
UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-K

(Mark One)

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

For the fiscal year ended October 25, 2003

OR

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

For the transition period from to

Commission file number: 000-25601

Brocade Communications Systems, Inc.

(Exact name of Registrant as specified in its charter)

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

77-0409517
*(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)

Securities registered pursuant to Section 12 (b) of the Act:

None

Securities registered pursuant to Section 12 (g) of the Act:

Common Stock, \$0.001 par value
Preferred Stock Purchase Rights

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

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

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

The aggregate market value of voting and non-voting common equity held by non-affiliates of the Registrant was approximately \$1,334,000,000 as of April 25, 2003, based upon the closing price on the Nasdaq National Market reported for such date. This calculation does not reflect a determination that certain persons are affiliates of the Registrant for any other purpose. The number of shares outstanding of the Registrant's Common Stock on December 19, 2003, was 258,720,039 shares.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Registrant's Proxy Statement for its 2004 Annual Meeting of Stockholders (the "Proxy Statement"), to be filed with the Securities and Exchange Commission, are incorporated by reference into Part III of this Form 10-K.

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PART I

Item 1. *Business*

General

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

- *revenues and profits;*
- *gross margin;*
- *customer concentration;*
- *research and development expenses;*
- *sales and marketing expenses;*
- *general and administrative expenses;*
- *pricing and cost reduction activities;*
- *income tax provision and effective tax rate;*
- *realization of deferred tax assets;*
- *cash flows from employee participation in employee stock programs;*
- *liquidity and sufficiency of existing cash, cash equivalents, and investments for near-term requirements;*
- *purchase commitments;*
- *technology and products;*
- *outcomes of pending or threatened litigation; and*
- *financial condition and results of operations as a result of recent accounting pronouncements.*

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.

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 (SAN) switches is designed to help companies reduce the cost and complexity of managing business information within a data storage environment. Brocade products are installed around the world at companies, institutions, and other entities of all sizes, ranging from large enterprises to small businesses. 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.

We were incorporated on May 14, 1999, as a Delaware corporation, succeeding operations that began on August 24, 1995. Our mailing address and executive offices are located at 1745 Technology Drive, San Jose, California 95110. Our telephone number is (408) 333-8000. Our corporate website is www.brocade.com. We make our filings with the SEC available on the Investor Relations page of our website free of charge. Information contained on our website is not a part of this Annual Report.

Products and Services

Our products and services are designed to help companies reduce the cost and complexity of managing business information within a data storage environment. Our products are generally used in conjunction with application servers, storage subsystems and devices, SAN interconnection components such as host bus adapters, and storage management software applications and tools. By networking servers and storage,

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companies can more easily share and consolidate server and storage resources; centralize and simplify data management; scale and provision storage resources more effectively, and improve application efficiency and performance. As a result, companies are able to better utilize information technology (IT) assets, improve productivity of IT personnel, reduce capital and operational expenditures, and more reliably and securely store, manage, and administer business information.

We believe that as the need for data storage grows, companies will look to further simplify the complexity of storing, managing, and administering their data, while looking to maximize their IT investments and reduce capital expenditures. SANs, which have been installed at some of the world's leading companies since the mid-1990's, provide a platform that helps companies optimize their IT assets and support future data growth. We also believe companies will also continue to expand the size and scope of their SANs and the number and types of applications that their SANs support. Consequently, components of SAN environments, which are also commonly referred to as SAN fabrics, will become increasingly heterogeneous, and will originate from different server, storage, and application providers.

Since our inception, we have been a pioneer and innovator in enabling the market for SAN-based solutions, and have grown to be a market leader in storage networking infrastructure. We believe that the future evolution of the storage networking market will be lead by the providers of products that simplify the management of heterogeneous storage environments and maximize end-users' IT investments on an ongoing basis. We also believe that storage networking infrastructure will evolve to provide increased capabilities that enable new types of storage management applications that simplify storage management, increase operational efficiencies, and reduce operating expense. As a result, many of our initiatives and investments are aimed at expanding the capabilities enabled by SANs, increasing end-to-end interoperability, protecting end-user investments in existing and new IT resources, and making it easier for our OEM and application partners to deliver products that manage heterogeneous storage environments.

We offer a line of intelligent storage networking products and SAN management operating system that enables companies to network application servers with storage devices through a SAN.

Storage Networking Switches

Our SilkWorm® family of fabric switches, based on the Fibre Channel protocol, are devices that provide bandwidth and high-speed routing of data, ranges from low cost entry-level 8-port switches to 128-port enterprise-class director switches. These products have been designed to meet the storage networking needs of end-users in environments ranging from small and medium-size businesses to large enterprises with SAN fabrics that scale to thousands of ports, spread across multiple locations around the world. Our SilkWorm family of switches share a set of advanced fabric services that enable key SAN management functionality that we believe is unique to Brocade.

SAN Management Operating System

Brocade Fabric Operating System (Fabric OS) is the operating system firmware that provides the core infrastructure for deploying SANs. As the foundation for our family of SilkWorm switches, Fabric OS helps ensure the reliable and high-performance data transport that is critical for scalable SAN fabrics interconnecting multiple servers and storage devices. Our SAN management operating system also includes a common set of optional, advanced fabric services that build upon the foundation of Fabric OS and help improve performance, availability, scalability, and the overall functionality of the network. These fabric services include the ability to proactively monitor the health and performance of the SAN, the ability to aggregate bandwidth between fabric switches to deliver higher performance for storage applications, and the ability to securely control data access in multi-vendor SAN environments. We believe that our software products provide us with an advantage in the storage networking market, enabling differentiation and increasing licensable features and services. In addition, we offer management tools that enable end-users to manage and administer their SANs.

We have an open approach to SAN management and work with nearly every leading provider of storage and SAN management applications and technologies. Our advanced fabric services are made available to our

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distribution and application partners through an application programmable interface (API), which enables them to quickly leverage these features in their storage management solutions.

Intelligent Fabric Application Platforms

On January 27, 2003, we completed our acquisition of Rhapsody Networks, Inc. (Rhapsody), a privately held technology company based in Fremont, California. We believe that the acquisition of Rhapsody will extend the capabilities of our existing intelligent storage-networking platform and facilitate the acceleration of time to market for new types of storage applications from our OEM and application partners. We believe that certain of the next generation of storage management applications will be fabric-based, rather than server or storage array-based. In general, this means that elements of the application functionality will reside in the network of Fibre Channel switches, commonly referred to as the “fabric”, rather than in the server or storage array. We believe this will allow for increased centralization of storage management functions and higher performance of storage related applications. We also believe that these fabric-based applications, such as fabric-based routing services, storage volume management, data replication, and data migration, will accelerate the migration of intelligence into the SAN fabric and minimize operational cost and complexity for the end-user. On October 27, 2003, the Brocade SilkWorm® Fabric Application Platform (SilkWorm Fabric AP), which is an intelligent switching platform designed to host SAN fabric-based storage management applications, was made generally available to our OEM and software developer partners.

Industry Initiatives

We work with industry-leading companies to facilitate the development of standards, technologies, products, and services that focus on the simplification of heterogeneous storage management, and the implementation and management of storage networking environments.

Industry Standards Development

Since our inception, we have been a major contributor to the evolution of industry standards ranging from Fibre Channel communication technology to SAN interoperability to storage and SAN management. We contribute to nearly every related industry standards committee, and have authored or co-authored the majority of the Fibre Channel protocol standards in existence today.

Storage Networking Environment Interoperability

As SANs have increased in size and comprise more and different types of server, storage, and interconnection devices, the need for interoperability among those devices has similarly increased. We have invested a significant amount of resources for purposes of providing interoperability among Brocade solutions and the servers, storage, and storage management applications that run in the Brocade environment, and in driving standards for interoperability among SAN interconnection devices. We also continually certify Brocade solutions in operational storage environments through our own testing programs, our partners’ testing and qualification initiatives, and through certification programs for third party products, such as the Brocade Fabric Aware program, which we offer as a resource to our application and technology partners. Through our testing initiatives, we also certify interoperability configurations of common customer environments, such as remote data backup in a multi-vendor server and storage environment.

Application Interoperability

An important aspect of managing storage environments is the management software used to administer, manage, and provision storage resources and data. Our intelligent platform offers advanced fabric services that allow third-party developers of storage software applications to gain additional functionality and simplify the development of their applications. We offer the Brocade Fabric Access API, which is a development interface that helps to simplify the delivery of third-party applications that utilize the intelligence in the Brocade SAN fabric. Our Fabric Access partners are the leaders in storage and SAN management solutions and include

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companies such as Computer Associates, EMC Corporation (EMC), Hewlett-Packard Company (HP), IBM Tivoli, and VERITAS Software Corporation (Veritas).

Education and Technical Certification Services

Our education and training organization delivers high-quality, technical education and training on SAN technology, design, implementation, and management to our partners and their customers. The Brocade SAN Certification Program, our educational service, offers certification on Brocade SANs for IT professionals who have completed certain tests administered by an independent testing organization. This certification program is designed to measure the knowledge and proficiency of IT professionals in SAN solutions and technologies, and to help ensure that our customers receive superior customer service and support. Our education and training services are made available through our own education facilities and through our worldwide training provider network.

Distribution Model

Our products are marketed, sold, and supported worldwide through a wide range of distribution partners, including OEM partners, master resellers, which are value-added distributors, and fabric partners, which are systems integrators and value-added resellers.

- Our OEM partners are leading storage systems and subsystems providers who offer our products under their own private label or as Brocade branded solutions. Sales through OEM partners comprise the majority of our business.
- Other distribution partners include Brocade-authorized value added distributors, systems integrators, and value-added resellers. These partners are authorized by us to market, sell, and support our SilkWorm family of fabric switches and software. Some also sell education and other value-added services.

We have OEM or distribution agreements with the majority of the companies that sell the world's storage systems and subsystems. In addition, we employ a worldwide overlay sales force to assist our distribution partners in marketing Brocade SAN solutions, assessing SAN requirements and designing, implementing, and maintaining Brocade-based SANs.

Customers

Our major OEM customers include Dell Computer Corporation, EMC, Fujitsu Siemens, Hitachi Data Systems, Inc., HP, IBM Corporation (IBM), Network Appliance, Siemens AG, StorageTek, Sun Microsystems, Inc., and Unisys Corporation. Our primary non-OEM customers include Bell Microproducts, GE Access, Tokyo Electron Limited, and XIOTech.

For the years ended October 25, 2003 and October 26, 2002, EMC, HP, and IBM each represented greater than ten percent of our total revenues. For the year ended October 27, 2001, Compaq Computer Corporation (Compaq), EMC, and IBM each represented greater than ten percent of our total revenues. The level of sales to any OEM customer may vary from quarter to quarter, and we expect that significant customer concentration will continue for the foreseeable future. The loss of any one of these customers, or a decrease in the level of sales to any one of these customers, could have a material adverse impact on our financial condition or results of operations.

Acquisitions and Investments

Our acquisition and investment strategy is focused on facilitating the evolution and expansion of the SAN market and enabling companies to further simplify storage management. In the past, we have made minority equity investments in companies that develop technology or provide services that are complementary to or broaden the markets for our products and further our business objectives. On January 27, 2003, we completed our acquisition of Rhapsody, a privately held technology company based in Fremont, California that has

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resulted in the SilkWorm Fabric AP. As of October 25, 2003, the carrying value of our minority investments in non-publicly traded companies was zero.

Research and Development

The industry in which we compete is subject to rapid technological developments, evolving industry standards, changes in customer requirements, and new product introductions. As a result, our success depends, in part, on our ability to continue to enhance our existing solutions and to develop and introduce new solutions that improve performance and reduce the total cost of ownership in the storage environment. We have invested significantly in product research and development. We continue to enhance and extend our products, and to increase the speed, performance, and port-density of our switching platform. We also continue to expand the value-added services of our intelligent platform to enable more functionality for end customers, OEM partners, and application partners and further simplify storage management.

Our products are designed to support current industry standards and will continue to support emerging standards that are consistent with our product strategy. Our products have been designed around a common platform architecture, which facilitates the product design, development, and testing cycle, and reduces the time to market for new products and features. We intend to continue to leverage this common architecture to develop and introduce additional hardware and software products and enhancements in the future.

For the years ended October 25, 2003, October 26, 2002, and October 27, 2001, our research and development expenses totaled \$145.1 million, \$132.2 million, and \$110.7 million, respectively. All expenditures for research and development costs have been expensed as incurred. We expect to continue to maintain our high level of investment in research and development.

Competition

The current and potential market for SAN solutions and technologies is competitive and subject to rapid technological change. Major storage systems and server providers are continually introducing new SAN-oriented solutions and products, and enhancing existing SAN-oriented solutions and products. We believe our primary competition is from providers of Fibre Channel switching products for interconnecting servers and storage, including Cisco Systems Inc. (Cisco), Computer Network Technology Corporation (CNT), McDATA Corporation (McDATA), and QLogic Corporation (QLogic).

As the SAN market evolves, additional technologies may become available for interconnecting servers and storage. To the extent that these products provide the ability to network servers and storage and support high-performance, block-data storage applications, they may compete with our current and future products. Competitive products might include, but are not limited to, non-Fibre Channel based emerging products based on Gigabit Ethernet, 10 Gigabit Ethernet, or InfiniBand. In addition, networking companies, manufacturers of networking equipment, or other companies may develop competitive products. Our OEM partners or other partners could also develop and introduce products competitive with our product offerings. We believe the competitive factors in this market segment include product performance and features, product reliability, price, size and extent of installed base, ability to meet delivery schedules, customer service, technical support, and distribution channels.

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 us. 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.

Manufacturing

We use two third-party contract manufacturers, Solectron Corporation (Solectron) and Hon Hai Precision Industry Co., Ltd. (Foxconn), to manufacture our products. Solectron and Foxconn invoice us based

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on prices and payment terms mutually agreed upon and set forth in purchase orders we issue to them. Although the purchase orders we place with our contract manufacturers are cancelable, we could be required to purchase all unused material not returnable or usable by other customers.

We use Solectron and Foxconn for final turnkey product assembly, but we also maintain key component selection and qualification expertise internally. We design and develop the key components of our products, including ASICs and operating system and other software, as well as certain details in the fabrication and enclosure of our products. In addition, we determine the components that are incorporated into our products and we select appropriate suppliers of those components.

Although we use standard parts and components for our products where possible, our contract manufacturers, Solectron and Foxconn, currently purchase, on our behalf, several key components used in the manufacture of our products from single and limited supplier sources. Our principal single source components are ASICs. Our principal limited source components include microprocessors, certain connectors, certain logic chips, and programmable logic devices. In addition, we license certain software from third parties that is incorporated into our Fabric Operating System and other software. If we are unable to buy or license these components on a timely basis, we may not be able to deliver our products to customers in a timely manner. We use rolling forecasts 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.

Patents, Intellectual Property, and Licensing

We rely on a combination of patents, copyrights, trademarks, trade secrets, confidentiality agreements, and other contractual restrictions with employees and third parties to establish and protect our proprietary rights. Despite these precautions, the measures we undertake may not prevent misappropriation or infringement of our proprietary technology. These measures may not preclude competitors from independently developing products with functionality or features similar to our products.

We maintain a program to identify and obtain patent protection for our inventions. It is possible that we will not receive patents for every application we file. Furthermore, our issued patents may not adequately protect our technology from infringement or prevent others from claiming that our products infringe the patents of those third parties. Our failure to protect our intellectual property could materially harm our business. In addition, our competitors may independently develop similar or superior technology, duplicate our products, or design around our patents. It is possible that litigation may be necessary in the future to enforce our intellectual property rights, to protect our trade secrets, or to determine the validity and scope of the proprietary rights of others. Litigation could result in substantial costs and diversion of resources and could materially harm our business.

Some of our products are designed to include software or other intellectual property licensed from third parties. While it may be necessary in the future to seek or renew licenses relating to various aspects of our products, we believe that such licenses generally could be obtained on commercially reasonable terms. Failure to do so could materially harm our business.

We have received, and may receive in the future, notice of claims of infringement of other parties' proprietary rights. Infringement or other claims could be asserted or prosecuted against us in the future, and it is possible that past or future assertions or prosecutions could harm our business. Any such claims, with or without merit, could be time-consuming, result in costly litigation and diversion of technical and management personnel, cause delays in the development and release of our products, or require us to develop non-infringing technology or enter into royalty or licensing arrangements. Such royalty or licensing arrangements, if required, may require us to license back our technology or may not be available on terms acceptable to us, or at all. For these reasons, infringement claims could materially harm our business.

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Backlog

Our business is characterized by short lead-time orders and fast delivery schedules. Sales of our products are generally made pursuant to contracts and purchase orders that are cancelable without significant penalties. These commitments are subject to price negotiations and to changes in quantities of products and delivery schedules in order to reflect changes in customers' requirements and manufacturing availability. In addition, actual shipments depend on the manufacturing capacity of suppliers and the availability of products from such suppliers. As a result of the foregoing factors, we do not believe that backlog at any given time is a meaningful indicator of our ability to achieve any particular level of revenue or financial performance.

Employees

As of October 25, 2003, we had 1,230 employees. No employees are represented by a labor union. We have not experienced any work stoppages and consider our relations with employees to be good. Employees are currently located in our United States headquarters in San Jose, California; our European headquarters in Geneva, Switzerland; our Asia Pacific headquarters in Hong Kong; and offices throughout North America, Europe, and Asia Pacific. Competition for technical personnel in the computing industry continues to be significant. We believe that our success depends in part on our ability to hire, assimilate, and retain qualified personnel. We cannot assure you that we will continue to be successful at hiring, assimilating, and retaining employees in the future.

Executive Officers of the Registrant

The following table sets forth certain information regarding our executive officers as of December 31, 2003:

<u>Name</u>	<u>Age</u>	<u>Position</u>
Gregory L. Reyes	41	Chairman of the Board of Directors and Chief Executive Officer
Paul Bonderson	52	Chief Technology Officer and Chief Engineer
Antonio Canova	42	Vice President, Finance and Chief Financial Officer
Jack Cuthbert	48	Vice President, OEM Sales
Michael Klayko	49	Vice President, Worldwide Marketing and Support
James LaLonde	38	Vice President, Worldwide Field Sales

Gregory L. Reyes has served as our Chairman of the Board of Directors and Chief Executive Officer since May 2001. From July 1998 to May 2001, Mr. Reyes served as our President and Chief Executive Officer and was a member of our Board of Directors. Before joining Brocade, from January 1995 to June 1998, Mr. Reyes was President and Chief Executive Officer of Wireless Access, Inc., a wireless data communications products company. From January 1995 to November 1997, Mr. Reyes served as Chairman of the Board of Directors of Wireless Access. From January 1991 to January 1995, Mr. Reyes served as Divisional Vice President and general manager of Norand Data Systems, a developer of wireless data networks and hand-held terminals. Mr. Reyes also serves on the Board of Directors and Compensation Committee of Verisign, Inc., an Internet infrastructure company. Mr. Reyes received a B.S. in Economics and Business Administration from Saint Mary's College in Moraga, California.

Paul Bonderson, a co-founder of Brocade, has served as our Chief Technology Officer and Chief Engineer since April 2003. From January 2003 to April 2003, Mr. Bonderson served as our Vice President, Engineering, and from November 2001 to January 2003, he served as Vice President Strategic Development. Mr. Bonderson was Vice President, Engineering from August 1995 to November 2001. Before founding Brocade, Mr. Bonderson held management positions at Intel Corporation and at Sun Microsystems. Mr. Bonderson received a B.S. in Electrical Engineering from California Polytechnic State University in San Luis Obispo, California.

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Antonio Canova has served as our Vice President, Finance and Chief Financial Officer since May 2001. Mr. Canova joined Brocade in November 2000 as our Vice President, Finance. From April 2000 to November 2000, Mr. Canova served as Vice President, Chief Financial Officer, and Secretary of Wireless Inc., a wireless broadband equipment manufacturer. From 1995 to 2000, Mr. Canova was an audit partner of KPMG LLP. Mr. Canova received a B.S. in Accounting from Santa Clara University in Santa Clara, California.

Jack Cuthbert has served as our Vice President, OEM Sales since August 2002. From November 2001 to August 2002, Mr. Cuthbert served as our Vice President, Worldwide Sales. From November 2000 to November 2001, Mr. Cuthbert served as our Vice President, Worldwide Sales, Marketing and Support, and from April 2000 to November 2000, he served as our Vice President, Worldwide Marketing. Mr. Cuthbert was Vice President North American Sales from October 1999 to April 2000, and was Director, Channel Sales from June 1998 to October 1999. From November 1996 to June 1998, Mr. Cuthbert served as Vice President, North American Sales at Macromedia, Inc., an Internet software development company. Mr. Cuthbert also held various positions at SGI, a producer of visual computing systems, most recently Director, North American Channels. Mr. Cuthbert received a B.Sc. in Physics from the University of Waterloo in Canada and a M.S. in Engineering Physics from McMaster University in Canada.

Michael Klayko has served as our Vice President, Worldwide Marketing and Support since joining Brocade in January 2003. From May 2001 to January 2003, Mr. Klayko was Chief Executive Officer and President of Rhapsody Networks, a privately held technology company. From December 1998 to April 2001, Mr. Klayko served as Executive Vice President of McDATA Corporation, a storage networking company. From March 1995 to November 1998, Mr. Klayko was Senior Vice President for North American Sales at EMC Corporation, a provider of information storage systems products. Mr. Klayko also held various executive sales and marketing positions at Hewlett-Packard Company and IBM Corporation. Mr. Klayko received a B.S. in Electronic Engineering from Ohio Institute of Technology, in Youngstown, Ohio.

James LaLonde has served as our Vice President, Worldwide Field Sales since November 2003. From May 2002 to November 2003, Mr. LaLonde served as our Vice President, International Sales. Mr. LaLonde was Vice President, Asia Pacific and Japan from December 2000 to May 2002. From April 1997 to November 2000, Mr. LaLonde was Managing Director of Asia Pacific Sales and Operations at Network Associates, a provider of network security products. From 1991 to 1997, Mr. LaLonde held several senior-level positions at Microsoft Corporation. Mr. LaLonde received a B.S. in Economics from The University of Texas in Austin, Texas.

Certain Financial Information

Financial information relating to foreign and domestic sales and operations for the three years ended October 25, 2003, October 26, 2002, and October 27, 2001, is set forth in Note 12, "Segment Information," of the Notes to Consolidated Financial Statements attached hereto. Financial information relating to revenues, income and total assets for the three years ended October 25, 2003, October 26, 2002, and October 27, 2001, can be found under "Item 6 — Selected Financial Data" and also in our Consolidated Financial Statements attached hereto.

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.

Risk Factors

Our quarterly and annual 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 and annual 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. Factors that may affect the predictability of our quarterly and annual results include, but are not limited to, the following:

- changes in general economic conditions, specifically in the information technology industry;
- the timing of customer orders, product qualifications, and product introductions 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;
- average unit prices of our products, which are likely to continue to decline in the future as a result of competitive pricing pressures or new product introductions by us or 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;
- pending or threatened 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 will likely 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. Although general economic conditions appear to be improving, 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 by the effects of the weakened economy in recent periods, 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 IT spending levels 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 principally face competition from providers of Fibre Channel switching products for interconnecting servers and storage. These competitors include Cisco, CNT, McDATA, and Qlogic.

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 recurring purchases from a limited number of large OEM partners for the majority of our revenue. Our agreements with our OEM partners are typically cancelable, non-exclusive, and have no minimum purchase requirements. For the year ended October 25, 2003, three customers each represented greater than ten percent of our total revenues for a combined total of 67 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, or unsuccessful negotiation on major terms and conditions of purchase orders placed during a quarter, 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. The pricing of our products is likely to continue to decline, which would reduce our revenues, gross margins, 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 attain profitability.

In fiscal year 2004, we do not expect to attain profitability due principally to the charge associated with our recent real estate acquisition, and may not be able to attain profitability at all in the future. We expect to incur significant costs and expenses for product development, sales and marketing, and customer support. 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. We also make operating decisions, such as our recent purchase of a 194,000 square foot building located at our San Jose headquarters, based on our anticipated future expansion. We expect our recent building purchase to adversely affect our earnings per share at least through our fiscal year 2004 as we expect to record a charge related to lease termination, facilities consolidation, and other associated costs (see Note 17, "Subsequent Event," of the Notes to Consolidated Financial Statements).

During fiscal year 2003 we 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 and annual revenues is limited for the reasons discussed above in "Our quarterly and annual 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.

On July 10, 2003, as part of our stock option exchange program, we granted to employees 26.6 million new stock options at an exercise price of \$6.54 per share. The 26.6 million new stock options represented approximately 10 percent of our total shares of common stock outstanding as of October 25, 2003, and could have a dilutive effect on our future earnings per share to the extent that we attain profitability in the future, or if 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, excess inventories of older products, product and software defects, and different sales and support requirements due to the complexity of these new systems. We expect to introduce new products in 2004. If we fail to develop and successfully introduce these new products, or if we fail to otherwise successfully manage the transition to these new products, our business and financial results will be adversely affected. For example, during the fourth quarter ended October 27, 2001, we recorded charges to cost of revenues of \$7.7 million primarily associated with the accrual of purchase commitments for excess inventory components related to a transition of product offerings from 1 to 2 Gigabit per second (Gbit/sec) technology.

We must achieve market acceptance for our recently introduced SilkWorm Fabric Application Platform product family.

We recently introduced, and intend to continue to make substantial investments in, our SilkWorm Fabric Application Platform product family. The success of this product family is subject to risks and uncertainties including our ability to produce these products in a timely manner, our ability to produce these products in the volume and with the performance and feature set required by customers, the market acceptance of these products, and the availability of applications developed by our OEM partners and other application developers for these products. We cannot be certain that the SilkWorm Fabric Application Platform product family will be successfully developed or achieve market acceptance. In addition, we cannot be certain that our OEM partners or other application developers will develop applications for this product family in a timely manner, if at all, or if applications that are developed will be sufficient. If our SilkWorm Fabric Application Platform product family does not achieve market acceptance, our business will be adversely affected.

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, and the demand and market acceptance of these new products are 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. For example, we have recently introduced our SilkWorm Fabric Application Platform product family. Our success with this product family will depend on the extent to which our OEM partners develop applications for this product family. The market acceptance of, and consequently the revenues we receive from, our Fabric Application Platform product family may be adversely affected if our OEM partners do not develop applications for these products, or do not successfully migrate applications to these products.

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. If we are unable to achieve market acceptance of our new products, our business and results of operations could be harmed.

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.

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.

Furthermore, 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 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. In the future, our ability to respond to the needs of these groups may depend on third parties producing complementary products and applications for our products. If we fail to respond to the needs of these groups, our business and operating results could be harmed.

Because we have an 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 operations and 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 design, manufacture, sell, and support our products;
- increased complexity and costs of managing international operations;
- increased exposure to foreign currency exchange rate fluctuations;
- 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 and manufacturing lead times;
- difficulties in collecting accounts receivable;
- reduced or limited protections of intellectual property rights;
- more complicated logistics and distribution arrangements; and
- political and economic instability.

To date, no material amount 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. Additionally, a decrease in the value of the United States dollar relative to foreign currencies could increase our operating costs in foreign locations. In the future, a larger 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 and uneven sales patterns in the future.

Many of our OEM partners experience seasonality and uneven sales patterns in their businesses. For example, some of our partners close a disproportionate percentage of their sales transactions in the last month, weeks and days of each quarter; and other partners experience spikes in sales during the fourth calendar quarter of each year. As a greater percentage of our products are sold to OEM partners who experience seasonal fluctuations and uneven sales patterns in their businesses, we could begin to experience similar seasonality and uneven sales patterns. It is difficult for us to evaluate the degree to which the seasonality and uneven sales patterns of our OEM partners may affect our business in the future because the historical growth of our business may have lessened the effect of this seasonality and uneven sales patterns 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, component parts shortages, 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

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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 product forecasts to our contract manufacturers and place purchase orders with them in advance of the scheduled delivery of products to our customers. Although our purchase orders placed with our contract manufacturers are cancelable, we could be required to purchase certain unused material not returnable, usable by, or sold to other customers if we cancel any of our orders. 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. This kind of transition would expose us to certain inherent risks, including unexpected changes in regulatory requirements and tariffs, delays related to the acquisition of product components and distribution of our products and potentially adverse tax consequences, all of which could harm our business. If we are not successful in our strategy to further transition our manufacturing to overseas markets, or if we are not successful in the implementation of this overseas manufacturing, 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 rolling forecasts 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.

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. 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, enterprise-wide management information and reporting systems, and procedures, and our failure to continue to train and manage our workforce worldwide, could seriously harm our business and financial results.

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

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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 low, 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 3 — Legal Proceedings for additional information regarding this lawsuit).

We are currently a party to another intellectual property-related lawsuit, and 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 current lawsuits, could subject us to

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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 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.

Securities class-action litigation is often brought against a company following periods of volatility in the market price of its securities. As our stock price remains volatile, we could become the target of securities litigation in the future. Any current or future securities litigation in which we are involved could result in substantial costs to us 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 completed our acquisition of Rhapsody on January 27, 2003. 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, or assume stock option plans 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

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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 will likely 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.

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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.

Item 2. *Properties*

Our principal administrative, sales and marketing, education, customer support, and research and development facilities are located in approximately 495,000 square feet of office space in San Jose, California. We currently occupy approximately 405,000 square feet of our total office space. Approximately 301,000 square feet of our office space is leased, and the remaining 194,000 was purchased in the first quarter of fiscal 2004 (see Note 17, "Subsequent Event," of the Notes to Consolidated Financial Statements). In connection with the building purchase and recent facilities consolidation activities, we identified 90,000 square feet of office space that we do not expect to utilize in the foreseeable future based on our anticipated hiring needs. Accordingly, this space has been made available for sublease. The leases on our leased office space will expire in August 2010. In addition to the San Jose facilities, we also lease sales, marketing, and administrative office space in various locations throughout the world.

Item 3. *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 case management conference is scheduled for February 20, 2004. 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.

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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. On October 14, 2003, the Court dismissed with prejudice all claims against Brocade. Brocade does not expect any further action on this case.

On February 14, 2002, a suit captioned *McDATA Corp. v. Brocade Communications Systems, Inc.* was filed against Brocade 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 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 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. The arbitration has been scheduled for the week of March 29, 2004. 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 for violation of the federal securities laws 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 Brocade’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 Brocade’s 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, making 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. The lawsuit against the Brocade parties is one of a number of cases challenging underwriter practices in the initial public offerings of more than 300 cases. All of the cases have been coordinated for pretrial proceedings as *In Re Initial Public Offering Securities Litigation, 21 MC 92(SAS)*. In October 2002, the individual defendants were dismissed without prejudice from the action, pursuant to a tolling agreement. On February 19, 2003, the Court issued an Opinion and Order dismissing all of the plaintiffs’ claims against Brocade.

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

No matters were submitted to a vote of security holders during the fourth quarter of fiscal 2003.

PART II

Item 5. *Market for Registrant's Common Equity and Related Stockholder Matters*

Our common stock has been quoted on the Nasdaq National Market under the symbol "BRCD" since our initial public offering on May 24, 1999. Prior to this time, there was no public market for the stock. See "Item 6 — Selected Financial Data" for the high and low bid prices per share of our common stock as reported on the Nasdaq National Market, for the periods indicated.

According to records of our transfer agent, we had 908 stockholders of record at December 19, 2003 and we believe there are a substantially greater number of beneficial holders. We currently expect to retain future earnings, if any, for use in the operation and expansion of our business and do not anticipate paying any cash dividends in the foreseeable future. See Note 10, "Stockholders' Equity," of the Notes to Consolidated Financial Statements for equity compensation plan information.

Item 6. *Selected Financial Data*

The following selected financial data should be read in conjunction with our consolidated financial statements and related notes, "Management's Discussion and Analysis of Financial Condition and Results of Operations," and other financial information appearing elsewhere in this Annual Report. The consolidated statement of operations data set forth below for each of the years in the three-year period ended October 25, 2003, the consolidated balance sheet data as of October 25, 2003 and October 26, 2002, are derived from, and qualified by reference to, the audited financial statements appearing elsewhere in this Annual Report. The statement of operations data for the years ended October 28, 2000 and October 31, 1999, and the balance sheet data as of October 27, 2001, October 28, 2000, and October 31, 1999, are derived from audited financial statements not included herein. All references to earnings per share and the number of common shares have been retroactively restated to reflect three two-for-one stock splits, effected on December 3, 1999, March 15, 2000, and December 22, 2000.

Note: On February 2, 2000, we changed our fiscal year end to the last Saturday in October, beginning with the fiscal year ended October 28, 2000. This change did not have a material impact on our financial position or results of operations. We report our fiscal year on a 52/53-week period ending on the last Saturday in October of each year. Accordingly, the fiscal year ends for fiscal years 2003, 2002 and 2001 were October 25, 26 and 27, respectively. Fiscal years 2003, 2002 and 2001 were all 52 weeks in length. As is customary for companies that use the 52/53-week convention, every 5th year contains a 53-week year. As a result, our fiscal year 2004 will be a 53-week year. Also as a result, our second quarter of fiscal year 2004 will include one extra week and will be 14 weeks in length.

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	Fiscal Year Ended				
	October 25, 2003(2)	October 26, 2002	October 27, 2001(1)	October 28, 2000	October 31, 1999
(In thousands, except per share amounts)					
Statement of Operations Data:					
Net revenues	\$ 525,277	\$ 562,369	\$513,030	\$329,045	\$ 68,692
Cost of revenues	241,105	226,414	212,956	137,456	33,497
Gross margin	284,172	335,955	300,074	191,589	35,195
Operating expenses:					
Research and development	145,082	132,205	110,749	50,505	15,267
Sales and marketing	114,879	118,130	94,931	46,524	13,288
General and administrative	21,312	18,836	17,737	10,506	3,849
Amortization of deferred stock compensation	649	969	1,082	1,120	1,937
Restructuring costs	20,828	—	—	—	—
In-process research and development	134,898	—	—	—	—
Facilities lease losses and other charges	—	—	49,888	—	—
Total operating expenses	437,648	270,140	274,387	108,655	34,341
Income (loss) from operations	(153,476)	65,815	25,687	82,934	854
Interest and other income, net	18,424	22,668	8,207	5,427	2,196
Interest expense	(13,339)	(11,427)	—	(45)	(459)
Gain on repurchases of convertible subordinated debt	11,118	—	—	—	—
Gain (loss) on investments, net	3,638	7,095	(16,092)	—	—
Income (loss) before provision for income taxes	(133,635)	84,151	17,802	88,316	2,591
Income tax provision	2,605	24,405	14,954	20,385	106
Net income (loss)	\$ (136,240)	\$ 59,746	\$ 2,848	\$ 67,931	\$ 2,485
Net income (loss) per share — basic	\$ (0.54)	\$ 0.26	\$ 0.01	\$ 0.33	\$ 0.02
Net income (loss) per share — diluted	\$ (0.54)	\$ 0.25	\$ 0.01	\$ 0.28	\$ 0.01
Shares used in per share calculation — basic	250,610	231,591	221,051	207,454	104,376
Shares used in per share calculation — diluted	250,610	242,962	243,162	242,504	204,584
Balance Sheet Data:					
Cash, cash equivalents and investments	\$ 835,565	\$ 888,388	\$255,148	\$155,039	\$ 89,305
Working capital	374,939	554,239	257,794	230,028	79,253
Total assets	1,323,946	1,421,663	683,722	455,179	117,280
Non-current liabilities associated with lease losses	16,518	22,602	30,896	—	—
Convertible subordinated debt and capital lease obligations	442,950	550,000	—	—	—
Total stockholders' equity	698,376	687,595	537,886	390,877	84,206

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	First Quarter(3)	Second Quarter(4)	Third Quarter	Fourth Quarter(5)
(In thousands, except per share and stock price amounts)				
Quarterly Data:				
Fiscal Year Ended October 25, 2003				
Net revenues	\$ 123,116	\$ 130,946	\$ 133,458	\$ 137,757
Gross margin	\$ 66,093	\$ 70,684	\$ 72,232	\$ 75,163
Income (loss) from operations	\$ (11,687)	\$(149,128)	\$ 1,811	\$ 5,528
Net income (loss)	\$ (6,890)	\$(146,017)	\$ 1,911	\$ 14,756
Per share amounts:				
Basic	\$ (0.03)	\$ (0.57)	\$ 0.01	\$ 0.06
Diluted	\$ (0.03)	\$ (0.57)	\$ 0.01	\$ 0.06
Shares used in computing per share amounts:				
Basic	234,898	254,687	255,873	256,983
Diluted	234,898	254,687	259,444	260,369
Bid prices:				
High	\$ 7.47	\$ 5.86	\$ 7.30	\$ 6.45
Low	\$ 4.14	\$ 3.66	\$ 5.14	\$ 5.22
Fiscal Year Ended October 26, 2002				
Net revenues	\$ 123,078	\$ 134,950	\$ 151,234	\$ 153,107
Gross margin	\$ 74,100	\$ 81,277	\$ 90,935	\$ 89,643
Income from operations	\$ 14,423	\$ 16,389	\$ 22,389	\$ 12,614
Net income	\$ 11,671	\$ 13,978	\$ 18,348	\$ 15,749
Per share amounts:				
Basic	\$ 0.05	\$ 0.06	\$ 0.08	\$ 0.07
Diluted	\$ 0.05	\$ 0.06	\$ 0.08	\$ 0.07
Shares used in computing per share amounts:				
Basic	228,256	231,185	233,017	233,905
Diluted	248,233	245,678	240,106	237,830
Bid prices:				
High	\$ 41.37	\$ 37.50	\$ 25.96	\$ 20.16
Low	\$ 23.08	\$ 21.61	\$ 14.16	\$ 5.21

- (1) The fiscal year ended October 27, 2001 includes the impact of the following items recorded during the fourth quarter ended October 27, 2001: charges to cost of revenues of \$7.7 million primarily associated with the accrual of purchase commitments for excess inventory components related to a transition of product offerings from 1 to 2 Gigabit per second (Gbit/sec) technology; charges included in operating expenses of \$45.5 million related to estimated facilities lease losses and the impairment of certain related leasehold improvements following a comprehensive evaluation of real estate facility requirements; charges included in operating expenses of \$4.4 million related to the impairment of equipment no longer used in research and development and sales and marketing efforts associated with a transition of product offerings from 1 to 2 Gbit/sec technology and other charges; and losses on investments of \$19.5 million related to other-than-temporary declines in the fair value of private minority equity investments in non-publicly traded companies as a result of significant deterioration in the private equity markets, and related adjustment for income tax provisions.
- (2) The fiscal year ended October 25, 2003 includes the impact of our acquisition of Rhapsody, which was completed in the second quarter of fiscal year 2003. In connection with our acquisition of Rhapsody, we recorded in-process research and development expense of \$134.9 million (see Note 3, "Acquisition of

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Rhapsody Networks, Inc.,” of the Notes to Consolidated Financial Statements). The fiscal year ended October 25, 2003 also includes restructuring costs of \$20.8 million (see Note 4, “Restructuring Costs,” of the Notes to Consolidated Financial Statements), gain on repurchases of convertible subordinated debt of \$11.1 million, and net gains on the disposition of non-marketable private strategic investments of \$3.6 million.

- (3) The first quarter of fiscal year 2003 includes restructuring costs of \$10.1 million related to a company-wide workforce reduction of approximately 12 percent, consolidation of excess facilities, and the restructuring of certain business functions (see Note 4, “Restructuring Costs,” of the Notes to Consolidated Financial Statements).
- (4) The second quarter of fiscal year 2003 includes restructuring costs of \$10.9 million related to a workforce reduction of approximately nine percent, primarily in the sales, marketing, and engineering organizations, and the impairment of certain assets associated with reorganized or eliminated functions (see Note 4, “Restructuring Costs,” of the Notes to Consolidated Financial Statements). In addition, in the second quarter of fiscal year 2003, in connection with our acquisition of Rhapsody, we recorded in-process research and development expense of \$134.9 million (see Note 3, “Acquisition of Rhapsody Networks, Inc.,” of the Notes to Consolidated Financial Statements).
- (5) The fourth quarter of fiscal year 2003 includes a reduction of \$0.2 million to our restructuring costs. The fourth quarter of fiscal year 2003 also includes gain on repurchases of convertible subordinated debt of \$11.1 million, and gain on the disposition of private strategic investments of \$3.1 million.

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

Recent Events

On November 18, 2003, we purchased a building located at our San Jose headquarters for \$106.8 million in cash plus transaction costs. The 194,000 square foot facility, which houses a portion of our engineering organization and development, test and interoperability laboratories, was previously leased. As a result of the building purchase, during the first quarter of fiscal 2004, we expect to record a charge ranging from \$75.0 million to \$85.0 million primarily related to lease termination, facilities consolidation and other associated costs, and we expect to reduce our annual operating expenses by approximately \$4.0 million to \$6.0 million. In addition, we issued a \$1.0 million guarantee as part of the purchase agreements, and cancelled an irrevocable letter of credit of \$10.4 million, which was previously issued as security for the building lease.

Results of Operations

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

	Fiscal Year Ended		
	October 25, 2003	October 26, 2002	October 27, 2001
Net revenues	100.0%	100.0%	100.0%
Cost of revenues	45.9	40.3	41.5
Gross margin	54.1	59.7	58.5
Operating expenses:			
Research and development	27.6	23.5	21.6
Sales and marketing	21.9	21.0	18.5
General and administrative	4.0	3.3	3.5
Amortization of deferred stock compensation	0.1	0.2	0.2
Restructuring costs	4.0	—	—
In-process research and development	25.7	—	—
Facilities lease losses and other charges	—	—	9.7
Total operating expenses	83.3	48.0	53.5
Income (loss) from operations	(29.2)	11.7	5.0
Interest and other income, net	3.5	4.0	1.6
Interest expense	(2.5)	(2.0)	—
Gain on repurchases of convertible subordinated debt	2.1	—	—
Gain (loss) on investments, net	0.7	1.3	(3.1)
Income (loss) before provision for income taxes	(25.4)	15.0	3.5
Income tax provision	0.5	4.4	2.9
Net income (loss)	(25.9)%	10.6%	0.6%

Revenues. Our revenues are derived primarily from sales of our SilkWorm family of products. Net revenues for the year ended October 25, 2003 were \$525.3 million, a decrease of 7 percent compared with net revenues of \$562.4 million for the year ended October 26, 2002. Net revenues for the year ended October 26, 2002 represented an increase of 10 percent over net revenues of \$513.0 million for the year ended October 27, 2001. Net revenues for the year ended October 25, 2003 were negatively affected by declines in average selling prices as a result of increased competition, partially offset by increases in volume as a result of continued increases in demand for SAN switching products. For the year ended October 26, 2002, the increases in net revenues reflect a general increased demand for SAN switching products, and were the result of increased unit sales offset by declines in average unit selling prices of our products. We expect that average unit prices of our products will likely continue to decline in the future as a result of competitive pricing pressures or new product introductions by us or our competitors. We also expect shipping volumes will fluctuate depending on the supply and demand for SAN switching products.

Domestic and international revenues were approximately 67 percent and 33 percent of our total revenues, respectively, for the year ended October 25, 2003. For the year ended October 26, 2002, domestic and international revenues were approximately 70 percent and 30 percent of our total revenues, respectively, and for the year ended October 27, 2001, domestic and international revenues were approximately 71 percent and 29 percent of our total revenues, respectively. 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 these

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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 revenue is concentrated among a relatively small number of customers. For the year ended October 25, 2003, three customers each represented greater than ten percent of our total revenues for a combined total of 67 percent of our total revenues. For the year ended October 26, 2002, the same three customers each represented greater than ten percent of our total revenues for a combined total of 62 percent of our total revenues, and for the year ended October 27, 2001, three customers each represented greater than ten percent of our total revenues for a combined total of 56 percent of our total revenues. 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 year ended October 25, 2003, was 54.1 percent compared to 59.7 percent and 58.5 percent for the years ended October 26, 2002, and October 27, 2001, respectively. Cost of goods sold consists of product costs and manufacturing operations costs. For the year ended October 25, 2003, the reduction in gross margins was the result of increased product costs and manufacturing operations costs relative to net revenues. The increase in product costs relative to net revenues is primarily the result of declines in average unit selling prices of our products, partially offset by lower component and manufacturing costs. The increase in manufacturing operations costs is a result of increased production volume and greater installed base, combined with continued migration of manufacturing operations to Asia. For the year ended October 26, 2002, the increase in gross margin was the result of decreased product costs and increased manufacturing operations costs relative to net revenues. The decrease in product costs relative to net revenues was primarily due to lower component and manufacturing costs, partially offset by decreases in the average unit selling prices of our products. The increase in manufacturing operations costs is a result of increased production volume and greater installed base. We expect that average unit prices of our products will likely continue to decline in the future as a result of competitive pricing pressures or new product introductions by us or our competitors. If we are unable to offset future average unit price reductions of our products with reduced manufacturing product costs, or if as a result of future reductions in average unit pricing our revenues do not grow, our gross margin may be negatively affected.

Research and development expenses. Research and development (R&D) expenses increased to \$145.1 million for the year ended October 25, 2003, compared with \$132.2 million and \$110.7 million for the years ended October 26, 2002, and October 27, 2001, respectively. 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 test equipment; and IT and facilities expenses. The increases in R&D expenses, both in absolute dollars and as a percentage of net revenues, reflect our belief that continued investment in research and development is a critical factor in maintaining our competitive position. Further, the increase in R&D expenses for the year ended October 25, 2003 were due to the incremental spending associated with our acquisition of Rhapsody. We currently anticipate that R&D expenses in fiscal year 2004 will increase in absolute dollars principally as a result of continued investment in research and development for new products and technologies.

Sales and marketing expenses. Sales and marketing expenses decreased to \$114.9 million for the year ended October 25, 2003, compared with \$118.1 million for the year ended October 26, 2002. Sales and marketing expenses were \$94.9 million for the year ended October 27, 2001. 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. For the year ended October 25, 2003, the decrease in sales and marketing expenses was primarily due to decreased commissions and decreased travel and marketing program expenses resulting from various cost-cutting actions, offset by increased expenses due to the expansion of our sales and marketing organizations. For the year ended October 26, 2002, the increase in sales and marketing expenses was primarily due to the expansion of our sales and marketing organizations, and an increase in direct selling expenses, principally commissions, associated

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with increased revenues. We currently anticipate that sales and marketing expenses in fiscal year 2004 will decrease slightly in absolute dollars.

General and administrative expenses. General and administrative (G&A) expenses increased to \$21.3 million for the year ended October 25, 2003, compared with \$18.8 million and \$17.7 million for the years ended October 26, 2002, and October 27, 2001, respectively. 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. For the year ended October 25, 2003, the increase in G&A expenses was primarily due to an increase in personnel related costs. For the year ended October 26, 2002, the increase in G&A expenses was primarily due to additional headcount and other expenses necessary to manage and support increased levels of business activity. We currently anticipate that G&A expenses in fiscal year 2004 will remain consistent with fiscal year 2003 in absolute dollars.

Amortization of deferred stock compensation. Amortization of deferred stock compensation decreased to \$0.6 million for the year ended October 25, 2003, compared with \$1.0 million, and \$1.1 million for the years ended October 26, 2002, and October 27, 2001, respectively. In the second quarter of fiscal 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 Consolidated Financial Statements). Amortization of deferred stock compensation for the years ended October 26, 2002 and October 27, 2001 was related to the grant of certain stock options to employees during the year ended October 31, 1999, which resulted in deferred stock compensation of \$5.1 million. Deferred stock compensation is amortized over the vesting periods of the applicable options.

Restructuring costs. Restructuring costs for the year ended October 25, 2003, were \$20.8 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 \$9.9 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 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 agreed to issue up to an additional 2.9 million shares of our common stock if the Rhapsody business successfully completed specified product milestones by November 30, 2003. Brocade has determined that the specified product milestones were not met, and therefore, Brocade does not intend to issue the additional shares. However, the representative for the former Rhapsody stockholders has indicated that he disagrees with Brocade's determination and has initiated discussions with Brocade on this matter.

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 \$17.2 million in expenses related to bringing the Rhapsody core technology to technological feasibility. 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 Consolidated Financial Statements).

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Facilities lease losses and other charges. During the year ended October 27, 2001, we experienced the impact of unfavorable economic conditions and a reduction in IT spending rates. As a result, during the fourth quarter ended October 27, 2001, we performed a comprehensive analysis of our real estate facility requirements and identified vacant excess facilities space, which was subsequently offered for sublease. Factors considered in the analysis included, but were not limited to, anticipated future revenue growth rates; anticipated future headcount requirements in terms of both headquarters and field personnel; anticipated sublease terms; anticipated time to sublease; and anticipated future operating expenses based upon then current market conditions. Based upon the results of this analysis and the excess facilities space identified, during the fourth quarter ended October 27, 2001, we recorded a charge of \$45.5 million related to estimated facilities lease losses, net of expected sublease income, and the impairment of certain related assets (see Note 5, "Liabilities Associated with Facilities Lease Losses and Asset Impairment Charges," of the Notes to Consolidated Financial Statements).

The facilities lease losses and related asset impairment charges were estimates and 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, and sublease rates.

During the quarter ended July 27, 2002, we completed a transaction to sublease a portion of these vacant facilities. Accordingly, based upon the most recent market data, we revised certain estimates and assumptions, including those related to expected sublease rates, estimated time to sublease the facilities, expected future operating costs, and expected future use of the facilities. No material adjustments were made to the facilities lease losses reserve as a result of these revised estimates and assumptions. As of October 25, 2003, no additional adjustments had been made to the estimated facilities lease losses reserve. 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.

Also during the fourth quarter ended October 27, 2001, as a result of an accelerated transition of our product offerings from 1 to 2 Gbit/sec technology, we recorded a charge of \$4.4 million primarily related to the impairment of certain 1 Gbit/sec related equipment no longer used in research and development and sales and marketing efforts (see Note 5, "Liabilities Associated with Facilities Lease Losses and Asset Impairment Charges," of the Notes to Consolidated Financial Statements).

On November 18, 2003, we purchased a previously leased building located at our San Jose headquarters for \$106.8 million in cash plus transaction costs. In connection with the building purchase, during the first quarter of fiscal 2004, we will record adjustments to the previously recorded facilities lease loss reserve and expect to record a charge ranging from \$75.0 million to \$85.0 million primarily related to lease termination, facilities consolidation and other associated costs. In addition, we issued a \$1.0 million guarantee as part of the purchase agreements, and cancelled an irrevocable letter of credit of \$10.4 million, which was previously issued as security for the building lease (see Note 17, "Subsequent Event," of the Notes to Consolidated Financial Statements).

Interest and other income, net. Net interest and other income decreased to \$18.4 million for the year ended October 25, 2003, compared with \$22.7 million for the year ended October 26, 2002. Net interest and other income was \$8.2 million for the year ended October 27, 2001. For the year ended October 25, 2003, the decrease was primarily the result of declining interest rates. For the year ended October 26, 2002, the increase was primarily the result of increased cash, cash equivalent and investment balances, partially offset by declining interest rates. The increase in cash balances was attributed to cash generated from operations and the proceeds from the \$550 million in aggregate principal amount of two percent convertible subordinated notes due 2007 that we issued in December 2001 and January 2002 (see Note 8, "Convertible Subordinated Debt," of the Notes to Consolidated Financial Statements).

Interest expense. Interest expense was \$13.4 million and \$11.4 million for the years ended October 25, 2003 and October 26, 2002, respectively. Interest expense primarily represents the interest cost associated with our convertible subordinated debt. The increase in interest expense for the year ended October 25, 2003,

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compared with the year ended October 26, 2002, was primarily due to a full year of interest expense related to our convertible subordinated debt during fiscal year 2003, partially offset by reduction of interest expense due to repurchases of convertible subordinated debt. For the year ended October 26, 2002, interest expense related to our convertible subordinated debt was outstanding for ten months.

Gain on repurchases of convertible subordinated debt. During the fourth quarter of fiscal 2003, we repurchased on the open market \$107.1 million in face value of our convertible subordinated debt. We paid an average of \$0.88 on each dollar of face value for an aggregate purchase price of \$94.4 million, which resulted in a pre-tax gain of \$11.1 million for fiscal year 2003. There were no repurchases of convertible subordinated debt during the years ended October 26, 2002 or October 27, 2001 (see Note 8, "Convertible Subordinated Debt," of the Notes to Consolidated Financial Statements).

Gain (loss) on investments, net. Net gain on investments of \$3.6 million for the year ended October 25, 2003 consisted of gains on the disposition of non-marketable private strategic investments of \$5.8 million, offset by an impairment charge of \$2.2 million 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. Net gain on investments for the year ended October 26, 2002 resulted from the sale of United States government agency debt securities. Net loss on investments for the year ended October 27, 2001 consisted of impairment losses on minority equity investments in non-publicly traded companies of \$24.2 million, partially offset by realized gains from sales of marketable equity securities of \$8.1 million. As of October 25, 2003 and October 26, 2002, we had net unrealized holding gains of \$8.8 million and \$10.7 million, respectively, associated with our remaining investment portfolio.

We have made certain minority equity investments in non-publicly traded companies that develop technology or provide services that are complementary to or broaden the markets for our products, and to promote our business and strategic objectives. Minority equity investments in non-public companies are included in other assets on our Consolidated Balance Sheets, are carried at cost, and are accounted for under the cost method. We hold less than 20 percent of the voting equity of such companies and do not have or seek control or significant influence over the respective companies' operating and financial policies. We monitor our investments for impairment on a quarterly basis and make appropriate reductions in carrying values when such impairment is determined to be other-than-temporary. 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 inability 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.

During the year ended October 25, 2003, we recorded impairment charges of \$2.2 million that resulted from other-than-temporary declines in the estimated fair value of our minority equity investments in non-publicly traded companies. The impairment charges reduced the carrying value of our investments to the estimated fair value. No impairment charges were recorded during the year ended October 26, 2002. During the year ended October 27, 2001, we made minority equity investments in non-publicly traded companies of \$23.6 million. Our investments were made primarily in companies in the storage networking, Internet infrastructure, fabless semiconductor, networking services, and managed storage services industries. These companies were, and continue to be, development stage companies with significant risks. During the year ended October 27, 2001, the industries in which these companies compete experienced considerable market declines associated with a depressed macroeconomic environment. Many of these companies had spent the majority of their funding on operating activities and/or lost key business partners due to bankruptcy, and we determined that the carrying value of our investments were impaired. Based upon the then current market conditions and substantial doubt about these companies' ability to raise additional funding, achieve positive cash flow, and achieve projected revenues, we concluded the impairments were other-than-temporary and recorded impairment charges of \$24.2 million. The impairment charges reduced the carrying value of our

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investments to the estimated fair value. The carrying value of our minority equity investments in non-publicly traded companies at October 25, 2003 and October 26, 2002 was zero and \$2.2 million, respectively.

Provision for income taxes. Our effective tax rate was 2.0 percent for the year ended October 25, 2003, compared with 29.0 percent and 84.0 percent for the years ended October 26, 2002 and October 27, 2001, respectively. For the year ended October 25, 2003, we recorded a tax provision even though we had a pre-tax book loss, because our pre-tax book loss included non-deductible expenses, primarily in-process research and development expenses, incurred in connection with our acquisition of Rhapsody. Our effective tax rates have historically differed from the federal statutory rate for various reasons (see Note 11, "Income Taxes," of the Notes to Consolidated Financial Statements). For the year ended October 27, 2001, our effective tax rate was significantly higher than the federal statutory rate primarily due to the inability to benefit from certain losses on minority equity investments in non-publicly traded companies. Our ability to maintain our current 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 tax rate could change.

Liquidity and Capital Resources

Cash, cash equivalents, short-term investments and long-term investments were \$835.6 million as of October 25, 2003, a decrease of \$52.8 million over the prior year amount of \$888.4 million. For the year ended October 25, 2003, we generated \$43.5 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. Days sales outstanding in receivables for the year ended October 25, 2003 was 52 days.

Net cash used in investing activities for the year ended October 25, 2003 totaled \$114.4 million and was primarily the result of \$91.0 million in net purchases of short and long-term investments and \$31.3 million invested in capital equipment. Net cash used in financing activities for the year ended October 25, 2003 totaled \$86.4 million. Net cash used in financing activities was primarily the result of repurchases of our convertible subordinated debt totaling \$94.4 million, payments of \$12.6 million related to assumed capital lease and debt obligations in connection with the Rhapsody acquisition, offset by \$11.5 million in net proceeds from the issuance of common stock related to employee participation in employee stock programs and exercises of stock options and \$9.0 million in repurchases of convertible debt pending settlement, which was included in accounts payable as of October 25, 2003.

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 flow resulting from the issuance of common stock related to employee participation in employee stock programs will vary. As a result of our recent voluntary stock options exchange program, we do not expect to generate significant cash flow from the issuance of common stock related to the employee participation in employee stock programs during fiscal year 2004 unless our future common stock price exceeds \$6.54 per share.

We have a manufacturing agreement 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 October 25, 2003, our aggregate commitment to Solectron and Foxconn for inventory components used in the manufacture of Brocade products was \$36.9 million, net of purchase commitment reserves of \$4.3 million, which we expect to utilize during future normal ongoing operations. Although the purchase orders we place with Solectron and Foxconn are cancelable, the terms of the agreements require us to purchase from Solectron and Foxconn all inventory components not returnable or usable by, or sold to other customers of Solectron or Foxconn.

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

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Notes to 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:

<u>Redemption Period</u>	<u>Price</u>
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. Debt issuance costs 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.

During the fourth quarter of fiscal 2003, we repurchased on the open market \$107.1 million in face value of our convertible subordinated notes due 2007. We paid an average of \$0.88 on each dollar of face value for an aggregate purchase price of \$94.4 million, which resulted in a pre-tax gain of \$11.1 million for fiscal year 2003. As of October 25, 2003, \$9.0 million in repurchases of convertible debt were pending settlement, and thus, were included in accounts payable. As of October 25, 2003, the remaining balance outstanding of the convertible subordinated debt was \$442.9 million.

The following table summarizes our contractual obligations (including interest expense) and commitments as of October 25, 2003 (in thousands):

	<u>Total</u>	<u>Less than 1 Year</u>	<u>1 – 3 Years</u>	<u>After 3 Years</u>
Contractual Obligations:				
Convertible subordinated notes, including interest	\$471,003	\$ 8,859	\$17,718	\$444,426
Non-cancelable operating leases	242,633	32,415	55,941	154,277
Unconditional purchase obligations, gross	41,229	41,229	—	—
Total contractual obligations	<u>\$754,865</u>	<u>\$82,503</u>	<u>\$73,659</u>	<u>\$598,703</u>
Other Commitments:				
Standby letters of credit	\$ 18,749	\$ n/a	\$ n/a	\$ n/a

On November 18, 2003, we purchased a previously leased building located at our San Jose headquarters for \$106.8 million in cash plus transaction costs (see Note 17, "Subsequent Event," of the Notes to the Consolidated Financial Statements). As a result the building purchase, our future contractual obligations related to non-cancelable operating leases in the table above has been reduced by \$142.5 million, and standby letters of credit have been reduced by \$10.4 million. In addition, we issued a \$1.0 million guarantee as part of the purchase agreements.

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The following table summarizes our contractual obligations (including interest expense) and commitments as of November 18, 2003 (in thousands) after we completed our building purchase described above:

	Total	Less than 1 Year	1 – 3 Years	After 3 Years
Contractual Obligations:				
Convertible subordinated notes, including Interest	\$471,003	\$ 8,859	\$17,718	\$444,426
Non-cancelable operating leases	100,085	20,098	30,187	49,800
Unconditional purchase obligations, gross	41,229	41,229	—	—
Total contractual obligations	\$612,317	\$70,186	\$47,905	\$494,226
Other Commitments:				
Standby letters of credit	\$ 8,343	\$ n/a	\$ n/a	\$ n/a
Guarantee	\$ 1,015	\$ 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, although we could elect to seek additional funding prior to that time, if available. Our future capital requirements will depend on many factors, including the rate of revenue growth, the timing and extent of spending to support product development efforts and the expansion of sales and marketing, 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, serves as a member and Chairman and CEO 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 years ended October 25, 2003, October 26, 2002, and October 27, 2001, were \$1.2 million, \$4.9 million, and \$0.6 million, respectively. We believe that the services rendered to us by WSGR were on terms no more favorable than those with unrelated parties.

Mark Leslie was a director of Brocade until May 2002 and served on the Board of Directors of Veritas, a company with whom we do business. During the years ended October 26, 2002 and October 27, 2001, total revenues from sales to Veritas were \$2.5 million and \$2.4 million, respectively. We believe that sales to Veritas were on terms no more favorable than those with unrelated parties.

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.

Critical Accounting Policies

Our discussion and analysis of financial condition and results of operations is based upon our Consolidated Financial Statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America. The preparation of these 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, on an on-going basis, our estimates and judgments, including those related to sales returns, bad debts, excess inventory and purchase commitments, investments, warranty obligations, lease losses, income taxes, and contingencies and litigation.

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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 impact on the results that we report in our 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 Consolidated Financial Statements:

- Revenue recognition, and allowances for sales returns and doubtful accounts;
- Warranty reserves;
- Inventory and purchase commitment reserves;
- Restructuring charges and lease loss reserves;
- Litigation costs; and
- Accounting for income taxes.

Revenue recognition, and allowances for sales returns and doubtful accounts. 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 customer's 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 on historical experience, current trends, and our expectations regarding future experience. Estimated sales returns and other allowances include consideration of historical sales levels, the timing and magnitude of historical sales returns and other allowances, and a projection of this experience into the future. In addition, we maintain allowances for doubtful accounts, which are also accounted for as a reduction in revenue, for estimated losses resulting from the inability of our customers to make required payments. We analyze accounts receivable, historical collection patterns, 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 actual sales returns and other allowances exceed our estimate, or if the financial condition of our customers was to deteriorate, resulting in an impairment of their ability to make payments, additional allowances and charges may be required.

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 software 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.

Warranty reserves. 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

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historical experience, current trends and our expectations regarding future experience. If actual warranty costs exceed our estimate, additional charges may be required.

Inventory and purchase commitment reserves. 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 impact 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.

Restructuring charges and lease loss reserves. We monitor and regularly evaluate our organizational structure and associated operating expenses. Depending on events and circumstances, we may decide to restructure our operations to reduce future operating costs. In determining the restructuring charges, we analyze our future operating requirements, including the required headcount by business functions and facility space requirements. Our restructuring costs, and any resulting accruals, involve significant estimates made by management using the best information available at the time the estimates are made, some of which maybe provided by third parties. In recording facilities lease loss reserves, we make various assumptions, 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. Our estimates involve a number of risks and uncertainties, some of which are beyond our control, including future real estate market conditions and our ability to successfully enter into subleases or lease termination agreements with terms as favorable as those assumed when arriving at our estimates. We regularly evaluate a number of factors to determine the appropriateness and reasonableness of our restructuring and lease loss accruals including the various assumptions noted above. If actual results differ significantly from our estimates, we may be required to adjust our restructuring and lease loss accruals in the future.

Litigation costs. We are subject to the possibility of legal actions arising in the ordinary course of business. We regularly monitor the status of pending legal actions to evaluate both the magnitude and likelihood of any potential loss. We accrue for these potential losses when it is probable that a liability has been incurred and the amount of loss, or possible range of loss, can be reasonably estimated. If actual results differ significantly from our estimates, we may be required to adjust our accruals in the future.

Accounting for income taxes. 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 principally 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. 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 July 2001, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards No. 143, *“Accounting for Asset Retirement Obligations”* (SFAS 143), which addresses accounting and reporting for obligations associated with the retirement of tangible long-lived assets and the associated asset retirement costs. SFAS 143 is effective for fiscal years beginning after June 15, 2002. The adoption of SFAS 143 did not have a material effect on the Company’s financial position, results of operations, or cash flows.

In October 2001, the FASB issued Statement of Financial Accounting Standards No. 144, *“Accounting for the Impairment or Disposal of Long-Lived Assets”* (SFAS 144). SFAS 144 supersedes Statement of Financial Accounting Standards No. 121, *“Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed of.”* SFAS 144 applies to all long-lived assets, including discontinued operations, and consequently amends the accounting and reporting provisions of Accounting Principles Board Opinion No. 30, *“Reporting the Results of Operations — Reporting the Effects of Disposal of a Division of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions.”* SFAS 144 develops one accounting model for long-lived assets that are to be disposed of by sale and requires the measurement to be at the lower of book value or fair value less cost to sell. Additionally, SFAS 144 expands the scope of discontinued operations to include all components of an entity with operations that (1) can be distinguished from the rest of the entity and (2) will be eliminated from the ongoing operations of the entity in a disposal transaction. SFAS 144 is effective for fiscal years beginning after December 15, 2001. The adoption of SFAS 144 did not have a material effect on the Company’s financial position, results of operations, or cash flows.

In April 2002, the FASB issued Statement of Financial Accounting Standards No. 145, *“Rescission of FASB Statements No. 4, 44, and 64, Amendment of FASB Statement No. 13, and Technical Corrections”* (SFAS 145). SFAS 145 eliminates extraordinary accounting treatment for reporting gain or loss on debt extinguishment and amends other existing authoritative pronouncements to make various technical corrections, clarify meanings, or describe their applicability under changed conditions. The provisions of SFAS 145 related to the rescission of FASB Statement No. 4 are applicable in fiscal years beginning after May 15, 2002, the provisions related to FASB Statement No. 13 are effective for transactions occurring after May 15, 2002, and all other provisions are effective for financial statements issued on or after May 15, 2002, however, early application is encouraged. Debt extinguishments reported as extraordinary items prior to scheduled or early adoption of SFAS 145 would be reclassified in most cases following adoption. The adoption of SFAS 145 did not have a material effect on the Company’s financial position, results of operations, or cash flows.

In June 2002, the 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

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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 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.

Item 7A. Quantitative and Qualitative Disclosure About Market Risk

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 October 25, 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 issued by United States government agencies as of October 25, 2003 that are sensitive to changes in interest rates (in thousands):

Issuer	Valuation of Securities Given an Interest Rate Decrease of X Basis Points			Fair Value as of October 25, 2003	Valuation of Securities Given an Interest Rate Increase of X Basis Points		
	(150 BPS)	(100 BPS)	(50 BPS)		(50 BPS)	(100 BPS)	(150 BPS)
U.S. government obligations	\$423,392	\$421,566	\$419,762	\$418,071	\$416,278	\$414,539	\$412,822
Corporate bonds and notes	\$ 59,058	\$ 58,525	\$ 57,996	57,482	\$ 56,963	\$ 56,455	\$ 55,954
Total	\$482,450	\$480,091	\$477,758	\$475,553	\$473,241	\$470,994	\$468,776

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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 at October 25, 2003. Carrying value approximates fair value.

	<u>Amount</u>	<u>Average Interest Rate</u>
Cash and cash equivalents	\$360,012	0.9%
Short-term investments	57,971	1.5%
Long-term investments	417,582	3.7%
Total	<u>\$835,565</u>	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 PortalSM Market. On October 24, 2003, the average bid and ask price on the Portal Market of our convertible subordinated notes due 2007 was 90.0, resulting in an aggregate fair value of approximately \$398.7 million. Our common stock is quoted on the Nasdaq National Market under the symbol "BRCD." On October 24, 2003, the last reported sale price of our common stock on the Nasdaq National Market was \$6.06 per share.

Equity Security Price Risk

Our exposure to market risk due to equity security price fluctuations primarily relates to investments in marketable 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 \$167,000, \$335,000, and \$502,000 in the fair value of marketable equity securities at October 25, 2003, respectively. At October 25, 2003, our equity securities balance of \$669,000 was included in other current assets on the accompanying Consolidated Balance Sheets.

Item 8. *Financial Statements and Supplementary Data*

BROCADE COMMUNICATIONS SYSTEMS, INC.

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REPORT OF INDEPENDENT AUDITORS

To the Board of Directors and Stockholders

Brocade Communications Systems, Inc.:

We have audited the accompanying consolidated balance sheets of Brocade Communications Systems, Inc. and subsidiaries (the Company) as of October 25, 2003 and October 26, 2002, and the related consolidated statements of operations, stockholders' equity and comprehensive income (loss), and cash flows for each of the years in the two-year period ended October 25, 2003. In connection with our audit of the consolidated financial statements, we have also audited the related financial statement schedule listed in Item 15(a)2. These consolidated financial statements and related financial statement schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements and related financial statement schedule based on our audit. The accompanying consolidated statements of operations, stockholders' equity and comprehensive income (loss) and cash flows for the year ended October 27, 2001 and related financial statement schedule were audited by other auditors who have ceased operations. Those auditors expressed an unqualified opinion on those consolidated financial statements and related financial statement schedule in their report dated November 20, 2001.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Brocade Communications Systems, Inc. and subsidiaries as of October 25, 2003 and October 26, 2002, and the results of their operations and their cash flows for each of the years in the two-year period ended October 25, 2003, in conformity with accounting principles generally accepted in the United States of America. Also, in our opinion the related financial statement schedule for the years ended October 25, 2003 and October 26, 2002, when considered in relation to the consolidated financial statements taken as a whole presents fairly, in all material respects, the information set forth therein.

/s/ KPMG LLP

Mountain View, California

November 14, 2003, except as to Note 17,
which is as of November 18, 2003

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We are including in this Annual Report on Form 10-K, pursuant to Rule 2-02(e) of Regulation S-X, a copy of the prior year's Report of Independent Public Accountants from the prior independent public accountants, Arthur Andersen LLP. This report was previously issued by Arthur Andersen LLP, for filing with our Annual Report on Form 10-K for fiscal year 2001, and has not been reissued by Arthur Andersen LLP. This report refers to previous consolidated financial statements that are not included in the current filing (consisting of the consolidated balance sheets as of October 27, 2001 and October 28, 2000 and the consolidated statements of operations, stockholders' equity and cash flows for the years ended October 28, 2000 and October 31, 1999).

REPORT OF INDEPENDENT PUBLIC ACCOUNTANTS

To Brocade Communications Systems, Inc.:

We have audited the accompanying consolidated balance sheets of Brocade Communications Systems, Inc. (a Delaware corporation) and subsidiaries as of October 27, 2001 and October 28, 2000, and the related consolidated statements of operations, stockholders' equity and cash flows for each of the three years in the period ended October 27, 2001. These financial statements and the schedule referred to below are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and schedule based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Brocade Communications Systems, Inc. and subsidiaries as of October 27, 2001 and October 28, 2000 and the results of their operations and their cash flows for each of the three years in the period ended October 27, 2001, in conformity with accounting principles generally accepted in the United States.

Our audit was made for the purpose of forming an opinion on the basic financial statements taken as a whole. The schedule listed under Item 14(a)(2) is presented for purposes of complying with the Securities and Exchange Commission's rules and is not part of the basic financial statements. This schedule has been subjected to the auditing procedures applied in the audit of the basic financial statements and, in our opinion, fairly states in all material respects the financial data required to be set forth therein in relation to the basic financial statements taken as a whole.

ARTHUR ANDERSEN LLP

San Jose, California

November 20, 2001

(except with respect to the matters discussed in Note 12,
as to which the date is January 10, 2002.)

BROCADE COMMUNICATIONS SYSTEMS, INC.

CONSOLIDATED STATEMENTS OF OPERATIONS

	Fiscal Year Ended		
	October 25, 2003	October 26, 2002	October 27, 2001
	(In thousands, except per share amounts)		
Net revenues	\$ 525,277	\$562,369	\$513,030
Cost of revenues	241,105	226,414	212,956
Gross margin	284,172	335,955	300,074
Operating expenses:			
Research and development	145,082	132,205	110,749
Sales and marketing	114,879	118,130	94,931
General and administrative	21,312	18,836	17,737
Amortization of deferred stock compensation	649	969	1,082
Restructuring costs	20,828	—	—
In-process research and development	134,898	—	—
Facilities lease losses and other charges	—	—	49,888
Total operating expenses	437,648	270,140	274,387
Income (loss) from operations	(153,476)	65,815	25,687
Interest and other income, net	18,424	22,668	8,207
Interest expense	(13,339)	(11,427)	—
Gain on repurchases of convertible subordinated debt	11,118	—	—
Gain (loss) on investments, net	3,638	7,095	(16,092)
Income (loss) before provision for income taxes	(133,635)	84,151	17,802
Income tax provision	2,605	24,405	14,954
Net income (loss)	\$(136,240)	\$ 59,746	\$ 2,848
Net income (loss) per share — basic	\$ (0.54)	\$ 0.26	\$ 0.01
Net income (loss) per share — diluted	\$ (0.54)	\$ 0.25	\$ 0.01
Shares used in per share calculation — basic	250,610	231,591	221,051
Shares used in per share calculation — diluted	250,610	242,962	243,162

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

BROCADE COMMUNICATIONS SYSTEMS, INC.

CONSOLIDATED BALANCE SHEETS

	October 25, 2003	October 26, 2002
(In thousands, except par value)		
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 360,012	\$ 516,535
Short-term investments	57,971	50,988
	<hr/>	<hr/>
Total cash, cash equivalents and short-term investments	417,983	567,523
Marketable equity securities	—	226
Accounts receivable, net of allowances for doubtful accounts of \$4,180 and \$3,763 in 2003 and 2002, respectively	74,935	97,707
Inventories, net	3,961	5,402
Deferred tax assets, net	29,569	28,418
Prepaid expenses and other current assets	14,593	16,429
	<hr/>	<hr/>
Total current assets	541,041	715,705
Long-term investments	417,582	320,865
Property and equipment, net	124,274	143,625
Deferred tax assets, net	231,203	221,878
Convertible subordinated debt issuance costs	6,288	10,274
Other assets	3,558	9,316
	<hr/>	<hr/>
Total assets	\$1,323,946	\$1,421,663
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	\$ 42,942	\$ 57,538
Accrued employee compensation	30,546	23,930
Deferred revenue	19,892	22,430
Current liabilities associated with lease losses	7,759	8,204
Other accrued liabilities	64,963	49,364
	<hr/>	<hr/>
Total current liabilities	166,102	161,466
Non-current liabilities associated with lease losses	16,518	22,602
Convertible subordinated debt	442,950	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: 257,641 and 234,652 shares at October 25, 2003 and October 26, 2002, respectively	258	235
Additional paid-in capital	725,253	577,171
Deferred stock compensation	(872)	(69)
Accumulated other comprehensive income	5,797	6,078
Accumulated earnings (deficit)	(32,060)	104,180
	<hr/>	<hr/>
Total stockholders' equity	698,376	687,595
	<hr/>	<hr/>
Total liabilities and stockholders' equity	\$1,323,946	\$1,421,663

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

BROCADE COMMUNICATIONS SYSTEMS, INC.
**CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY AND
COMPREHENSIVE INCOME (LOSS)**

	Common Stock		Additional Paid-In Capital	Deferred Stock Compensation	Accumulated Other Comprehensive Income (Loss)	Retained Earnings (Deficit)	Total Stockholders' Equity	Comprehensive Income (Loss)
	Shares	Amount						
	(In thousands)							
Balances at October 28, 2000	222,559	\$223	\$306,868	\$(2,320)	\$ 44,520	\$ 41,586	\$ 390,877	\$ —
Issuance of common stock	7,369	7	81,328	—	—	—	81,335	—
Tax benefits from employee stock option transactions	—	—	104,682	—	—	—	104,682	—
Charitable contribution of stock	42	—	1,000	—	—	—	1,000	—
Compensation charges	—	—	107	—	—	—	107	—
Deferred stock compensation adjustment	—	—	(200)	200	—	—	—	—
Amortization of deferred stock compensation	—	—	—	1,082	—	—	1,082	—
Repurchase of common stock	(208)	—	(47)	—	—	—	(47)	—
Change in unrealized gain (loss) on marketable equity securities and investments, net of tax	—	—	—	—	(43,998)	—	(43,998)	(43,998)
Reclassification adjustment for gains previously included in other comprehensive income	—	—	—	—	—	—	—	8,112
Net income	—	—	—	—	—	2,848	2,848	2,848
Balances at October 27, 2001	229,762	230	493,738	(1,038)	522	44,434	537,886	(33,038)
Issuance of common stock	4,965	5	50,497	—	—	—	50,502	—
Tax benefits from employee stock option transactions	—	—	32,993	—	—	—	32,993	—
Amortization of deferred stock compensation	—	—	—	969	—	—	969	—
Repurchase of common stock	(75)	—	(57)	—	—	—	(57)	—
Change in unrealized gain (loss) on marketable equity securities and investments, net of tax	—	—	—	—	5,873	—	5,873	5,873
Cumulative translation adjustments	—	—	—	—	(317)	—	(317)	(317)
Net income	—	—	—	—	—	59,746	59,746	59,746
Balances at October 26, 2002	234,652	235	577,171	(69)	6,078	104,180	687,595	65,302
Issuance of common stock	3,511	3	11,641	—	—	—	11,644	—
Issuance of common stock related to the Rhapsody acquisition	19,735	20	134,853	—	—	—	134,873	—
Warrants issued related to the Rhapsody acquisition	—	—	1,939	—	—	—	1,939	—
Deferred stock compensation related to the acquisition of Rhapsody	—	—	—	(1,677)	—	—	(1,677)	—
Amortization of deferred stock compensation	—	—	—	649	—	—	649	—
Deferred stock compensation adjustment	—	—	(225)	225	—	—	—	—
Repurchase of common stock	(257)	—	(126)	—	—	—	(126)	—
Change in unrealized gain (loss) on marketable equity securities and investments, net of tax	—	—	—	—	(1,094)	—	(1,094)	(1,094)
Cumulative translation adjustments	—	—	—	—	813	—	813	813
Net loss	—	—	—	—	—	(136,240)	(136,240)	(136,240)
Balances at October 25, 2003	257,641	\$258	\$725,253	\$(872)	\$ 5,797	\$ (32,060)	\$ 698,376	\$(136,521)

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

BROCADE COMMUNICATIONS SYSTEMS, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS

	Fiscal Year Ended		
	October 25, 2003	October 26, 2002	October 27, 2001
	(In thousands)		
Cash flows from operating activities:			
Net income (loss)	\$(136,240)	\$ 59,746	\$ 2,848
Adjustments to reconcile net income (loss) to net cash provided by operating activities:			
Tax benefits from employee stock option transactions	—	32,993	104,682
Deferred taxes	(10,476)	(19,325)	(104,984)
Depreciation and amortization	46,941	32,843	16,351
Loss on disposal of property and equipment	4,568	—	608
Amortization of debt issuance costs	2,440	2,101	—
(Gain) loss on investments and marketable equity securities, net	(3,640)	(7,095)	16,092
Gain on repurchases of convertible subordinated debt	(11,118)	—	—
Provision for doubtful accounts receivable and sales returns	3,137	2,008	1,444
Amortization of deferred stock compensation	649	969	1,189
Charitable stock contribution charge	—	—	1,000
Asset impairment charges	—	—	6,683
Non-cash restructuring charges	8,088	—	—
In-process research and development	134,898	—	—
Changes in assets and liabilities:			
Accounts receivable	19,635	(30,815)	1,898
Inventories	1,441	4,905	(10,020)
Prepaid expenses and other assets	4,739	(9,401)	(8,157)
Accounts payable	(24,394)	32,456	1,124
Accrued employee compensation	5,712	1,936	(1,369)
Deferred revenue	(2,726)	9,800	10,574
Other accrued liabilities	8,514	5,469	32,924
Liabilities associated with lease losses	(8,660)	(8,028)	38,834
Net cash provided by operating activities	43,508	110,562	111,721
Cash flows from investing activities:			
Purchases of short-term investments	(53,954)	(45,880)	(49,194)
Purchases of long-term investments	(130,468)	(640,777)	—
Proceeds from maturities of short-term investments	62,543	99,692	72,207
Proceeds from sales and maturities of long-term investments	30,859	335,339	—
Proceeds from sales of marketable equity securities	5,454	—	12,765
Purchases of property and equipment	(31,306)	(80,272)	(82,330)
Purchases of non-marketable minority equity investments	—	—	(23,562)
Acquired cash and cash equivalents from acquisition of Rhapsody	2,453	—	—
Net cash used in investing activities	(114,419)	(331,898)	(70,114)
Cash flows from financing activities:			
Proceeds from issuance of convertible subordinated debt	—	537,625	—
Repurchases of convertible subordinated debt	(94,386)	—	—
Accrual of repurchase obligation	9,029	—	—
Proceeds from issuance of common stock, net	11,515	50,445	81,288
Payments on assumed capital lease and debt obligations for Rhapsody acquisition	(12,583)	—	—
Payments on capital lease obligations	—	—	(42)
Net cash provided by (used in) financing activities	(86,425)	588,070	81,246
Effect of exchange rate fluctuations on cash and cash equivalents	813	(317)	—
Net increase (decrease) in cash and cash equivalents	(156,523)	366,417	122,853
Cash and cash equivalents, beginning of year	516,535	150,118	27,265
Cash and cash equivalents, end of year	\$ 360,012	\$ 516,535	\$ 150,118
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	\$ —	\$ —

Cash paid for interest	\$ 14,056	\$ 5,770	\$ 236
Cash paid for income taxes	\$ 4,831	\$ 3,181	\$ 537

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

BROCADE COMMUNICATIONS SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

Fiscal Year

The Company reports its fiscal year on a 52/53-week period ending on the last Saturday in October of each year. Accordingly, the fiscal year ends for fiscal years 2003, 2002 and 2001 were October 25, 26 and 27, respectively. Fiscal years 2003, 2002 and 2001 were all 52 weeks in length.

Principles of Consolidation

The Consolidated Financial Statements include the accounts of Brocade Communication Systems, Inc. and its subsidiaries. All significant intercompany accounts and transactions have been eliminated.

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 six major financial institutions.

Investments and Marketable Equity Securities

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 of debt securities issued by United States government agencies and corporate bonds and notes. Short-term and long-term investments are maintained at four major financial institutions, are classified as available-for-sale, and are recorded on the accompanying Consolidated Balance Sheets at fair value. Fair value is determined using quoted market prices for those securities. Unrealized holding gains and losses are included as a separate component of accumulated other comprehensive income on the accompanying 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 gain (loss) on investments, net on the Consolidated Statements of Operations.

Marketable equity securities consist of equity holdings in public companies and are classified as available-for-sale when there are no restrictions on the Company's ability to immediately liquidate such securities. Marketable equity securities are recorded on the accompanying Consolidated Balance Sheets at fair value.

BROCADE COMMUNICATIONS SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

Fair value is determined using quoted market prices for those securities. Unrealized holding gains and losses are included as a separate component of accumulated other comprehensive income on the accompanying 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 gain (loss) on investments, net on the 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 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 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, 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 (see Note 14). As of October 25, 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.

Fair Value of Financial Instruments

Fair value of certain of the Company's financial instruments, including cash and cash equivalents, accounts receivable, employee notes receivable, accounts payable, and accrued liabilities, approximate cost because of their short maturities. The fair value of investments and marketable equity securities is determined using quoted market prices for those securities or similar financial instruments. The fair value of convertible subordinated debt is determined using the average bid and ask price on the Portal Market for the convertible debt.

Inventories

Inventories are stated at the lower of cost or market, using the first-in, first-out method. Inventory costs include material, labor, and overhead. The Company provides inventory allowances based on excess and obsolete inventories determined primarily by future demand forecasts. All of our inventory are located offsite.

Property and Equipment

Property and equipment are stated at cost less accumulated depreciation and amortization. Depreciation is computed using the straight-line method over the estimated useful lives of the assets. Estimated useful lives of four years are used for computer equipment, software, furniture and fixtures, except for the Company's enterprise-wide, integrated business information system, which is being depreciated over five to seven years. Estimated useful lives of up to four years are used for engineering and other equipment. Leasehold improvements are amortized using the straight-line method over the shorter of the useful life of the asset or the remaining term of the lease.

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

BROCADE COMMUNICATIONS SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

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 Consolidated Balance Sheets depending upon their remaining term. As of October 25, 2003 and October 26, 2002, the Company had outstanding loans to various employees totaling \$3.0 million and \$9.0 million, respectively.

Accrued Employee Compensation

Accrued employee compensation consists of accrued wages, commissions, payroll taxes, vacation, payroll deductions for the Company's employee stock purchase plan, and other employee benefit payroll deductions.

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 six 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 principally invests in United States government agency debt securities and corporate bonds and notes, and limits the amount of credit exposure to any one entity.

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 October 25, 2003, and October 26, 2002, 77 percent and 73 percent of accounts receivable were concentrated with five customers, respectively. The Company performs ongoing credit evaluations of its customers and 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.

For the fiscal years ended October 25, 2003, October 26, 2002, and October 27, 2001, three customers each represented greater than ten percent of the Company's total revenues for combined totals of 67 percent, 62 percent, and 56 percent of total revenues, respectively. The level of sales to any single customer may vary and the loss of any one of these customers, or a decrease in the level of sales to any one of these customers, 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, which has been impacted by unfavorable economic conditions and reduced IT spending rates. 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

BROCADE COMMUNICATIONS SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

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, current trends, and the Company's expectations regarding future experience. In addition, the Company maintains allowances for doubtful accounts, which are also accounted for as a reduction in revenue.

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 software operating system, 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.

Software Development Costs

Eligible software development costs are capitalized upon the establishment of technological feasibility in accordance with Statement of Financial Accounting Standards No. 86, "Accounting for the Costs of Computer Software to be Sold, Leased, or Otherwise Marketed." Technological feasibility is defined as completion of designing, coding and testing activities. Total eligible software development costs have not been material to date.

Costs related to internally developed software and software purchased for internal use are capitalized in accordance with Statement of Position 98-1, "Accounting for Costs of Computer Software Developed or Obtained for Internal Use." During the year ended October 28, 2000, the Company purchased an enterprise-wide, integrated business information system. As of October 25, 2003, capitalized costs of \$16.1 million, with a net book value of \$9.5 million, related to the purchase and subsequent implementation and upgrade of this system were included in property and equipment. These costs are being depreciated over the initial estimated useful life of seven years.

Advertising Costs

The Company expenses all advertising costs as incurred.

Impairment of Long-lived Assets

Long-lived assets to be held and used are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of such assets may not be recoverable. Determination of recoverability is based on an estimate of undiscounted future cash flows resulting from the use of the asset and its eventual disposition. Measurement of an impairment loss for long-lived assets that management expects to hold and use is based on the fair value of the asset as estimated using a discounted cash flow model. Long-lived assets to be disposed of are reported at the lower of carrying amount or fair value less costs to sell.

BROCADE COMMUNICATIONS SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

Income Taxes

Income tax expense is based on pretax financial accounting income. Deferred tax assets and liabilities are recognized for the expected tax consequences of temporary differences between the tax bases of assets and liabilities and their reported amounts, along with net operating loss carryforwards and credit carryforwards. A valuation allowance is recognized to the extent that it is more likely than not that the tax benefits will not be realized. The Company believes its net deferred tax assets will be realized through future profitable operations.

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.

Foreign Currency Translation

Assets and liabilities of non-United States subsidiaries that operate where the functional currency is the local currency are translated to United States dollars at exchange rates in effect at the balance sheet date with the resulting translation adjustments recorded as a separate component of accumulated other comprehensive income. Income and expense accounts are translated at average exchange rates during the year. Where the functional currency is the United States dollar, transaction gains and losses are recorded in other income or expense.

Derivatives

Derivative instruments are recognized as either assets or liabilities on the Consolidated Balance Sheets and measured at fair value. The accounting for changes in the fair value of a derivative instrument depends on the intended use of the derivative and the resulting designation. As of October 25, 2003, the Company did not hold any derivative instruments.

Stock-Based Compensation

The Company accounts for its stock option plans and its Employee Stock Purchase Plan in accordance with the provisions of Accounting Principles Board Opinion 25, "Accounting for Stock Issued to Employees," (APB 25), whereby the difference between the exercise price and the fair value at the date of grant is recognized as compensation expense. Under the intrinsic value method of accounting, no compensation expense is recognized in the Company's 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 plans. Companies that elect to account for stock-based compensation plans in accordance with 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

BROCADE COMMUNICATIONS SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

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):

	Fiscal Year Ended		
	October 25, 2003	October 26, 2002	October 27, 2001
Net income (loss) — as reported	\$(136,240)	\$ 59,746	\$ 2,848
Add: Stock-based employee compensation expense included in reported net income (loss), net of tax	389	688	649
Deduct: Stock-based compensation expense determined under fair value based method, net of tax	(138,739)	(471,573)	(595,189)
Pro forma net loss	\$(274,590)	\$(411,139)	\$(591,692)
Basic earnings (loss) per share:			
As reported	\$ (0.54)	\$ 0.26	\$ 0.01
Pro Forma	\$ (1.10)	\$ (1.78)	\$ (2.68)
Diluted earnings (loss) per share:			
As reported	\$ (0.54)	\$ 0.25	\$ 0.01
Pro Forma	\$ (1.10)	\$ (1.78)	\$ (2.68)

The fair value of stock options granted under the Plans during fiscal year 2003, and the fair value of common stock issued under the Purchase Plan during fiscal year 2003, was approximately \$88.9 million. Pro forma compensation expense associated with stock options granted under the Plans during fiscal year 2003, and common stock issued under the Purchase Plan during fiscal year 2003, was approximately \$35.0 million.

The fair value of each option grant is estimated on the date of grant using the Black-Scholes option-pricing model with the following weighted-average assumptions for each respective fiscal year ended:

	Employee Stock Option Plans			Employee Stock Purchase Plan		
	October 25, 2003	October 26, 2002	October 27, 2001	October 25, 2003	October 26, 2002	October 27, 2001
Expected dividend yield	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Risk-free interest rate	1.2-4.1%	1.5-4.3%	2.1-4.6%	0.9-1.0%	1.4%	2.1%
Expected volatility	70.5%	97.1%	127.4%	63.5%	93.7%	123.4%
Expected life from vest date (in years)	0.5	0.5	0.5	0.5	0.5	0.5

The Black-Scholes option-pricing model was developed for use in estimating the fair value of traded options that have no vesting restrictions and are fully transferable. In addition, option-pricing models require the input of highly subjective assumptions, including the expected stock price volatility. Because the Company's employee stock options have characteristics significantly different from those of traded options, and because changes in the subjective input assumptions can materially affect the fair value estimate, in management's opinion, the existing models do not necessarily provide a reliable single measure of the fair value of the Company's options. Under the Black-Scholes option-pricing model, the weighted-average fair value of employee stock options granted during the years ended October 25, 2003, October 26, 2002, and October 27, 2001, was \$2.00 per share, \$10.26 per share, and \$26.17 per share, respectively.

BROCADE COMMUNICATIONS SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

Use of Estimates in Preparation of Consolidated Financial Statements

The preparation of financial statements and related disclosures in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the amounts reported in the Consolidated Financial Statements and accompanying notes. Estimates are used for, but not limited to, the useful lives of fixed assets, allowances for doubtful accounts and product returns, inventory and warranty reserves, facilities lease losses and other charges, fixed asset and investment impairment charges, accrued liabilities and other reserves, taxes, and contingencies. Actual results could differ materially from these estimates.

Stock Splits

On November 8, 1999, January 21, 2000, and November 29, 2000, the Company's Board of Directors approved two-for-one splits of the Company's common stock. The stock began trading on a split-adjusted basis on December 3, 1999, March 15, 2000, and December 22, 2000, respectively. All references in the accompanying consolidated financial statements and notes thereto to earnings per share and the number of common shares have been retroactively restated to reflect the common stock splits.

Recent Accounting Pronouncements

In July 2001, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards No. 143, "*Accounting for Asset Retirement Obligations*" (SFAS 143), which addresses accounting and reporting for obligations associated with the retirement of tangible long-lived assets and the associated asset retirement costs. SFAS 143 is effective for fiscal years beginning after June 15, 2002. The adoption of SFAS 143 did not have a material effect on the Company's financial position, results of operations, or cash flows.

In October 2001, the FASB issued Statement of Financial Accounting Standards No. 144, "*Accounting for the Impairment or Disposal of Long-Lived Assets*" (SFAS 144). SFAS 144 supersedes Statement of Financial Accounting Standards No. 121, "*Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed of*." SFAS 144 applies to all long-lived assets, including discontinued operations, and consequently amends the accounting and reporting provisions of Accounting Principles Board Opinion No. 30, "*Reporting the Results of Operations — Reporting the Effects of Disposal of a Division of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions*." SFAS 144 develops one accounting model for long-lived assets that are to be disposed of by sale and requires the measurement to be at the lower of book value or fair value less cost to sell. Additionally, SFAS 144 expands the scope of discontinued operations to include all components of an entity with operations that (1) can be distinguished from the rest of the entity and (2) will be eliminated from the ongoing operations of the entity in a disposal transaction. SFAS 144 is effective for fiscal years beginning after December 15, 2001. The adoption of SFAS 144 did not have a material effect on the Company's financial position, results of operations, or cash flows.

In April 2002, the FASB issued Statement of Financial Accounting Standards No. 145, "*Rescission of FASB Statements No. 4, 44, and 64, Amendment of FASB Statement No. 13, and Technical Corrections*" (SFAS 145). SFAS 145 eliminates extraordinary accounting treatment for reporting gain or loss on debt extinguishment and amends other existing authoritative pronouncements to make various technical corrections, clarify meanings, or describe their applicability under changed conditions. The provisions of SFAS 145 related to the rescission of FASB Statement No. 4 are applicable in fiscal years beginning after May 15, 2002, the provisions related to FASB Statement No. 13 are effective for transactions occurring after May 15, 2002, and all other provisions are effective for financial statements issued on or after May 15, 2002, however, early application is encouraged. Debt extinguishments reported as extraordinary items prior to scheduled or early

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

adoption of SFAS 145 would be reclassified in most cases following adoption. The adoption of SFAS 145 did not have a material effect on the Company's financial position, results of operations, or cash flows.

In June 2002, the 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 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.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

Reclassifications

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

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 agreed to issue up to an additional 2.9 million shares of its common stock if the Rhapsody business successfully completed specified product milestones by November 30, 2003. The Company has determined that the specified product milestones were not met, and therefore, the Company does not intend to issue the additional shares. However, the representative for the former Rhapsody stockholders has indicated that he disagrees with the Company's determination and has initiated discussions with the Company on this matter.

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 \$17.2 million in expenses related to bringing the Rhapsody core technology to technological feasibility. 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.

BROCADE COMMUNICATIONS SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

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.

BROCADE COMMUNICATIONS SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

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 October 25, 2003:

	Severance and Benefits	Contract Terminations and Other	Equipment Impairment	Total
Restructuring costs incurred	\$ 4,165	\$ 1,478	\$ 5,245	\$10,888
Cash payments	(3,915)	(991)	—	(4,906)
Non-cash charges	(25)	—	(5,245)	(5,270)
Remaining accrued liabilities at October 25, 2003	\$ 225	\$ 487	\$ —	\$ 712

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 Consolidated Balance Sheets. No material changes in estimates were made to the fiscal 2003 second quarter restructuring accrual. The Company expects to pay or otherwise substantially settle the remaining accrued liabilities during the next fiscal year.

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 October 25, 2003:

	Severance and Benefits	Contract Terminations	Equipment Impairment	Total
Restructuring costs incurred	\$ 8,549	\$ 947	\$ 622	\$10,118
Cash payments	(6,104)	(947)	—	(7,051)
Non-cash charges	(2,196)	—	(622)	(2,818)
Adjustments	(178)	—	—	(178)
Remaining accrued liabilities at October 25, 2003	\$ 71	\$ —	\$ —	\$ 71

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

BROCADE COMMUNICATIONS SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

\$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 Consolidated Balance Sheets. No material changes in estimates were made to the fiscal 2003 first quarter restructuring accrual. The Company expects to pay or otherwise substantially settle the remaining accrued liabilities during the next fiscal year.

5. Liabilities Associated with Facilities Lease Losses and Asset Impairment Charges*Facilities Lease Losses and Related Asset Impairment Charges*

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 year ended October 25, 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
Initial charge in fourth quarter of fiscal 2001	\$39,804
Cash payments on facilities leases	(970)
Reserve balances at October 27, 2001	\$38,834
Cash payments on facilities leases	(7,406)
Non-cash charges and adjustments	(622)
Reserve balances at October 26, 2002	\$30,806
Cash payments on facilities leases	(8,660)
Non-cash charges	(709)
Lease loss liability assumed in connection with the acquisition of Rhapsody (see Note 3)	2,840
Reserve balances at October 25, 2003	\$24,277

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.

BROCADE COMMUNICATIONS SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

Asset Impairments Related to Product Transition

During the fourth quarter ended October 27, 2001, the Company announced the general availability of its SilkWorm 3800 Enterprise Fabric Switch, the first in a family of 2 Gbit/sec per second products. As a result of the transition of the Company's product offerings from 1 to 2 Gbit/sec technology, the Company recorded a charge of \$4.4 million primarily related to the impairment of certain 1 Gbit/sec related equipment no longer used in research and development and sales and marketing efforts. No product related impairment charges were recorded for the years ended October 25, 2003 or October 26, 2002.

6. Balance Sheet Details

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

	October 25, 2003	October 26, 2002
Inventories, net:		
Raw materials	\$ 893	\$ 645
Finished goods	3,068	4,757
Total	\$ 3,961	\$ 5,402
Property and equipment, net:		
Computer equipment and software	\$ 71,887	\$ 64,220
Engineering and other equipment	104,544	96,904
Furniture and fixtures	3,882	3,647
Leasehold improvements	34,777	31,259
	215,090	196,030
Less: Accumulated depreciation and amortization	(90,816)	(52,405)
Total	\$ 124,274	\$ 143,625
Other accrued liabilities:		
Income taxes payable	\$ 30,815	\$ 24,605
Accrued warranty	3,723	3,966
Purchase commitments	4,305	1,609
Other	26,120	19,184
Total	\$ 64,963	\$ 49,364

Leasehold improvements at October 25, 2003 and October 26, 2002 are shown net of estimated impairments related to facilities lease losses (see Note 3).

BROCADE COMMUNICATIONS SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

7. Investments and Equity Securities

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

	Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
October 25, 2003				
U.S. government obligations	\$409,045	\$9,063	\$ (37)	\$418,071
Corporate bonds and notes	57,649	27	(194)	57,482
Equity securities	694	—	(25)	669
Total	\$467,388	\$9,090	\$(256)	\$476,222
Reported as:				
Short-term investments				\$ 57,971
Other current assets				669
Long-term investments				417,582
Total				\$476,222
	Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
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 year ended October 25, 2003, gross realized gains on sales of marketable equity securities were \$2.7 million. For the year ended October 26, 2002, gross gains of \$7.1 million were realized on sales of investments in debt securities issued by United States government agencies. For the year ended October 27, 2001, gross gains of \$8.1 million were realized on sales of marketable equity securities. At October 25, 2003 and October 26, 2002, net unrealized holding gains of \$8.8 million and \$10.7 million, respectively, were included in accumulated other comprehensive income in the accompanying Consolidated Balance Sheets.

BROCADE COMMUNICATIONS SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

The following table summarizes the maturities of the Company's investments in debt securities issued by United States government agencies and corporate bonds and notes as of October 25, 2003 (in thousands):

	Amortized Cost	Fair Value
Less than one year	\$ 57,896	\$ 57,971
Due in 1 – 2 years	366,133	375,122
Due in 2 – 3 years	42,665	42,460
Total	<u>\$466,694</u>	<u>\$475,553</u>

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 or conversion of the notes. The net proceeds remain available for general corporate purposes, including working capital and capital expenditures.

During the fourth quarter of fiscal 2003, the Company repurchased on the open market \$107.1 million in face value of its two percent convertible subordinated notes due 2007. The Company paid an average of \$0.88 on each dollar of face value for an aggregate purchase price of \$94.4 million, which resulted in a pre-tax gain of \$11.1 million for fiscal year 2003. As of October 25, 2003, settlement for \$9.0 million of the \$94.4 million was included in accounts payable on the accompanying Consolidated Balance Sheets. As of October 25, 2003, the remaining balance outstanding of the convertible subordinated debt was \$442.9 million.

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 PortalSM Market. On October 24, 2003, the average bid and ask price on the Portal Market of the notes was 90.0, resulting in an aggregate fair value of approximately \$398.7 million.

9. Commitments and Contingencies*Leases*

The Company leases its facilities under various operating lease agreements expiring through November 2013. In connection with these agreements the Company has signed unconditional, irrevocable letters of credit totaling \$18.7 million as security for the leases. In addition to base rent, many of the operating lease agreements require that the Company pay a proportional share of the respective facilities' operating expenses.

BROCADE COMMUNICATIONS SYSTEMS, INC.**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**

Rent expense for the years ended October 25, 2003, October 26, 2002, and October 27, 2001 was \$22.7 million, \$20.0 million, and \$16.5 million, respectively.

Future minimum lease payments under all non-cancelable operating leases at October 25, 2003 were as follows (in thousands):

Fiscal Year Ended October,	Operating Leases
2004	\$ 32,415
2005	29,596
2006	26,345
2007	25,916
2008	26,693
Thereafter	101,668
Total minimum lease payments	<u>\$242,633</u>

At October 25, 2003, the Company had recorded \$24.3 million in facilities lease loss reserves related to future lease commitments, net of expected sublease income (see Note 5).

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 Consolidated Balance Sheets. The following table summarizes the activity related to the Company's accrued liability for estimated future warranty costs during the year ended October 25, 2003 (in thousands):

	Accrued Warranty
Balance at October 26, 2002	\$ 3,966
Liabilities accrued	1,606
Claims paid	(717)
Changes in liability for pre-existing warranties	(1,132)
Balance at October 25, 2003	<u>\$ 3,723</u>

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 October 25, 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 October 25, 2003, the Company's aggregate commitment to Solectron and Foxconn for inventory components

BROCADE COMMUNICATIONS SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

used in the manufacture of Brocade products was \$36.9 million, net of purchase commitment reserves of \$4.3 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 effect 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 case management conference is scheduled for February 20, 2004. 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 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. On October 14, 2003, the Court dismissed with prejudice all claims against Brocade.

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. The arbitration has been scheduled for the week of March 29, 2004. The Company believes that it has meritorious defenses to the claims and intends to defend the action vigorously. The Company believes that

BROCADE COMMUNICATIONS SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

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 for violation of the federal securities laws 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. The lawsuit against the Brocade parties is one of a number of cases challenging underwriter practices in the initial public offerings of more than 300 cases. All of the cases have been coordinated for pretrial proceedings as *In Re Initial Public Offering Securities Litigation, 21 MC 92(SAS)*. In October 2002, the individual defendants were dismissed without prejudice from the action, pursuant to a tolling agreement. On February 19, 2003, the Court issued an Opinion and Order dismissing all of the plaintiffs' claims against the Company.

10. Stockholders' Equity

Stock Option Exchange Program

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 October 25, 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 year ended October 25, 2003 was associated with this transaction.

Stockholder Rights Plan

On February 5, 2002, the Company's Board of Directors adopted a stockholder rights plan. Under the plan, the Company declared and paid a dividend of one right for each share of common stock held by stockholders of record as of the close of business on February 19, 2002. Each right initially entitles

BROCADE COMMUNICATIONS SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

stockholders to purchase a fractional share of the Company's preferred stock at \$280 per share. However, the rights are not immediately exercisable and will become exercisable only upon the occurrence of certain events. If a person or group acquires or announces a tender or exchange offer that would result in the acquisition of 15 percent or more of the Company's common stock while the stockholder rights plan remains in place, then, unless the rights are redeemed by the Company for \$0.001 per right, the rights will become exercisable by all rights holders except the acquiring person or group for shares of the Company or the third party acquirer having a value of twice the right's then-current exercise price. The stockholder rights plan may have the effect of deterring or delaying a change in control of Brocade.

Employee Stock Purchase Plan

In March 1999, the Board of Directors approved the adoption of the Company's 1999 Employee Stock Purchase Plan (the Purchase Plan), and the Company's shareholders approved the Purchase Plan in April 1999. The Purchase Plan permits eligible employees to purchase shares of the Company's common stock through payroll deductions at 85 percent of the fair market value at certain plan-defined dates. The maximum number of shares of the Company's common stock available for sale under the Purchase Plan is 1.6 million shares, plus an annual increase to be added on the first day of the Company's fiscal year, equal to the lesser of 20.0 million shares, or 2.5 percent of the outstanding shares of common stock at such date. Accordingly, on October 26, 2003 and October 27, 2002, 6.4 million and 5.9 million additional shares, respectively, were made available for issuance under the Purchase Plan. During the years ended October 25, 2003, October 26, 2002, and October 27, 2001, the Company issued 2.4 million shares, 0.6 million shares, and 0.2 million shares, respectively, under the Purchase Plan. At October 25, 2003, 20.4 million shares were available for future issuance under the Purchase Plan.

Deferred Stock Compensation

In connection with the grant of certain stock options to employees during the year ended October 31, 1999, the Company recorded deferred stock compensation of \$5.1 million, representing the difference between the deemed fair value of the common stock for accounting purposes and the option exercise price of such options at the date of grant. In the second quarter of fiscal 2003, the Company recorded \$1.7 million of deferred stock compensation in connection with its 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 Consolidated Financial Statements). Deferred stock compensation is presented as a reduction of stockholders' equity and amortized ratably over the vesting period of the applicable options. Accordingly, the Company recorded \$0.6 million, \$1.0 million, and \$1.1 million, as amortization of deferred stock compensation during the years ended October 25, 2003, October 26, 2002, and October 27, 2001, respectively. Deferred stock compensation is decreased in the period of forfeiture for any accrued but unvested compensation arising from the early termination of an option holder's services. No deferred stock compensation related to any other periods presented has been recorded. At October 25, 2003, unamortized deferred stock compensation was \$872,000.

1999 Director Option Plan

In March 1999, the Board of Directors approved the 1999 Director Option Plan (the Director Plan) and the Company's shareholders approved the Director Plan in April 1999. The Director Plan provides for the grant of common stock to Directors of the Company. At October 25, 2003, the Company had reserved 1.5 million shares of authorized but unissued shares of common stock for future issuance under the Director Plan. Of this amount, 0.7 million shares were outstanding, and 0.8 million shares were available for future grants.

BROCADE COMMUNICATIONS SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

1999 Stock Plan

In March 1999, the Board of Directors approved the Company's 1999 Stock Plan (the 1999 Plan) and the Company's shareholders approved the 1999 Plan in April 1999. The 1999 Plan provides for the grant of incentive stock options and/or nonstatutory stock options to employees. Per the terms of the 1999 Plan, the maximum number of shares of the Company's common stock available for sale under the 1999 Plan is 105.9 million shares, plus an annual increase to be added on the first day of the Company's fiscal year, equal to the lesser of 40.0 million shares, or 5.0 percent of the outstanding shares of common stock at such date. Accordingly, on October 26, 2003 and October 27, 2002, 12.9 million and 11.7 million additional shares, respectively, were made available for grant under the 1999 Plan. At October 25, 2003, the Company had reserved 51.5 million shares of authorized but unissued shares of common stock for future issuance under the 1999 Plan. Of this amount, 26.1 million shares were outstanding, and 25.5 million shares were available for future grants.

1999 Nonstatutory Stock Option Plan

In September 1999, the Board of Directors approved the Company's 1999 Nonstatutory Stock Option Plan (the NSO Plan). The NSO Plan provides for the grant of nonstatutory stock options to employees and consultants. A total of 51.4 million shares of common stock have been reserved for issuance under the NSO Plan. At October 25, 2003, the Company had reserved approximately 47.0 million shares of authorized but unissued shares of common stock for future issuance under the NSO Plan. Of this amount, 19.5 million shares were outstanding, and 27.5 million shares were available for future grants. During the year ended October 25, 2003, the Company granted 18.5 million shares under the NSO Plan. No stock options were granted under the NSO Plan during fiscal year 2002.

Rhapsody Stock Option Plan

In January 2003, in connection with the Rhapsody acquisition, the Company assumed the Rhapsody's Stock Option Plan (the Rhapsody Plan). The Rhapsody Plan provides for the grant of incentive stock options and/or nonstatutory stock options to employees and consultants. A total of 0.3 million shares of common stock have been reserved for issuance under the Rhapsody Plan. At October 25, 2003, the Company had reserved approximately 0.3 million shares of authorized but unissued shares of common stock for future issuance under the Rhapsody Plan. Of this amount, 0.3 million shares were outstanding, and no shares were available for future grants. The Company does not plan to grant new stock option shares to its employees or consultant under the Rhapsody Plan.

Stock Options

The Company, under the various stock option plans (the Plans) discussed above, grants stock options for shares of common stock to employees and directors. In accordance with the Plans, the stated exercise price for non-qualified stock options shall not be less than 85 percent of the estimated fair market value of common stock on the date of grant. Incentive stock options may not be granted at less than 100 percent of the estimated fair market value of the common stock, and stock options granted to a person owning more than 10 percent of the combined voting power of all classes of stock of the Company must be issued at 110 percent of the fair market value of the stock on the date of grant. The Plans provide that the options shall be exercisable over a period not to exceed ten years. The majority of options granted under the Plans vest over a period of four years. Certain options granted under the Plans vest over shorter periods. At October 25, 2003, the Company had cumulatively reserved 100.4 million shares of authorized but unissued shares of common stock for future issuance under the Plans. Of this amount, 46.6 million shares were outstanding, and 53.8 million shares were available for future grants.

BROCADE COMMUNICATIONS SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

The following table summarizes stock option plan activity under all of the Plans (in thousands except per share amounts):

	Fiscal Year Ended October 25, 2003		Fiscal Year Ended October 26, 2002		Fiscal Year Ended October 27, 2001	
	Shares	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price
Outstanding at beginning of year	78,982	\$34.71	80,721	\$35.43	44,871	\$33.24
Granted	42,272	\$ 6.04	9,487	\$16.81	49,835	\$34.15
Exercised	(1,113)	\$ 0.61	(4,406)	\$ 9.03	(7,179)	\$10.32
Cancelled	(73,550)	\$35.82	(6,820)	\$34.84	(6,806)	\$36.90
Outstanding at end of year	46,591	\$ 7.70	78,982	\$34.71	80,721	\$35.43
Exercisable at end of year	19,475	\$ 8.33	27,770	\$35.02	14,837	\$33.23

The following table summarizes information about stock options outstanding and exercisable at October 25, 2003 (in thousands except number of years and per share amounts):

Range of Exercise Prices	Options Outstanding			Options Exercisable		
	Number	Weighted Average Remaining Years	Weighted Average Exercise Price	Number	Weighted Average Exercise Price	
\$ 0.04 – \$ 5.94	17,060	7.42	\$ 4.70	2,959	\$ 2.18	
\$ 6.01 – \$ 7.38	26,150	9.70	\$ 6.54	14,540	\$ 6.54	
\$12.27 – \$ 25.34	2,269	7.23	\$16.37	1,371	\$15.13	
\$28.11 – \$ 45.53	401	6.47	\$36.04	192	\$37.68	
\$62.00 – \$104.94	711	6.90	\$78.41	413	\$79.28	
\$ 0.04 – \$104.94	46,591	8.67	\$ 7.70	19,475	\$ 8.33	

At October 25, 2003, 0.6 million shares of common stock issued upon exercise of stock options with a weighted-average exercise price of \$0.63 per share were subject to repurchase by the Company. There was no dilutive impact of potential common shares associated with stock options, by application of the treasury stock method, for the year ended October 25, 2003, as the Company had a net loss. The dilutive impact of potential common shares associated with stock options, by application of the treasury stock method, for the years ended October 26, 2002 and October 27, 2001, were 9.9 million shares and 16.4 million shares, respectively.

BROCADE COMMUNICATIONS SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

Equity Compensation Plan Information

The following table summarizes information, as of October 25, 2003, with respect to shares of the Company's common stock that may be issued under the Company's existing equity compensation plans (in thousands except per share amounts):

Plan Category	A Number of Securities to be Issued upon Exercise of Outstanding Options	B Weighted Average Exercise Price of Outstanding Options	C Number of Securities Remaining Available for Future Issuance Under Equity Compensation Plans (Excluding Securities Reflected in Column A)
Equity compensation plans approved by shareholders(1)	27,392(3)	\$6.73	25,967(4)
Equity compensation plans not approved by shareholders(2)	19,199(5)	\$9.08	27,799
Total	46,591	\$7.70	53,766

(1) Consists of the Purchase Plan, the Director Plan, the 1999 Plan and the Rhapsody Plan.

(2) Consists solely of the NSO Plan.

(3) Excludes purchase rights accruing under the Purchase Plan. As of October 25, 2003, the Purchase Plan had a shareholder-approved reserve of 24.1 million shares, of which 20.4 million shares were available for future issuance.

(4) Consists of shares available for future issuance under the Purchase Plan, the Director Plan, the 1999 Plan, and the Rhapsody Plan.

(5) Consists of 17.6 million shares granted on July 10, 2003 related to the stock option Exchange Program and 1.6 million shares granted prior to year ended October 25, 2003.

Employee 401(k) Plan

The Company sponsors the Brocade Communications Systems, Inc. 401(k) Plan (the Plan), which qualifies under Section 401(k) of the Internal Revenue Code and is designed to provide retirement benefits for its eligible employees through tax deferred salary deductions.

Through December 31, 2001, employees could contribute from 1 percent to 20 percent of their eligible compensation to the Plan. Effective January 1, 2002, the employee contribution limit was increased to 60 percent of eligible compensation. Employee contributions are limited to a maximum annual amount as set periodically by the Internal Revenue Service. The Company matches employee contributions dollar for dollar up to a maximum of \$1,500 per year per person. All matching contributions vest immediately. The Company's matching contributions to the Plan totaled \$1.5 million, \$1.5 million, and \$1.4 million for the years ended October 25, 2003, October 26, 2002, and October 27, 2001, respectively.

BROCADE COMMUNICATIONS SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

11. Income Taxes

Income (loss) before provision for income taxes consisted of the following (in thousands):

	Fiscal Year Ended		
	October 25, 2003	October 26, 2002	October 27, 2001
United States	\$(136,231)	\$62,162	\$(20,933)
International	2,596	21,989	38,735
Total	\$(133,635)	\$84,151	\$ 17,802

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

	Fiscal Year Ended		
	October 25, 2003	October 26, 2002	October 27, 2001
Federal:			
Current	\$ 1,843	\$16,682	\$ 27,141
Deferred	(6,187)	(157)	(19,626)
	(4,344)	16,525	7,515
State:			
Current	279	2,829	8,706
Deferred	(3,556)	(968)	(4,966)
	(3,277)	1,861	3,740
Foreign:			
Current	10,226	6,019	3,699
Deferred	—	—	—
	10,226	6,019	3,699
Total	\$ 2,605	\$24,405	\$ 14,954

The difference between the United States federal statutory rate and the Company's income tax provision for financial statement purposes consisted of the following:

	Fiscal Year Ended		
	October 25, 2003	October 26, 2002	October 27, 2001
Provision for (benefit from) income taxes at statutory rate	(35.0)%	35.0%	35.0%
State taxes, net of federal tax benefit	(2.5)	3.0	6.1
R&D tax credit	(1.0)	(4.0)	(4.2)
Increase (decrease) in valuation allowance/ investment losses	(1.5)	(3.1)	61.0
Foreign income taxed at other than U.S. rates	6.0	(2.1)	(17.9)
In-process research and development	35.3	—	—
Other, net	0.7	0.2	4.0
Provision for income taxes	2.0%	29.0%	84.0%

BROCADE COMMUNICATIONS SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

United States income taxes were not provided for undistributed earnings of certain non-United States subsidiaries taxed at rates lower than United States rates. As of October 25, 2003, the Company had unrecognized deferred tax liabilities of approximately \$14.6 million related to approximately \$59.9 million of cumulative net undistributed earnings of foreign subsidiaries. The Company intends to utilize these earnings through expansion of its business operations outside the United States for an indefinite period of time.

The components of net deferred tax assets are as follows (in thousands):

	October 25, 2003	October 26, 2002
Net operating loss carryforwards	\$176,635	\$174,422
Tax credit carryforwards	53,769	42,261
Reserves and accruals	29,593	32,387
Capitalized research expenditures	26,968	8,404
Net unrealized losses on investments	832	3,544
Other	109	166
	<hr/>	<hr/>
Total	287,906	261,184
Less: Valuation allowance	(27,134)	(10,888)
	<hr/>	<hr/>
Net deferred tax assets	\$260,772	\$250,296

The valuation allowance balance at October 25, 2003 increased by \$16.2 million primarily due to the fact that the Company has provided a valuation allowance of \$15.9 million against the net operating loss and tax credit carryforwards related to the Rhapsody acquisition because these carryforwards may be subject to certain limitations when utilized. Additionally, the Company has also provided a valuation allowance of \$3.8 million against the deferred tax assets related to net operating losses and tax credits resulting from employee stock options. The valuation allowance on the latter will be reduced if the Company is able to utilize such net operating loss and tax credit carryforwards on its tax return, resulting in a lower tax liability. The tax benefit of these credits and loss carryforwards from the employee stock options will be accounted for as a credit to the shareholders' equity rather than a reduction of income tax expense. The increases in the valuation allowance balance at October 25, 2003 was offset by a decrease of \$3.5 million in the valuation allowance related to unbenefitted investment losses, which were initially recorded during the year ended October 27, 2001, due to the write-off of certain investments. Management believes that it is more likely than not that the remaining net deferred tax assets will be realized through future profitable operations.

As of October 25, 2003, the Company had federal net operating loss carryforwards of \$475.3 million and state net operating loss carryforwards of \$228.0 million. Additionally, the Company had \$30.0 million of federal tax credits and \$36.6 million of state tax credits. The federal net operating loss and other tax credit carryforwards expire on various dates between 2016 through 2023. The state net operating loss carryforwards expire on various dates between 2004 through 2023. Among the net operating and other tax credit carryforwards, \$31.2 million of federal net operating losses, \$28.4 million of state net operating losses, \$1.9 million of federal tax credit, and \$2.3 million of state tax credits are attributable to the Rhapsody pre-acquisition years, which maybe subject to certain limitations upon utilization. Under the current tax law, net operating loss and credit carryforwards available to offset future income in any given year may be limited by statute or upon the occurrence of certain events, including significant changes in ownership interests.

For the year ended October 26, 2002, the Company's income taxes payable for federal, state, and foreign purposes have been reduced, and the deferred tax assets increased by the tax benefits associated with employee stock options. The benefits were credited directly to stockholders' equity and amounted to \$33.0 million. Benefits reducing taxes payable amounted to \$14.8 million, and benefits increasing gross deferred tax assets amounted to \$18.2 million for the year ended October 26, 2002.

BROCADE COMMUNICATIONS SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

12. Segment Information

The Company is organized and operates as one operating segment: the design, development, manufacturing, marketing and selling of infrastructure for storage area networks (SANs). The Chief Executive Officer 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 consolidated revenues and overall profitability.

Revenues are attributed to geographic areas based on the location of the customer to which products are 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 67 percent and 33 percent of total revenues, respectively, for the year ended October 25, 2003, 70 percent and 30 percent of total revenues, respectively, for the year ended October 26, 2002, and 71 percent and 29 percent for the year ended October 27, 2001, respectively. To date, service revenue has not exceeded 10 percent of total revenues.

For the year ended October 25, 2003, three customers accounted for 30 percent, 20 percent, and 17 percent of total revenues, respectively. For the year ended October 26, 2002, the same three customers accounted for 29 percent, 19 percent, and 14 percent of total revenues, respectively. For the year ended October 27, 2001, three customers accounted for 26 percent, 20 percent, and 10 percent of total revenues, respectively. The level of sales to any single customer may vary and the loss of any one of these customers, or a decrease in the level of sales to any one of these customers, could have a material adverse impact on the Company's financial condition or results of operations.

Geographic information for the years ended October 25, 2003, October 26, 2002, and October 27, 2001 are presented below (in thousands). Identifiable assets located in foreign countries were not material at October 25, 2003, October 26, 2002, or October 27, 2001.

	Fiscal Year Ended		
	October 25, 2003	October 26, 2002	October 27, 2001
Net Revenues:			
North America (principally the United States)	\$351,576	\$394,339	\$364,270
Europe, the Middle East, and Africa	134,669	132,445	117,896
Asia Pacific	39,032	35,585	30,864
Total	\$525,277	\$562,369	\$513,030

13. Interest and Other Income, net

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

	Fiscal Year Ended		
	October 25, 2003	October 26, 2002	October 27, 2001
Interest income	\$19,099	\$23,230	\$10,201
Other income (expense), net	(675)	(562)	(1,994)
Total	\$18,424	\$22,668	\$ 8,207

BROCADE COMMUNICATIONS SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

14. Gain (Loss) on Investments, net

Gain (loss) on investments for the year ended October 25, 2003, consisted of a gain on the disposition of private strategic investments of \$3.1 million, and a gain of \$2.7 million that resulted from the acquisition of a non-publicly traded company in which the Company had a minority equity investment, offset by an impairment charge of \$2.2 million 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. Gain (loss) on investments for the year ended October 26, 2002, consisted of gross realized gains on sales of investments in debt securities issued by United States government agencies of \$7.1 million. Gain (loss) on investments for the year ended October 27, 2001, consisted of impairment losses on minority equity investments in non-publicly traded companies of \$24.2 million, partially offset by gross realized gains on sales of marketable equity securities of \$8.1 million.

In the past, the Company has made certain minority equity investments in non-publicly traded companies that develop technology or provide services that are complementary to or broaden the markets for its products, and to promote its business and strategic objectives. During the year ended October 27, 2001, the Company made minority equity investments in non-publicly traded companies of \$23.6 million. The investments were made primarily in companies in the storage networking, Internet infrastructure, fabless semiconductor, networking services, and managed storage service provider industries. These companies were development stage companies with significant risks.

During the year ended October 27, 2001, the industries in which these companies compete experienced considerable market declines associated with a depressed macroeconomic environment. Many of these companies had spent the majority of their funding on operating activities and/or lost key business partners due to bankruptcy, and the Company determined that the carrying value of its investments were impaired. Based upon the then current market conditions and substantial doubt about these companies' ability to raise additional funding, achieve positive cash flow, and achieve projected revenues, the Company concluded the impairments were other-than-temporary and recorded impairment charges of \$24.2 million. The impairment charges reduced the carrying value of the Company's investments to the estimated fair value. No impairment charges were recorded during the year ended October 26, 2002. During the year ended October 25, 2003, the Company recorded impairment charges of \$2.2 million that resulted from other-than-temporary declines in the estimated fair value of its remaining minority equity investments in non-publicly traded companies. The carrying value of the Company's minority equity investments in non-publicly traded companies at October 25, 2003 and October 26, 2002 was zero and \$2.2 million, respectively.

BROCADE COMMUNICATIONS SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

15. 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):

	Fiscal Year Ended		
	October 25, 2003	October 26, 2002	October 27, 2001
Net income (loss)	\$ (136,240)	\$ 59,746	\$ 2,848
Basic and diluted net income (loss) per share:			
Weighted-average shares of common stock outstanding	251,275	233,048	226,798
Less: Weighted-average shares of common stock subject to repurchase	(665)	(1,457)	(5,747)
Weighted-average shares used in computing basic net income (loss) per share	250,610	231,591	221,051
Dilutive potential common shares	—	11,371	22,111
Weighted-average shares used in computing diluted net income per share	250,610	242,962	243,162
Basic net income (loss) per share	\$ (0.54)	\$ 0.26	\$ 0.01
Diluted net income (loss) per share	\$ (0.54)	\$ 0.25	\$ 0.01

For the year ended October 25, 2003, stock option outstanding of 46.6 million shares were antidilutive as the Company had a net loss and, therefore, not included in the computation of diluted earnings per share. For the years ended October 26, 2002 and October 27, 2001, potential common shares in the form of stock options to purchase 51.8 million and 24.1 million weighted-average shares of common stock, respectively, were antidilutive and, therefore, not included in the computation of diluted earnings per share. In addition, for the years ended October 25, 2003 and October 26, 2002, potential common shares resulting from the potential conversion of the Company's convertible subordinated debt of 10.7 million weighted-average common shares were antidilutive and, therefore, not included in the computation of diluted earnings per share.

16. Related Party Transactions

Larry W. Sonsini, a director of Brocade, serves as a member and Chairman and CEO of Wilson Sonsini Goodrich & Rosati, Professional Corporation (WSGR), the Company's principal outside legal counsel. Aggregate fees billed to the Company by WSGR for legal services rendered, including general corporate counseling, litigation services, merger and acquisition related services, and services related to the Company's convertible debt offering, during the years ended October 25, 2003, October 26, 2002, and October 27, 2001, were \$1.2 million, \$4.9 million, and \$0.6 million, respectively. The Company believes that the services rendered to the Company by WSGR were on terms no more favorable than those with unrelated parties.

Mark Leslie was a director of Brocade until May 2002 and served on the Board of Directors of VERITAS Software (Veritas), a company with whom Brocade does business. During the years ended October 26, 2002 and October 27, 2001, total revenues from sales to Veritas were \$2.5 million and \$2.4 million, respectively. The Company believes that sales to Veritas were on terms no more favorable than those with unrelated parties.

During the normal course of business the Company purchases certain equipment from vendors who are also its customers and with whom the Company has contractual arrangements. The equipment purchase by the Company is primarily used for testing purposes in its development labs or otherwise consumed internally.

BROCADE COMMUNICATIONS SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

The Company believes that all such transactions are on an arms-length basis and subject to terms no more favorable than those with unrelated parties.

17. Subsequent Event

On November 18, 2003, the Company purchased a building located at its San Jose headquarters for \$106.8 million in cash plus transaction costs. The 194,000 square foot facility, which houses a portion of the Company's engineering organization and development, test and interoperability laboratories, was previously leased. As a result of the building purchase, during the first quarter of fiscal 2004, the Company will record adjustments to the previously recorded facilities lease loss reserve and expects to record a charge ranging from \$75.0 million to \$85.0 million primarily related to lease termination, facilities consolidation and other associated costs. In addition, the Company issued a \$1.0 million guarantee as part of the purchase agreements, and cancelled an irrevocable letter of credit of \$10.4 million, which was previously issued as security for the building lease.

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

On June 18, 2002, Brocade Communications Systems, Inc. (the Company) dismissed its independent accountants, Arthur Andersen LLP (AA), and on June 18, 2002 engaged the services of KPMG LLP (KPMG) as its new independent accountants for its fiscal year, ending October 26, 2002. The Audit Committee of the Company's Board of Directors (the Board) recommended, and the Board approved, the dismissal of AA and the appointment of KPMG.

During the two fiscal years of the Company ended October 27, 2001 and October 28, 2000, respectively, and the subsequent interim periods through June 18, 2002, there were no disagreements between the Company and AA on any matter of accounting principles or practices, financial statement disclosure, or auditing scope or procedure, which disagreements, if not resolved to AA's satisfaction, would have caused AA to make reference to the subject matter of the disagreement in connection with its reports; and there were no reportable events described under Item 304(a)(1)(v) of Regulation S-K.

The audit reports of AA on the consolidated financial statements of the Company as of and for the fiscal years ended October 27, 2001 and October 28, 2000 did not contain any adverse opinion or disclaimer of opinion, nor were they qualified or modified as to uncertainty, audit scope or accounting principles.

During the two fiscal years of the Company ended October 27, 2001 and October 28, 2000 and through June 18, 2002, the Company did not consult with KPMG with respect to the application of accounting principles to a specified transaction, either completed or proposed, or the type of audit opinion that might be rendered on our consolidated financial statements, or any other matter or reportable events as set forth in Item 304(a)(2)(i) and (ii) of Regulation S-K.

Item 9A. *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 Annual Report on Form 10-K. 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 Annual Report on Form 10-K that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

PART III

Certain information required by Part III is incorporated by reference from the Company's definitive Proxy Statement to be filed with the Securities and Exchange Commission in connection with the solicitation of proxies for the Company's 2003 Annual Meeting of Stockholders to be held on April 16, 2003 (the "Proxy Statement").

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

The information required by this section is incorporated by reference from the information in the section entitled "Election of Directors" in the Proxy Statement. Item 405 of Regulation S-K calls for disclosure of any known late filing or failure by an insider to file a report required by Section 16 of the Exchange Act. This disclosure is incorporated by reference to the section entitled "Section 16(a) Beneficial Ownership Reporting

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Compliance” in the Proxy Statement. The information required by this Item with respect to the Company’s executive officers is contained in Item 1 of Part I of this Annual Report under the heading “Executive Officers of the Registrant.”

Item 11. *Executive Compensation*

The information required by this section is incorporated by reference from the information in the section entitled “Executive Compensation and Other Matters” in the Proxy Statement.

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

The information required by this section is incorporated by reference from the information in the section entitled “Security Ownership of Certain Beneficial Owners and Management” in the Proxy Statement.

Item 13. *Certain Relationships and Related Transactions*

The information required by this section is incorporated by reference from the information in the section entitled “Certain Relationships and Related Transactions” in the Proxy Statement.

Item 14. *Principal Accountant Fees and Services*

The information required by this section is incorporated by reference from the information in the section entitled “Ratification of Appointment of Independent Auditors” in the Proxy Statement.

PART IV

Item 15. *Exhibits, Financial Statement Schedules and Reports on Form 8-K*

(a) The following documents are filed as part of this Form 10-K

(1) Financial Statements:

Reference is made to the Index to Consolidated Financial Statements of Brocade Communications Systems, Inc. under Item 8 in Part II of this Form 10-K.

(2) Financial Statement Schedules:

The following financial statement schedule of Brocade Communications Systems, Inc. for the years ended October 25, 2003, October 26, 2002, and October 27, 2001, is filed as part of this Annual Report and should be read in conjunction with the Consolidated Financial Statements of Brocade Communications Systems, Inc.

Schedule II — Valuation and Qualifying Accounts Page 80

(3) Exhibits:

Item 601 of Regulation S-K requires the exhibits listed below. Each management contract or compensatory plan or arrangement required to be filed as an exhibit to this Form 10-K has been identified.

(b) Reports on Form 8-K

We filed a current report on Form 8-K on August 13, 2003, to furnish as exhibits a press release announcing our financial results for the third quarter ended July 26, 2003 under Items 7 and 12 thereof.

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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.
10.9(1)	Master Equipment Lease Agreement between Venture Lending & Leasing, Inc. and Brocade dated September 5, 1996.
10.10(1)#	Acknowledgement between Wind River Systems, Inc. and Brocade dated April 22, 1999.
10.11(1)*	Letter Agreement with Michael J. Byrd dated April 5, 1999.
10.12(3)#	Manufacturing Agreement between Solectron California Corporation and Brocade dated July 30, 1999.
10.13(3)	Master Lease Agreement between Spieker Properties and Brocade dated December 17, 1999.
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.
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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Exhibit Number	Description of Document
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10.24(14)	Extension Agreement between EMC Corporation and Brocade dated November 13, 2002.
10.25(8)#	Goods Agreement between International Business Machines Corporation and Brocade dated April 15, 1999.
10.26(8)	Amendment #1 to the Goods Agreement between International Business Machines Corporation and Brocade.
10.27(8)#	Statement of Work #1 between International Business Machines Corporation and Brocade.
10.28(8)#	Amendment #3 to Statement of Work #1 between International Business Machines Corporation and Brocade.
10.29(8)#	Amendment #4 to Statement of Work #1 between International Business Machines Corporation and Brocade.
10.30(8)#	Statement of Work #2 between International Business Machines Corporation and Brocade.
10.31(6)	Third Amendment to Credit Agreement between Comerica Bank-California and Brocade dated January 22, 2001.
10.32(6)	Lease Agreement between MV Golden State San Jose, LLC and Brocade dated December 1, 2000.
10.33(11)#	Amendment No. 5 to Statement of Work No. 1 between International Business Machines Corporation and Brocade.
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.
10.38(11)#	Amendment No. 1 to Statement of Work No. 2 between International Business Machines Corporation and Brocade.
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.
10.43(12)+	OEM Purchase Agreement between Brocade and Hewlett-Packard Company dated April 20, 2001 (2001 OEM Purchase Agreement).
10.44(12)+	Amendment No. 1 to 2001 OEM Purchase Agreement between Brocade and Hewlett-Packard Company dated July 1, 2001.
10.45(12)+	Amendment No. 2 to 2001 OEM Purchase Agreement between Brocade and Hewlett-Packard Company dated November 6, 2001.
10.46(12)+	Amendment No. 3 to 2001 OEM Purchase Agreement between Brocade and Hewlett-Packard Company dated February 1, 2002.
10.47(12)+	Amendment No. 4 to 2001 OEM Purchase Agreement between Brocade and Hewlett-Packard Company dated June 5, 2002.
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Exhibit Number	Description of Document
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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.
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10.56+	Amendment No. 3 to EMC Purchase Agreement between Brocade and EMC dated July 30, 2003
10.57+	Amendment # 12 to Statement of Work #1 between International Business Machines Corporation and Brocade
12.1	Statement of Computation of Ratio of Earnings to Fixed Charges.
16.1(12)	Letter from Arthur Andersen LLP to the Securities and Exchange Commission dated June 20, 2002.
21.1	Subsidiaries of Registrant.
23.1	Consent of KPMG LLP.
24.1	Power of attorney (see signature page).
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.

(5) Incorporated by reference from Brocade's Annual Report on Form 10-K for the fiscal year ended October 28, 2000.

(6) Incorporated by reference from Brocade's Quarterly Report on Form 10-Q for the fiscal quarter ended January 27, 2001.

(7) Incorporated by reference from Brocade's Quarterly Report on Form 10-Q for the fiscal quarter ended July 28, 2001.

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- (8) Incorporated by reference from Brocade's Annual Report on Form 10-K for the fiscal year ended October 27, 2001.
- (9) Incorporated by reference from Brocade's Quarterly Report on Form 10-Q for the fiscal quarter ended January 26, 2002.
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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.

VALUATION AND QUALIFYING ACCOUNTS

Years Ended October 25, 2003, October 26, 2002, and October 27, 2001

Description	Balance at Beginning of Period	Additions Charged to Expenses/ Revenues	Deductions	Balance at End of Period
(In thousands)				
Allowance for doubtful accounts:				
2003	\$ 1,927	\$ (491)	\$ (797)	\$ 639
2002	\$ 1,768	\$ 650	\$ (491)	\$ 1,927
2001	\$ 1,353	\$ 619	\$ (204)	\$ 1,768
Sales returns and allowances:				
2003	\$ 1,836	\$ 3,628	\$ (1,923)	\$ 3,541
2002	\$ 1,257	\$ 1,358	\$ (779)	\$ 1,836
2001	\$ 1,629	\$ 268	\$ (280)	\$ 1,617

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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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- (9) Incorporated by reference from Brocade's Quarterly Report on Form 10-Q for the fiscal quarter ended January 26, 2002.
- (10) Incorporated by reference from Brocade's Registration Statement on Form 8-A filed on February 11, 2002.
- (11) Incorporated by reference from Brocade's Quarterly Report on Form 10-Q for the fiscal quarter ended April 27, 2002.
- (12) Incorporated by reference from Brocade's Quarterly Report on Form 10-Q for the fiscal quarter ended July 27, 2002.
- (13) Incorporated by reference from Brocade's Annual Report on Form 10-K for the fiscal year ended October 26, 2002.
- (14) Incorporated by reference from Brocade's Quarterly Report on Form 10-Q for the fiscal quarter ended January 25, 2003.
- (15) Incorporated by reference from Brocade's Quarterly Report on Form 10-Q for the fiscal quarter ended April 26, 2003.

Amendment No.3
Purchase Agreement

This Amendment No. 3 ("the Amendment") to the Purchase Agreement (the "Agreement") dated January 25, 2000 by and among Brocade Communications Systems, Inc., a corporation organized under the laws of the State of Delaware, U.S.A., and having its principal place of business at 1745 Technology Drive, San Jose, California 95110 ("Brocade-US"), and Brocade Communications Switzerland SarL., a corporation organized under the laws of Geneva, and having its principal place of business at 29-31 Route de l'Aeroport, Case Postale 105 CH-1215 Geneva 15, Switzerland ("Brocade-Switzerland"), (collectively "SUPPLIER") and EMC Corporation, ("EMC"), a Massachusetts corporation, is made this 30 day of July 2003 by and between SUPPLIER and EMC and commences on the date accepted and executed by SUPPLIER ("Effective Date"). While [*] may [*]of its obligations under this Agreement [*] Brocade-US and Brocade-Switzerland shall [*] to EMC for the [*] under this Agreement.

WHEREAS, the parties wish to amend the Agreement so as to incorporate the Exhibit M (EMC/Brocade Order Fulfillment).

NOW THEREFORE, IN CONSIDERATION OF THE ABOVE AND THE OTHER RESPECTIVE PROMISES OF THE PARTIES SET FORTH HEREIN, THE PARTIES HERETO AGREE AS FOLLOWS:

1) Exhibit M, (EMC/Brocade Order Fulfillment) is hereby incorporated into the Agreement in its entirety by this Amendment No. 3 to the Agreement.

2) All Other terms and conditions of the Agreement shall remain unchanged.

* Certain information on this page has been omitted and filed separately with the Commission. Confidential treatment has been requested with respect to the omitted portions.

EMC/BROCADE CONFIDENTIAL

IN WITNESS WHEREOF, the parties hereto have executed this Amendment No. 3 to OEM Purchase and License Agreement by their duly authorized representatives. Such execution of the Amendment may be in three counterparts, each of which shall be an original and together which shall constitute one and the same instrument.

Executed and agreed to:

Executed and agreed to:

BROCADE COMMUNICATIONS SYSTEMS, INC.
(Brocade "SUPPLIER")

EMC CORPORATION (EMC)

By: /s/ JACK CUTHBERT

By: /s/ WILLIAM MONAGLE

Name: Jack Cuthbert

Name: William Monagle

Title: VP Worldwide Sales

Title: Vice President Corporate
Procurement

Date: 09/02/03

Date: 08/21/03

BROCADE COMMUNICATIONS SWITZERLAND SARL.

(Brocade "Supplier")

By: /s/ KEVIN MCKENNA

Print Name: Kevin McKenna

Title: EMEA Finance Controller

Place: Geneva, Switzerland

Date: 08/28/03

EMC/BROCADE CONFIDENTIAL

EXHIBIT M
EMC/BROCADE Order Fulfillment

The following Order Fulfillment model is applicable for [*] Products including but not limited to the [*]. See appendix 1 to this Exhibit for Product list. This Order Fulfillment model Exhibit M provides terms and conditions for EMC's [*] to issue Purchase Orders for pull model fulfillment. All other Purchase Orders are pursuant to the Terms and Conditions of the EMC-Brocade Purchase Agreement (dated January 25, 2000 here after referenced as "Agreement").

1.0 PROGRAM SCOPE.

Brocade will hold [*] of Finished Goods Inventory (FGI), which is determined based upon EMC's forecast and the [*] call consensus plan. Such FGI inventory will be stored at [*]. In addition, Brocade will maintain [*] of [*] at [*] site. Replenishment lead-time for inventory levels beyond the designated supply above will be [*].

2.0 PLANNING.

Support for demand flexibility and mitigation of liability will be managed through the [*] collaborative planning sessions held between Brocade and EMC personnel pursuant to 1.0 Program Scope above. The [*] will be held on the [*] to review the forecasts (site and corporate) and inventory levels. Consensus between EMC and Brocade will be reached regarding the appropriate level of FGI to be held [*]. These [*] provide the opportunity for [*] or [*] and [*] to be [*] relative to the [*] established above in Section 1. Program Scope.

[*] will provide the following [*] each [*] in a [*] incremental format: [*] for the next [*] for the next [*], and [*] and any [*] that will impact inventory levels.

In the event [*] does not provide a [*] for either [*] or [*] use (material requirement), [*] will assume that [*] does not require any [*] to be [*] If there is failure to provide a [*] and/or to [*] for a period of [*], this program (Exhibit M) may be terminated by [*] providing [*] of Exhibit M termination to [*]

3. ORDERING:

EMC shall issue quarterly blanket Purchase Orders to Brocade for Products to be delivered in accordance with this Exhibit M. The Blanket Purchase Order will be issued in keeping with [*] lead time to the start of the next calendar quarter.

The blanket purchase order shall include a heading that reads, "This Blanket Purchase Order is issued in accordance with the EMC-Brocade Purchase Agreement, Exhibit M, EMC-Brocade Order Fulfillment Program."

* Certain information on this page has been omitted and filed separately with the Commission. Confidential treatment has been requested with respect to the omitted portions.

EMC/BROCADE CONFIDENTIAL

This blanket order does not commit EMC to [*].

The blanket order may be modified from time to time during the quarter. [*] will be made by EMC via email on the same day [*].

Brocade will replenish the [*] to the [*] facility as required [*] pursuant to the site forecast. Brocade will [*] on an as required basis as mutually agreed upon between the parties.

4. SHIPMENTS:

Shipments from Brocade manufacturer shall occur no later than [*] from [*] of the [*]. Brocade shall use [*] efforts to achieve a [*] turnaround however; failure to achieve turn around within [*] shall not be considered a breach of the Agreement.

Shipping terms (excluding title transfer) shall be [*] or, [*].

5. INVOICING AND TITLE TRANSFER:

Brocade shall invoice and title shall transfer upon Brocade's [*] EMC.

6. [*] FACILITY:

EMC shall [*] for the Products to [*] and shall [*] to Brocade. Brocade shall provide EMC no less than [*].

7. PRODUCT WITHDRAWALS:

Once a Product Withdrawal notice (Section 15.0 Product Withdrawals) has been provided to EMC, the fulfillment program for the Product will convert to a discrete Order fulfillment methodology [*] after EMC's receipt of the written notice. The discrete orders shall be fulfilled pursuant to the Agreement.

8. TERM AND TERMINATION:

Exhibit M shall be coterminous with the Agreement unless otherwise terminated by either party.

If either party fails to comply with the material terms and conditions of this Program pursuant to Exhibit M, a written warning shall commence a cure period of thirty- (30) Days and the parties shall meet to discuss the fulfillment model requirements. In the event either party fails to make progress within the thirty- (30) Day cure period, a termination notice will follow. Such termination shall only apply to Exhibit M.

* Certain information on this page has been omitted and filed separately with the Commission. Confidential treatment has been requested with respect to the omitted portions.

APPENDIX 1 - PRODUCT LIST

Model No.	EMC Part Number	Brocade Part No.	Description
-----	-----	-----	-----
[*]	[*]	[*]	8 Port FC Switch
[*]	[*]	[*]	16 Port FC Switch
[*]	[*]	[*]	32 Port FC Switch

* Certain information on this page has been omitted and filed separately with the Commission. Confidential treatment has been requested with respect to the omitted portions.

EMC/BROCADE CONFIDENTIAL

(IBM LOGO)
5600 Cottle Road
San Jose, CA 95193 0001

August 24, 2003

Brocade Communications Systems, Inc.
1745 Technology Drive
San Jose, CA 95110

Attention: Mr. Michael Harrison

Subject: Amendment 12 to SOW#1 of the IBM/Brocade Goods Agreement ROC-P-68

Dear Michael:

This letter (the "Amendment") serves as Amendment Number 12 to SOW#1, including all amendments thereto ("SOW#1") of the Goods Agreement ROC-P-68, including all amendments thereto (the "Goods Agreement") which the parties hereto do mutually agree to amend as follows:

1. Delete pricing table in its entirety in Section 2.1, "Pricing" and replace with the following:

IBM P/N / P/N	NUMA-Q	BROCADE P/N	DESCRIPTION	UNIT PRICE
[*]	[*]	[*]	8-Port Fibre Channel Switch Single Power Supply (SW2400) Includes SES, Web tools, Zoning and Fabric Watch - whole unit switch Product	[*]
[*]	[*]	[*]	16 Port Fibre Channel Switch Single Power Supply (SW2800) Includes SES, Web tools, Zoning and Fabric Watch - whole unit switch Product	[*]
[*]	[*]	[*]	Silkworm 2000 Power Supply	[*]
[*]	[*]	[*]	Mainboard, SW 2400 (8-port)	[*]
[*]	[*]	[*]	Fan Tray, SW 2400 (8-port)	[*]
[*]	[*]	[*]	Chassis, SW 2400 (8-port)	[*]
[*]	[*]	[*]	Mainboard, SW 2800 (16-port)	[*]
[*]	[*]	[*]	Fan Tray, SW 2800 (16-port)	[*]
[*]	[*]	[*]	Chassis, SW 2800 (16-	[*]

* Certain information on this page has been omitted and filed separately with the Commission. Confidential treatment has been requested with respect to the omitted portions.

Amendment #12 to SOW#1 of IBM/Brocade Agreement ROC-P-68
August 24, 2003

port) with operator panel / LCD

[*]	[*]	Quick Loop License	[*]
[*]	[*]	Fabric Watch License	[*]
[*]	[*]	Extended Fabrics	[*]
[*]	[*]	Extended Fabrics	[*]
[*]	[*]	Remote Switch	[*]
[*]	[*]	Remote Switch	[*]
[*]	[*]	8 Port Fibre Channel Switch Single Power Supply (SW3200) Includes Web Tools	[*]
[*]	[*]	8 Port Fibre Channel Switch Single Power Supply (SW3200) Includes Web Tools, Full Fabric Upgrade Zoning and Fabric Watch	[*]
[*]	[*]	Full Fabric Upgrade Includes Zoning and Fabric Watch	[*]
[*]	[*]	16 Port Fibre Channel Switch Single Power Supply (SW3800) Includes Web tools, Zoning and Fabric Watch - whole unit switch Product	[*]
[*]	[*]	Fan (SW3800)	[*]
[*]	[*]	Power Supply (SW3800)	[*]
[*]	[*]	Mainboard FRU (SW3800)	[*]
[*]	[*]	32 Port Fibre Channel Switch Double Power Supply (SW3900) Includes, Webtools, Zoning, Fabric Watch, Trunking, and Performance Monitor - whole unit switch Product	[*]
[*]	[*]	Fan (SW3900)	[*]
[*]	[*]	Power Supply (SW3900)	[*]
[*]	[*]	Mainboard FRU (SW3900)	[*]
[*]	[*]	LUN Zoning	[*]
[*]	[*]	LUN Zoning	[*]
[*]	[*]	LUN Zoning	[*]
[*]	[*]	Secure Fabric OS (SW3200)	[*]
[*]	[*]	Secure Fabric OS (SW3800)	[*]
[*]	[*]	1Gb Secure Fabric OS	[*]

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Amendment #12 to SOW#1 of IBM/Brocade Agreement ROC-P-68
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[*]	[*]	Secure Fabric OS (SW3900)	[*]
[*]	[*]	Secure Fabric OS (SW12000)	[*]
[*]	[*]	Performance Bundle (Trunking and Performance Monitoring)	[*]
[*]	[*]	Performance Bundle (Trunking and Performance Monitoring)	[*]
[*]	[*]	32 Port Fibre Channel Core Switch (SW12000) Includes 2 Stiletto Port Blades, 2 CP Blades, 4 Power Supplies, 3 Blowers, 6 Port Blade Filler Panels, 1 Cable Management Pillar, Fabric OS, Advanced Web Tools, Advanced Zoning, Fabric Watch, Performance Monitoring, Trunking.	[*]
[*]	[*]	Rack Mounting Kit 14U, FRU	[*]
[*]	[*]	Switch Blade 16 port, 2GB	[*]
[*]	[*]	Switch Blade 16 port, 2Gb, FRU	[*]
[*]	[*]	Chassis Door, Includes Plastic and Metal door Components and IBM Front Badge	[*]
[*]	[*]	Control Processor Blade	[*]
[*]	[*]	Stiletto Port Blade Slot Filler Panel, SW12000, FRU	[*]
[*]	[*]	Power Supply , 180-264VAC, 1000W, FRU	[*]
[*]	[*]	Blower Assembly, FRU	[*]
[*]	[*]	Cable Management Pillar, FRU	[*]
[*]	[*]	WWN Card	[*]
[*]	[*]	Power Plug, Switch and Distribution Panel	[*]
[*]	[*]	Chassis FRU, includes backplane, blower and power supply backplane, AC and blower harness.	[*]

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Amendment #12 to SOW#1 of IBM/Brocade Agreement ROC-P-68
August 24, 2003

[*]	[*]	Rear WWN Bezel Assy	[*]
[*]	[*]	Cable Management Tray	[*]
[*]	[*]	AC Power Cord, FRU	[*]
[*]	[*]	AC Power Cord, UK/Ireland, 250V, FRU	[*]
[*]	[*]	AC Power Cord, Cont. Europe CEE7/7, FRU	[*]
[*]	[*]	AC Power Cord, AUST/INZ, 250V	[*]
[*]	[*]	AC Power Cord, Intl IEC	[*]
[*]	[*]	Remote Switch software	[*]
[*]	[*]	Extended Fabric software	[*]
[*]	[*]	Fabric Manager 3.x	[*]
[*]	[*]	Fabric Manager 4.x-Enterprise (Unlimited copies per one server/PC)	[*]
[*]	[*]	Fabric Manager 4.x - 3.0 to 4.x Upgrade to Enterprise (Unlimited copies per one server/PC)	[*]
[*]	[*]	Fabric Manager 4.x with 10 Domains	[*]
[*]	[*]	Fabric Manager 4.x Upgrade from 10 Domains to Maximum Domains	[*]
[*]	[*]	ISL Trunking (SW3200)	[*]
[*]	[*]	ISL Trunking (SW3800)	[*]

All prices are in U.S. dollars.

* Certain information on this page has been omitted and filed separately with the Commission. Confidential treatment has been requested with respect to the omitted portions.

Amendment #12 to SOW#1 of IBM/Brocade Agreement ROC-P-68
August 24, 2003

Please have your authorized representative indicate acceptance thereof by signing both copies of the Amendment and returning one copy to the attention of Karen Takahashi at 5600 Cottle Road, San Jose, California 95193.

The effective date of this Amendment shall be the date on the top of this Amendment (the "Effective Date").

The parties acknowledge that they have read this Amendment, understand it, and agree to be bound by its terms and conditions. All capitalized terms not defined herein shall have the meaning set forth in the Goods Agreement or the SOW #1. All other terms and conditions of the Goods Agreement and SOW#1 that are unaffected by the revisions set forth in this Amendment shall remain in full force and effect. Further, the parties agree that this Amendment and the Goods Agreement and SOW#1 are the complete and exclusive statement of the agreement between the parties, superseding all proposals or other prior agreement, oral or written, and all other communications between the parties relating to this subject.

ACCEPTED AND AGREED TO:
INTERNATIONAL BUSINESS MACHINES CORPORATION

By: /s/ KAREN TAKABASHI 9/11/03

Authorized Signature Date

Karen Takabashi

Type or Print Name

Procurement Commodity Mgr

Title & Organization

ACCEPTED AND AGREED TO:
BROCADE COMMUNICATIONS SYSTEMS, INC.

By: /s/ JACK CUTHBERT

Authorized Signature Date

Jack Cuthbert

Type or Print Name

VP Worldwide Sales

Title & Organization

* Certain information on this page has been omitted and filed separately with the Commission. Confidential treatment has been requested with respect to the omitted portions.

Amendment #12 to SOW#1 of IBM/Brocade Agreement ROC-P-68
August 24, 2003

. . .
Exhibit 12.1

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

	Fiscal Year Ended				
	October 25, 2003	October 26, 2002	October 27, 2001	October 28, 2000	October 31, 1999
Earnings (loss) from continuing operations before taxes	\$ (133,635)	\$ 84,151	\$ 17,802	\$ 88,316	\$ 2,591
Fixed charges from continuing operations					
Interest expense and amortization of debt discount and issuance costs on all indebtedness	13,339	11,427	--	45	459
Interest included in rent	7,579	6,679	5,507	1,381	428
Total fixed charges from continuing operations	20,917	18,106	5,507	1,426	887
Earnings (loss) before taxes and fixed charges	\$ (112,718)	\$ 102,257	\$ 23,309	\$ 89,742	\$ 3,478
Ratio of earnings to fixed charges (1)	--	5.6x	4.2x	62.9x	3.9x
Coverage deficiency(2)	\$ 133,635	\$ --	\$ --	\$ --	\$ --

(1) The ratio of earnings to fixed charges was computed by dividing earnings (loss) from continuing operations before taxes 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 year ended October 25, 2003, the Company needed additional earnings of \$133.6 million to achieve a ratio of earnings to fixed charges of 1.0x.

SUBSIDIARIES OF REGISTRANT

NAME -----	JURISDICTION OF INCORPORATION -----
Brocade Communications Systems Proprietary Ltd.	Australia
Brocade Communications Systems FSC Inc.	Barbados
Brocade Communications Canada Corp.	Canada
Brocade Communications Systems China HK Ltd.	China
Brocade Communications Denmark ApS	Denmark
Brocade Communications France SAS	France
Brocade Communications GmbH	Germany
Brocade Communications Systems HK Ltd.	Hong Kong
Brocade Communications Italy SrL	Italy
Brocade Communications Systems K.K.	Japan
Brocade Korea Ltd.	Korea
Brocade Communications Luxembourg SarL	Luxembourg
Brocade Communications Systems Netherlands B.V.	The Netherlands
Brocade Communications Singapore Pte. Ltd.	Singapore
Brocade Communications Spain, S.L.	Spain
Brocade Communications Switzerland SarL	Switzerland
Brocade Communications Systems Taiwan Ltd.	Taiwan
Brocade Communications Systems UK Ltd.	United Kingdom
Brocade Communications Systems Belgium S.P.R.L.	Belgium

CONSENT OF KPMG LLP

The Board of Directors
Brocade Communications Systems, Inc.

We hereby consent to the incorporation by reference into Brocade Communications Systems, Inc.'s previously filed Registration Statements on Form S-8 (Nos. 333-103571, 333-85187, 333-95653, 333-39126, 333-53734, 333-64260, 333-72480, and 333-100797) and Form S-3 (No. 333-84698) of our report dated November 14, 2003, except as to note 17, which is as of November 18, 2003, with respect to the consolidated balance sheets of Brocade Communications Systems, Inc. and subsidiaries as of October 25, 2003 and October 26, 2002, and the related consolidated statements of operations, stockholders' equity and comprehensive income (loss), and cash flows for each of the years in the two-year period ended October 25, 2003, and related financial statement schedule, which report appears in this annual report on Form 10-K of Brocade Communications Systems, Inc. for the year ended October 25, 2003.

/s/ KPMG LLP

Mountain View, California
January 19, 2004

CERTIFICATION

I, Gregory L. Reyes, certify that:

1. I have reviewed this annual report on Form 10-K 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: January 20, 2004

By: /s/ Gregory L. Reyes

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

CERTIFICATION

I, Antonio Canova, certify that:

1. I have reviewed this annual report on Form 10-K 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: January 20, 2004

By: /s/ Antonio Canova

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

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 Annual Report of Brocade Communications Systems, Inc. on Form 10-K for the fiscal year ended October 25, 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 Annual Report on Form 10-K 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

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 Annual Report of Brocade Communications Systems, Inc. on Form 10-K for the fiscal year ended October 25, 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 Annual Report on Form 10-K 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