Form 8-K on May 14, 2003, to reference and furnish as exhibits a press release announcing our financial results for the second quarter ended April 26, 2003 under Items 7 and 9 thereof.

Items 2, 3, 4 and 5 are not applicable and have been omitted.

SIGNATURES

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.

BROCADE COMMUNICATIONS SYSTEMS, INC.

BY: /s/ ANTONIO CANOVA

Antonio Canova
Vice President, Finance and
Chief Financial Officer

Date: September 8, 2003

Exhibit Index

Exhibit Number	Description of Document
2.1(14)	Agreement and Plan of Reorganization by and among Brocade, Rhapsody Networks, Inc., and certain other parties dated November 5, 2002.
2.2(14)	First Amendment to Agreement and Plan of Reorganization by and among Brocade, Rhapsody Networks, Inc., and certain other parties dated January 5, 2003.
3.1(8)	Amended and Restated Certificate of Incorporation.
3.2(1)	Bylaws of the Registrant.
3.3(10)	Certificate of Designation of Rights, Preferences and Privileges of Series A Participating Preferred Stock of Brocade Communications Systems, Inc.
4.1(1)	Form of Registrant’s Common Stock certificate.
4.2(10)	Preferred Stock Rights Agreement dated as of February 7, 2002 between Brocade and Wells Fargo Bank MN, N.A.
4.3(9)	Indenture, dated as of December 21, 2001, between Brocade and State Street Bank and Trust Company of California, N.A.
4.4(9)	Form of Note (included in Exhibit 4.3).
4.5(9)	Registration Rights Agreement, dated as of December 21, 2001, by and among Brocade and Morgan Stanley & Co. Incorporated, Goldman, Sachs & Co., Salomon Smith Barney Inc. and Merrill Lynch Pierce Fenner and Smith Incorporated.
10.1(1)	Form of Indemnification Agreement entered into between Brocade and each of its directors and executive officers.
10.2(1)*	1995 Equity Incentive Plan and forms of agreements thereunder.
10.3(1)*	1998 Equity Incentive Plan and forms of agreements thereunder.
10.4(1)*	1998 Executive Equity Incentive Plan and forms of agreements thereunder.
10.5(7)*	Amended and Restated 1999 Director Option Plan as of April 17, 2001, and form of agreement thereunder.
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31.2	Rule 13a-14(a)/15d-14(a) Certification by the Chief Financial Officer.
32.1	Certification by the Chief Executive Officer and Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

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Exhibit 12.1

Statement of Computation of Ratio of Earnings to Fixed Charges
(in thousands, except ratios)

	Nine Months Ended		Fiscal Year Ended				
	July 26, 2003	July 27, 2002	Oct. 26, 2002	Oct. 27, 2001	Oct. 28, 2000	Oct. 31, 1999	Oct. 31, 1998
Earnings (loss) from continuing operations before taxes	$ (154,413)	$ 61,967	$ 84,151	$ 17,802	$ 88,316	$ 2,591	$ (15,111)
Fixed charges from continuing operations							
Interest expense and amortization of debt discount and issuance costs on all indebtedness	10,129	8,057	11,427	--	45	459	557
Interest included in rent	5,792	4,838	6,679	5,507	1,381	428	268
Total fixed charges from continuing operations	15,921	12,895	18,106	5,507	1,426	887	825
Earnings (loss) before taxes and fixed charges	$ (138,492)	$ 74,862	$ 102,257	$ 23,309	$ 89,742	$ 3,478	$ (14,286)
Ratio of earnings to fixed charges (1)	(8.7x)(2)	5.8x	5.6x	4.2x	62.9x	3.9x	(17.3x)(2)
Coverage deficiency	$ 154,413	$ --	$ --	$ --	$ --	$ --	$ 15,111

(1) The ratio of earnings to fixed charges was computed by dividing earnings (earnings from continuing operations before taxes adjusted for fixed charges from continuing operations) by fixed charges from continuing operations for the periods indicated. Fixed charges from continuing operations include (i) interest expense and amortization of debt discount and issuance costs on all indebtedness, and (ii) one-third of all rental expense, which the Company considers to be a reasonable approximation of the interest factor included in rental expense.

(2) Earnings were inadequate to cover fixed charges. For the nine-month period ended July 26, 2003, and for the year ended October 31, 1998, the Company needed additional earnings of $154.4 million and $15.1 million, respectively, to achieve a ratio of earnings to fixed charges of 1.0x.

Exhibit 31.1

CERTIFICATION

I, Gregory L. Reyes, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Brocade Communications Systems, Inc.;

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the registrant and have:

a. Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

b. Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

c. Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):

a. All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

b. Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: September 8, 2003

By: /s/ Gregory L. Reyes

Gregory L. Reyes
Chairman of the Board and
Chief Executive Officer
(Principal Executive Officer)

Exhibit 31.2

CERTIFICATION

I, Antonio Canova, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Brocade Communications Systems, Inc.;

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the registrant and have:

a. Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

b. Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

c. Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):

a. All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

b. Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: September 8, 2003

By: /s/ Antonio Canova

Antonio Canova
Vice President, Finance and
Chief Financial Officer
(Principal Financial and Accounting Officer)

Exhibit 32.1

CERTIFICATION OF CHIEF EXECUTIVE OFFICER AND CHIEF FINANCIAL OFFICER
PURSUANT TO
18 U.S.C. SECTION 1350,
AS ADOPTED PURSUANT TO
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

I, Gregory L. Reyes, certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that the Quarterly Report of Brocade Communications Systems, Inc. on Form 10-Q for the fiscal quarter ended July 26, 2003 fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934 and that information contained in such Quarterly Report on Form 10-Q fairly presents in all material respects the financial condition and results of operations of Brocade Communications Systems, Inc.

By: /s/ Gregory L. Reyes

Gregory L. Reyes
Chairman of the Board and
Chief Executive Officer

A signed original of this written statement required by Section 906 has been provided to Brocade communications Systems, Inc. and will be retained by Brocade Communications Systems, Inc. and furnished to the Securities and Exchange Commission or its staff upon request.

I, Antonio Canova, certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that the Quarterly Report of Brocade Communications Systems, Inc. on Form 10-Q for the fiscal quarter ended July 26, 2003 fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934 and that information contained in such Quarterly Report on Form 10-Q fairly presents in all material respects the financial condition and results of operations of Brocade Communications Systems, Inc.

By: /s/ Antonio Canova

Antonio Canova
Vice President, Finance and
Chief Financial Officer

A signed original of this written statement required by Section 906 has been provided to Brocade Communications Systems, Inc. and will be retained by Brocade Communications Systems, Inc. and furnished to the Securities and Exchange Commission or its staff upon request.