ARMSTRONG WORLD INDUSTRIES INC
Form 10-Q
October 27, 2014
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

x **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the quarterly period ended September 30, 2014

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 1-2116

ARMSTRONG WORLD INDUSTRIES, INC.

(Exact name of registrant as specified in its charter)

Pennsylvania	**23-0366390**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification No.)**
2500 Columbia Avenue, Lancaster, Pennsylvania	**17603**
(Address of principal executive offices)	**(Zip Code)**

Registrant s telephone number, including area code (717) 397-0611

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 x No ¨

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter time period that the registrant was required to submit and post such files). Yes x No ¨

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

Large accelerated filer x	Accelerated filer ¨
Non-accelerated filer ¨	Smaller reporting company ¨

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

Number of shares of Armstrong World Industries, Inc. s common stock outstanding as of October 21, 2014 54,888,401.

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CAUTIONARY NOTE REGARDING FORWARD-LOOKING STATEMENTS

Certain statements in this Quarterly Report on Form 10-Q and the documents incorporated by reference may constitute forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. Those forward-looking statements are subject to various risks and uncertainties and include all statements that are not historical statements of fact and those regarding our intent, belief or expectations, including, but not limited to, our expectations concerning our residential and commercial markets and their effect on our operating results; our expectations regarding the payment of dividends, and our ability to increase revenues, earnings and EBITDA (as such terms are defined by documents incorporated by reference herein). Words such as anticipate, expect, intend, plan, target, project, predict, believe, may, will, would, could, should, seek, estimate and similar exp identify such forward-looking statements. These statements are based on management s current expectations and beliefs and are subject to a number of factors that could lead to actual results materially different from those described in the forward-looking statements. Although we believe that the assumptions underlying the forward-looking statements are reasonable, we can give no assurance that our expectations will be attained. Factors that could have a material adverse effect on our financial condition, liquidity, results of operations or future prospects or which could cause actual results to differ materially from our expectations include, but are not limited to:

- global economic conditions;
- construction activity;
- availability and costs of raw materials and energy;
- our liquidity;
- covenants in our debt agreements;
- our indebtedness;
- competition;
- key customers;
- labor;
- plant construction projects;

our WAVE joint venture;

environmental matters;

availability of deferred tax assets;

strategic transactions;

negative tax consequences;

international operations;

our intellectual property rights;

outsourcing;

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- costs savings and productivity initiatives;
- claims and litigation;
- concentration of share ownership and voting control;
- anti-takeover provisions; and
- other risks detailed from time to time in our filings with the Securities and Exchange Commission (the SEC), press releases and other communications, including those set forth herein, and under Risk Factors included in our Annual Report on Form 10-K and in the documents incorporated by reference.

Such forward-looking statements speak only as of the date they are made. We expressly disclaim any obligation to release publicly any updates or revisions to any forward-looking statements to reflect any change in our expectations with regard thereto or change in events, conditions or circumstances on which any statement is based.

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PART I FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

Armstrong World Industries, Inc., and Subsidiaries

Condensed Consolidated Statements of Earnings and Comprehensive Income

(amounts in millions, except per share data)

Unaudited

	Three Months Ended September 30, 2014	Three Months Ended September 30, 2013	Nine Months Ended September 30, 2014	Nine Months Ended September 30, 2013
Net sales	$ 728.3	$ 729.7	$ 2,072.7	$ 2,058.6
Cost of goods sold	564.1	549.8	1,597.8	1,569.9
Gross profit	164.2	179.9	474.9	488.7
Selling, general and administrative expenses	114.0	103.0	346.0	326.9
Goodwill impairment			0.8	
Restructuring charges, net		(0.1)		(0.2)
Equity earnings from joint venture	(18.8)	(16.6)	(51.2)	(46.2)
Operating income	69.0	93.6	179.3	208.2
Interest expense	11.0	11.4	34.4	56.4
Other non-operating expense	0.6	0.2	7.0	0.9
Other non-operating income	(0.7)		(2.0)	(2.7)
Earnings from continuing operations before income taxes	58.1	82.0	139.9	153.6
Income tax expense	26.3	26.1	70.2	63.9
Earnings from continuing operations	31.8	55.9	69.7	89.7
Loss on sale of discontinued business, net of tax benefit of $ -, ($2.9) ($1.2), and ($3.4)	(0.2)	(5.5)	(2.3)	(6.4)
Net loss from discontinued operations	(0.2)	(5.5)	(2.3)	(6.4)
Net earnings	$ 31.6	$ 50.4	$ 67.4	$ 83.3
Other comprehensive income (loss), net of tax:				
Foreign currency translation adjustments	(14.1)	6.2	(10.0)	(8.7)

Derivative gain (loss)		4.9		(2.7)		(1.3)		13.8
Pension and postretirement adjustments		8.5		3.9		21.3		18.8
Total other comprehensive (loss) income		(0.7)		7.4		10.0		23.9
Total comprehensive income	$	30.9	$	57.8	$	77.4	$	107.2
Earnings per share of common stock, continuing operations:								
Basic	$	0.57	$	0.95	$	1.26	$	1.51
Diluted	$	0.57	$	0.94	$	1.25	$	1.50
Loss per share of common stock, discontinued operations:								
Basic			($	0.09)	($	0.04)	($	0.11)
Diluted			($	0.09)	($	0.04)	($	0.11)
Net earnings per share of common stock:								
Basic	$	0.57	$	0.86	$	1.22	$	1.40
Diluted	$	0.57	$	0.85	$	1.21	$	1.39
Average number of common shares outstanding:								
Basic		55.0		58.4		54.9		58.9
Diluted		55.5		59.0		55.4		59.5

See accompanying notes to Condensed Consolidated Financial Statements beginning on page 9.

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Armstrong World Industries, Inc., and Subsidiaries

Condensed Consolidated Balance Sheets

(amounts in millions, except share data)

	Unaudited September 30, 2014	December 31, 2013
Assets		
Current assets:		
Cash and cash equivalents	$ 148.4	$ 135.2
Accounts and notes receivable, net	252.6	222.2
Inventories, net	415.9	381.7
Deferred income taxes	46.0	72.0
Income tax receivable	11.6	17.4
Other current assets	59.4	55.5
Total current assets	933.9	884.0
Property, plant, and equipment, less accumulated depreciation and amortization of $721.5 and $639.7, respectively	1,128.4	1,107.2
Prepaid pension costs	200.0	167.0
Investment in joint venture	132.2	132.0
Intangible assets, net	514.4	522.9
Deferred income taxes	23.3	30.1
Other non-current assets	73.9	73.4
Total assets	$ 3,006.1	$ 2,916.6
Liabilities and Shareholders Equity		
Current liabilities:		
Current installments of long-term debt	$ 36.5	$ 23.9
Accounts payable and accrued expenses	399.5	383.6
Income tax payable	4.5	2.7
Deferred income taxes	0.7	0.7
Total current liabilities	441.2	410.9
Long-term debt, less current installments	1,013.6	1,042.6
Postretirement benefit liabilities	228.4	234.2
Pension benefit liabilities	207.7	225.5
Other long-term liabilities	58.5	67.5
Income taxes payable	45.8	81.7
Deferred income taxes	234.0	181.0
Total non-current liabilities	1,788.0	1,832.5
Shareholders equity:		

Common stock, $0.01 par value per share, authorized 200 million shares; issued 59,944,849 shares, outstanding 54,887,467 shares in 2014 and 59,464,309 shares issued, 54,406,927 outstanding shares in 2013		0.6		0.6
Capital in excess of par value		1,124.7		1,098.4
Retained earnings		274.6		207.2
Treasury stock, at cost, 5,057,382 shares		(261.4)		(261.4)
Accumulated other comprehensive loss		(361.6)		(371.6)
Total shareholders equity		776.9		673.2
Total liabilities and shareholders equity	$	3,006.1	$	2,916.6

See accompanying notes to Condensed Consolidated Financial Statements beginning on page 9.

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Armstrong World Industries, Inc., and Subsidiaries

Condensed Consolidated Statements of Shareholders Equity

(amounts in millions, except share data)

Unaudited

	Nine Months Ended September 30, 2014							
	Common Stock				Treasury Stock			
	Shares	Amount	Additional Paid-In Capital	Retained Earnings	Shares	Amount	Accumulated Other Comprehensive Loss	Total
Balance at beginning of period	54,406,927	$ 0.6	$ 1,098.4	$ 207.2	5,057,382	($ 261.4)	($ 371.6)	$ 673.2
Stock issuance	480,540							
Share-based employee compensation			26.3					26.3
Net earnings				67.4				67.4
Other comprehensive income							10.0	10.0
Balance at end of period	54,887,467	$ 0.6	$ 1,124.7	$ 274.6	5,057,382	($ 261.4)	($ 361.6)	$ 776.9

	Nine Months Ended September 30, 2013							
	Common Stock				Treasury Stock			
	Shares	Amount	Additional Paid-In Capital	Retained Earnings	Shares	Amount	Accumulated Other Comprehensive Loss	Total
Balance at beginning of period	58,934,050	$ 0.6	$ 1,076.8	$ 113.1			($ 471.4)	$ 719.1
Stock issuance	274,587							
Repurchase of common stock	(5,057,382)				5,057,382	($ 261.4)		(261.4)
Share-based employee compensation			14.7					14.7
Net earnings				83.3				83.3
Other comprehensive income							23.9	23.9

Balance at end of period	54,151,255	$ 0.6	$ 1,091.5	$ 196.4	5,057,382	($ 261.4)	($ 447.5)	$ 579.6

See accompanying notes to Condensed Consolidated Financial Statements beginning on page 9.

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Armstrong World Industries, Inc., and Subsidiaries

Condensed Consolidated Statements of Cash Flows

(amounts in millions)

Unaudited

	Nine Months Ended September 30,	
	2014	2013
Cash flows from operating activities:		
Net earnings	$ 67.4	$ 83.3
Adjustments to reconcile net earnings to net cash provided by operating activities:		
Depreciation and amortization	98.1	79.4
Write off of debt financing costs		18.9
Loss on sale of discontinued operations	3.5	9.8
Fixed asset impairment	16.7	
Deferred income taxes	34.2	28.0
Share-based compensation	10.2	12.7
Equity earnings from joint venture	(51.2)	(46.2)
Other non-cash adjustments, net	11.6	(6.1)
Changes in operating assets and liabilities:		
Receivables	(36.9)	(46.9)
Inventories	(43.4)	(15.9)
Other current assets	(6.1)	(8.7)
Other non-current assets	(7.5)	0.8
Accounts payable and accrued expenses	16.8	54.4
Income taxes payable	14.2	23.7
Other long-term liabilities	(17.4)	(23.6)
Other, net	0.9	(1.9)
Net cash provided by operating activities	111.1	161.7
Cash flows from investing activities:		
Purchases of property, plant and equipment	(151.1)	(139.9)
Return of investment from joint venture	50.8	46.4
(Payment of) proceeds from company owned life insurance, net	(0.3)	(0.1)
Proceeds from settlement of note receivable	1.9	
Proceeds from the sale of assets	1.8	7.2
Net cash (used for) investing activities	(96.9)	(86.4)
Cash flows from financing activities:		
Proceeds from revolving credit facility and other short-term debt	82.8	
Payments of revolving credit facility and other short-term debt	(82.8)	

Proceeds from long-term debt		1,083.0
Payments of long-term debt	(16.3)	(1,086.4)
Financing costs		(7.1)
Special dividends paid	(1.2)	(1.0)
Proceeds from exercised stock options	11.3	4.3
Excess tax benefit from share-based awards	7.5	
Payment for treasury stock acquired		(261.4)
Net cash provided by (used for) financing activities	1.3	(268.6)
Effect of exchange rate changes on cash and cash equivalents	(2.3)	(5.4)
Net increase (decrease) in cash and cash equivalents	13.2	(198.7)
Cash and cash equivalents at beginning of year	135.2	336.4
Cash and cash equivalents at end of period	$ 148.4	$ 137.7
Supplemental Cash Flow Disclosures:		
Interest paid	$ 30.1	$ 32.2
Income taxes paid, net	13.1	8.8
Amounts in accounts payable for capital expenditures	17.5	15.8

See accompanying notes to Condensed Consolidated Financial Statements beginning on page 9.

Armstrong World Industries, Inc., and Subsidiaries

Notes to Condensed Consolidated Financial Statements (Unaudited)

(dollar amounts in millions)

NOTE 1. BUSINESS AND BASIS OF PRESENTATION

Armstrong World Industries, Inc. (AWI) is a Pennsylvania corporation incorporated in 1891. When we refer to we, our and us in these notes, we are referring to AWI and its subsidiaries. We use the term AWI when we are referring solely to Armstrong World Industries, Inc.

In December 2000, AWI filed a voluntary petition for relief (the Filing) under Chapter 11 of the U.S. Bankruptcy Code (the Bankruptcy Code) in the United States Bankruptcy Court for the District of Delaware (the Bankruptcy Court) in order to use the court-supervised reorganization process to achieve a resolution of AWI s asbestos-related liability. On October 2, 2006, AWI s court-approved plan of reorganization became effective and AWI emerged from Chapter 11. All claims in AWI s Chapter 11 case have been resolved and closed.

On October 2, 2006, the Armstrong World Industries, Inc. Asbestos Personal Injury Settlement Trust (the Asbestos PI Trust) was created to address AWI s personal injury (including wrongful death) asbestos-related liability. All present and future asbestos-related personal injury claims against AWI, including contribution claims of co-defendants but excluding certain foreign claims against subsidiaries, arising directly or indirectly out of AWI s pre-Filing use of, or other activities involving, asbestos are channeled to the Asbestos PI Trust.

In August 2009, Armor TPG Holdings LLC (TPG) and the Asbestos PI Trust entered into agreements pursuant to which TPG purchased from the Asbestos PI Trust 7,000,000 shares of our common stock and acquired an economic interest in an additional 1,039,777 shares pursuant to a forward sales contract. During the fourth quarter of 2012, the Asbestos PI Trust and TPG together sold 5,980,000 shares in a secondary public offering. In the third quarter of 2013, the Asbestos PI Trust and TPG together sold 12,057,382 shares in another secondary public offering. Contemporaneously with this secondary public offering, we paid $261.4 million, including associated fees, to buy back 5,057,382 shares, which we currently hold in treasury. The treasury share purchase was funded by existing cash and borrowings under our credit and securitization facilities. In November 2013, the Asbestos PI Trust physically settled the 2009 forward sales contract by delivering to TPG the 1,039,777 shares in which TPG previously held an economic interest. Additionally, during the fourth quarter of 2013, the Asbestos PI Trust and TPG together sold an additional 6,000,000 shares. In March 2014, the Asbestos PI Trust and TPG together sold an additional 3,900,000 shares, which consisted of the last remaining 2,054,977 shares owned by TPG and an additional 1,845,023 shares owned by the Asbestos PI Trust. We did not sell any shares and did not receive any proceeds from these offerings. As a result of these transactions the Asbestos PI Trust currently holds 17.4% of our outstanding shares and TPG no longer owns any of our common stock.

In September 2012, we entered into a definitive agreement to sell our cabinets business for $27.0 million. The sale was completed in October 2012. The transaction was subject to working capital adjustments which were completed in the second quarter of 2013. The financial results related to the cabinets business, which were previously shown as a separate reporting segment, are recorded as discontinued operations for all periods presented. See Note 3 to the Condensed Consolidated Financial Statements for additional financial information related to discontinued operations.

The accounting policies used in preparing the Condensed Consolidated Financial Statements in this Form 10-Q are the same as those used in preparing the Consolidated Financial Statements for the year ended December 31, 2013. These

statements should therefore be read in conjunction with the Consolidated Financial Statements and notes that are included in the Form 10-K for the fiscal year ended December 31, 2013. In the opinion of management, all adjustments of a normal recurring nature have been included to provide a fair statement of the results for the reporting periods presented. Quarterly results are not necessarily indicative of annual earnings, primarily due to the different level of sales in each quarter of the year and the possibility of changes in general economic conditions.

The September 30, 2013 Condensed Consolidated Statement of Cash Flows has been revised to reflect a change between receivables and accounts payable and accrued expenses. Certain other amounts in the prior year s Condensed Consolidated Financial Statements have been recast to conform to the 2014 presentation.

These Condensed Consolidated Financial Statements are prepared in accordance with U.S. generally accepted accounting principles (U.S. GAAP). The statements include management estimates and judgments, where appropriate. Management utilizes estimates to record many items including certain asset values, allowances for

Armstrong World Industries, Inc., and Subsidiaries

Notes to Condensed Consolidated Financial Statements (Unaudited)

(dollar amounts in millions)

bad debts, inventory obsolescence and lower of cost or market charges, warranty reserves, workers compensation, general liability and environmental claims and income taxes. When preparing an estimate, management determines the amount based upon the consideration of relevant information. Management may confer with outside parties, including outside counsel. Actual results may differ from these estimates.

In April 2014, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2014-08 *Reporting Discontinued Operations and Disclosures of Disposals of Components of an Entity* which is part of Accounting Standards Codification (ASC) 205: Presentation of Financial Statements and ASC 360: Property, Plant and Equipment. The amendments in this guidance change the requirements for reporting discontinued operations. Under the new guidance a disposal of a component of an entity or a group of components is required to be reported in discontinued operations if the disposal represents a strategic shift that has (or will have) a major effect on an entity s operations and financial results. The guidance is effective prospectively for disposals that occur within annual periods beginning on or after December 15, 2014. We do not expect a material impact to our financial condition, results of operations or cash flows from the adoption of this guidance.

In May 2014, the FASB issued ASU 2014-09 *Revenue from Contracts with Customers* . The guidance requires an entity to recognize the amount of revenue to which it expects to be entitled for the transfer of promised goods or services to a customer. The ASU will replace most existing revenue recognition guidance in U.S. GAAP when it becomes effective, January 1, 2017. Early application is not permitted, but the standard permits the use of either the retrospective or cumulative effect transition method. We have not selected a transition method and are currently evaluating the impact this guidance will have on our financial condition, results of operations and cash flows.

In June 2014, the FASB issued ASU 2014-12 *Accounting for Share-Based Payments When the Terms of an Award Provide That a Performance Target Could Be Achieved after the Requisite Service Period* which is part of ASC 718: Compensation-Stock Compensation. The guidance requires that a performance target that affects vesting and that could be achieved after the requisite service period be treated as a performance condition and should not be reflected in the estimate of the grant-date fair value of the award. The guidance is effective for annual periods beginning after December 15, 2015. The guidance can be applied prospectively for all awards granted or modified after the effective date or retrospectively to all awards with performance targets outstanding as of the beginning of the earliest annual period presented in the financial statements and to all new or modified awards thereafter. We do not expect a material impact on our financial condition, results of operation or cash flows from the adoption of this guidance.

In February 2013, the FASB issued ASU 2013-04 *Obligations Resulting from Joint and Several Liability Arrangements for Which the Total Amount of the Obligation Is Fixed at the Reporting Date* which is part of ASC 405: Liabilities. The guidance requires an entity to measure obligations resulting from joint and several liability arrangements, within the scope of this ASU, as the amount the reporting entity agreed to pay on the basis of its arrangement among its co-obligors and any additional amount the reporting entity expects to pay on behalf of its co-obligors. The guidance requires an entity to disclose the nature and amount of the obligation. The guidance is to be applied retrospectively and was effective for us beginning January 1, 2014. There was no impact on our financial condition, results of operations or cash flows as a result of the adoption of this guidance.

In July 2013, the FASB issued ASU 2013-11 *Income Taxes Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists* which is part of ASC 740: Income Taxes. The guidance requires an entity to present an unrecognized tax benefit and a net operating loss (NOL) carryforward, a similar tax loss, or a tax credit carryforward on a net basis as part of a deferred tax asset, unless the unrecognized tax benefit is not available to reduce the deferred tax asset component or would not be utilized for that purpose, then a liability would be recognized. The guidance was applied prospectively and was effective for us beginning January 1, 2014. As a result of adopting this guidance, we recorded a reduction to non-current income taxes payable and a corresponding increase to non-current deferred tax liabilities of $40.0 million. There was no impact on results of operations or cash flows as a result of the adoption of this guidance.

Operating results for the third quarter and first nine months of 2014 and 2013 included in this report are unaudited. However, these Condensed Consolidated Financial Statements have been reviewed by an

Armstrong World Industries, Inc., and Subsidiaries

Notes to Condensed Consolidated Financial Statements (Unaudited)

(dollar amounts in millions)

independent registered public accounting firm in accordance with standards of the Public Company Accounting Oversight Board (United States) for a limited review of interim financial information.

NOTE 2. SEGMENT RESULTS

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
Net sales to external customers				
Building Products	$ 351.7	$ 335.5	$ 983.4	$ 944.6
Resilient Flooring	239.6	246.2	694.8	713.1
Wood Flooring	137.0	148.0	394.5	400.9
Total net sales to external customers	$ 728.3	$ 729.7	$ 2,072.7	$ 2,058.6

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
Segment operating income (loss)				
Building Products	$ 86.6	$ 86.7	$ 209.3	$ 210.7
Resilient Flooring	(1.7)	22.5	22.8	46.6
Wood Flooring	2.0	2.6	4.5	5.6
Unallocated Corporate	(17.9)	(18.2)	(57.3)	(54.7)
Total consolidated operating income	$ 69.0	$ 93.6	$ 179.3	$ 208.2

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
Total consolidated operating income	$ 69.0	$ 93.6	$ 179.3	$ 208.2
Interest expense	11.0	11.4	34.4	56.4
Other non-operating expense	0.6	0.2	7.0	0.9
Other non-operating income	(0.7)		(2.0)	(2.7)
Earnings from continuing operations before income taxes	$ 58.1	$ 82.0	$ 139.9	$ 153.6

	September 30, 2014	December 31, 2013
Segment assets		
Building Products	$ 1,120.1	$ 1,071.9
Resilient Flooring	649.7	635.2
Wood Flooring	359.9	335.2
Unallocated Corporate	876.4	874.3
Total consolidated assets	$ 3,006.1	$ 2,916.6

Impairment testing of our tangible assets occurs whenever events or changes in circumstances indicate that the carrying amount of the assets may not be recoverable. In June 2014, we made the decision to dispose of certain idle equipment at five of our wood flooring manufacturing facilities and as a result we recorded a $4.4 million impairment charge in cost of goods sold.

Armstrong World Industries, Inc., and Subsidiaries

Notes to Condensed Consolidated Financial Statements (Unaudited)

(dollar amounts in millions)

During the second quarter of 2014, we decided to close our resilient flooring plant in Thomastown, Australia and our engineered wood flooring plant in Kunshan, China. In the second and third quarters of 2014, we recorded $0.5 million and $1.7 million, respectively, in cost of goods sold for fixed asset accelerated depreciation due to the closure of the resilient flooring plant in Australia. We also recorded $1.0 million and $3.0 million in the second and third quarters of 2014, respectively, in cost of goods sold for fixed asset accelerated depreciation due to the closure of the wood flooring plant in China. Additionally, in the second quarter of 2014, we recorded a charge of $0.8 million in selling, general and administrative cost for the impairment of goodwill related to the closure of the wood flooring plant in China.

Our European Resilient Flooring business continues to report disappointing operating results. As a result, we recorded an asset impairment charge of $11.9 million in the third quarter of 2014. We continue to evaluate strategic alternatives for this business. No strategic alternative has been selected and approved by management or the Board of Directors at this time, but we believe a decision remains possible before the end of 2014. That decision may have a further impact on the carrying value of the European Resilient Flooring assets and liabilities. The carrying value of assets was $152.0 million as of September 30, 2014, which included property, plant & equipment of $73.4 million and inventory of $57.1 million. The carrying value of liabilities was $171.3 million as of September 30, 2014, including an unfunded pension liability of $126.5 million.

NOTE 3. DISCONTINUED OPERATIONS

In September 2012, we entered into a definitive agreement to sell our cabinets business to American Industrial Partners (AIP) for $27.0 million in cash. During the third quarter of 2012, we recorded an impairment charge of $17.5 million on the cabinets assets to reflect the expected proceeds from the sale. The sale was completed in October 2012, with working capital adjustments completed in the second quarter of 2013.

During the third quarter of 2013, we recorded an estimated liability of $7.5 million for a potential withdrawal liability related to a multi-employer pension plan. We have been making regular quarterly payments pending resolution of the matter. During the second quarter of 2014, we recorded an additional $3.3 million expense to increase the total estimated remaining liability to $10.0 million. In August 2014, we entered into a settlement agreement with the Carpenters Labor-Management Pension Fund (the Fund) to resolve this matter for $10.3 million, including a complete release of all claims against us. As a result of the settlement, we recorded an additional charge of $0.3 million during the third quarter of 2014 within discontinued operations. Payment was made to the Fund in the third quarter of 2014. See Note 18 to the Condensed Consolidated Financial Statements for further information.

The Condensed Consolidated Statement of Cash Flows does not separately report the cash flows of the discontinued operation.

The following is a summary of the results related to the cabinets business, which are included in discontinued operations.

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
Net Sales				
Loss before income tax	($ 0.2)	($ 8.4)	($ 3.5)	($ 9.8)
Income tax benefit		2.9	1.2	3.4
Net loss from discontinued operations	($ 0.2)	($ 5.5)	($ 2.3)	($ 6.4)

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NOTE 4. ACCOUNTS AND NOTES RECEIVABLE

	September 30, 2014	December 31, 2013
Customer receivables	$ 271.6	$ 242.7
Customer notes	1.0	1.6
Miscellaneous receivables	7.8	5.9
Less allowance for warranties, discounts and losses	(27.8)	(28.0)
Accounts and notes receivable, net	$ 252.6	$ 222.2

Generally, we sell our products to select, pre-approved customers whose businesses are affected by changes in economic and market conditions. We consider these factors and the financial condition of each customer when establishing our allowance for losses from doubtful accounts.

NOTE 5. INVENTORIES

	September 30, 2014	December 31, 2013
Finished goods	$ 307.5	$ 292.8
Goods in process	32.4	29.2
Raw materials and supplies	143.1	118.6
Less LIFO and other reserves	(67.1)	(58.9)
Total inventories, net	$ 415.9	$ 381.7

NOTE 6. OTHER CURRENT ASSETS

	September 30, 2014	December 31, 2013
Prepaid expenses	$ 49.3	$ 46.0
Fair value of derivative assets	4.5	5.9
Other	5.6	3.6

Total other current assets	$	59.4	$	55.5

NOTE 7. EQUITY INVESTMENT

Investment in joint venture at September 30, 2014 reflected our 50% equity interest in our Worthington Armstrong Venture (WAVE) joint venture with Worthington Industries, Inc. Condensed income statement data for WAVE is summarized below:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
Net sales	$ 105.8	$ 102.5	$ 298.6	$ 291.0
Gross profit	51.6	47.4	142.3	132.5
Net earnings	40.6	36.8	109.8	102.7

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NOTE 8. INTANGIBLE ASSETS

The following table details amounts related to our intangible assets as of September 30, 2014 and December 31, 2013.

		September 30, 2014		December 31, 2013	
	Estimated Useful Life	Gross Carrying Amount	Accumulated Amortization	Gross Carrying Amount	Accumulated Amortization
Amortizing intangible assets					
Customer relationships	20 years	$ 165.5	$ 66.3	$ 165.5	$ 60.2
Developed technology	15 years	84.0	43.8	83.1	39.4
Other	Various	21.5	2.2	21.5	1.9
Total		$ 271.0	$ 112.3	$ 270.1	$ 101.5
Non-amortizing intangible assets					
Trademarks and brand names	Indefinite	355.7		354.3	
Total intangible assets		$ 626.7		$ 624.4	

	Nine Months Ended September 30,	
	2014	2013
Amortization expense	$ 10.9	$ 10.8

NOTE 9. SEVERANCES AND RELATED COSTS

In the second and third quarters of 2014, we recorded $1.7 million and $0.2 million, respectively, in cost of goods sold for severance and related costs due to the closure of a resilient flooring plant in Australia. We also recorded $1.4 million and $0.7 million in the second and third quarters of 2014, respectively, in cost of goods sold for severance and related costs due to the closure of a wood flooring plant in China. Both plants were closed due to excess capacity and ceased operations in the third quarter of 2014.

In the first quarter of 2013, we recorded $5.2 million for severance and related costs to reflect approximately 40 position eliminations in our European Resilient Flooring business ($1.8 million in cost of goods sold and $1.0 million in selling, general and administrative (SG&A) expense) and approximately 40 position eliminations in our Resilient

Flooring business in Australia ($2.4 million in cost of goods sold).

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NOTE 10. INCOME TAX EXPENSE

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
Earnings from continuing operations before income taxes	$ 58.1	$ 82.0	$ 139.9	$ 153.6
Income tax expense	26.3	26.1	70.2	63.9
Effective tax rate	45.3%	31.8%	50.2%	41.6%

The effective tax rate for the third quarter and first nine months of 2014 was higher than the comparable period of 2013 primarily due to increased losses in foreign jurisdictions which was impacted by the European Resilient Flooring fixed asset impairment charge and a decrease in consolidated pre-tax income which increased the impact of the losses on the effective tax rate. Tax benefits for foreign losses, which would have reduced consolidated income tax expense, were not recorded (unbenefitted) because our ability to utilize these tax benefits in future periods is uncertain.

We do not expect to record any material changes during 2014 to unrecognized tax benefits that were claimed on tax returns covering tax years ended on or before December 31, 2013.

As of September 30, 2014, we consider foreign unremitted earnings to be permanently reinvested.

NOTE 11. DEBT

In March 2013, we refinanced our $1.3 billion senior credit facility and amended the underlying credit agreement. The amended facility is composed of a $250 million revolving credit facility (with a $150 million sublimit for letters of credit), a $550 million Term Loan A and a $475 million Term Loan B. The terms of the facility resulted in a lower interest rate spread (2.5% vs. 3.0%) than our previous facility. We also extended the maturity of Term Loan A from November 2015 to March 2018 and of Term Loan B from March 2018 to March 2020. The facility is secured by U.S. personal property, the capital stock of material U.S. subsidiaries, and a pledge of 65% of the stock of our material first tier foreign subsidiaries. In connection with the refinancing, we incurred $8.3 million for bank, legal, and other fees, of which $7.2 million was capitalized and is being amortized into interest expense over the life of the loans. Additionally, we wrote off $18.9 million of unamortized debt financing costs in the first quarter of 2013 related to our previous credit facility to interest expense (see Liquidity for further information).

As of September 30, 2014, we were in compliance with all covenants of the amended senior credit facility. Our debt agreements include other restrictions, including restrictions pertaining to the acquisition of additional debt, the redemption, repurchase or retirement of our capital stock, payment of dividends, and certain financial transactions as it relates to specified assets. We currently believe that default under these covenants is unlikely, and that fully borrowing under our revolving credit facility would not violate these covenants.

In March 2013, we amended our $100 million Accounts Receivable Securitization Facility with the Bank of Nova Scotia. We decreased the facility to $75 million to reduce commitment fees on unused capacity. The maturity was extended to March 2016.

There were no outstanding balances on the revolving credit facility and accounts receivable securitization facility as of September 30, 2014 and December 31, 2013.

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NOTE 12. PENSIONS AND OTHER BENEFIT PROGRAMS

Following are the components of net periodic benefit costs:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
U.S. defined-benefit plans:				
Pension benefits				
Service cost of benefits earned during the period	$ 3.6	$ 4.3	$ 10.8	$ 12.7
Interest cost on projected benefit obligation	21.4	19.9	64.2	59.8
Expected return on plan assets	(34.8)	(34.2)	(104.4)	(102.4)
Amortization of prior service cost	0.5	0.5	1.4	1.4
Amortization of net actuarial loss	10.6	10.2	31.8	30.7
Net periodic pension cost	$ 1.3	$ 0.7	$ 3.8	$ 2.2
Retiree health and life insurance benefits				
Service cost of benefits earned during the period	$ 0.2	$ 0.3	$ 0.7	$ 0.9
Interest cost on projected benefit obligation	2.8	2.4	8.2	7.3
Amortization of prior service credit	(0.2)	(0.2)	(0.5)	(0.5)
Amortization of net actuarial gain	(1.0)	(0.8)	(3.1)	(2.7)
Net periodic postretirement benefit cost	$ 1.8	$ 1.7	$ 5.3	$ 5.0
Non-U.S. defined-benefit pension plans				
Service cost of benefits earned during the period	$ 0.6	$ 0.8	$ 2.1	$ 2.2
Interest cost on projected benefit obligation	3.6	3.2	10.6	9.8
Expected return on plan assets	(2.9)	(2.3)	(8.7)	(7.1)
Amortization of net actuarial loss	0.5	0.7	1.6	2.1
Net periodic pension cost	$ 1.8	$ 2.4	$ 5.6	$ 7.0

NOTE 13. FINANCIAL INSTRUMENTS

We do not hold or issue financial instruments for trading purposes. The estimated fair values of our financial instruments are as follows:

	September 30, 2014		December 31, 2013	
	Carrying amount	Estimated fair value	Carrying amount	Estimated fair value
Assets (Liabilities), net:				
Total long-term debt, including current portion	($ 1,050.1)	($ 1,042.9)	($ 1,066.5)	($ 1,065.2)
Foreign currency contract obligations	4.1	4.1	5.2	5.2
Natural gas contracts	(0.3)	(0.3)	0.5	0.5
Interest rate swap contracts	(6.6)	(6.6)	(7.9)	(7.9)

The carrying amounts of cash and cash equivalents, receivables, accounts payable, accrued expenses, and short-term debt approximate fair value because of the short-term maturity of these instruments. The fair value estimates of long-term debt were based upon quotes from a major financial institution of recently observed trading levels of our Term Loan B debt. The fair value estimates of foreign currency contract obligations are estimated from market quotes provided by a well-recognized national market data provider. The fair value estimates of natural gas contracts are estimated using internal valuation models with verification by obtaining quotes from major financial institutions. For natural gas swap transactions, fair value is calculated using NYMEX market quotes provided by a well-recognized national market data provider. For natural gas option based strategies, fair value is calculated using an industry standard Black-Scholes model with market based inputs, including but not limited to, underlying asset price, strike price, implied volatility, discounted risk free rate and time to expiration, provided by a well-recognized national market data provider. The fair value estimates for

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interest rate swap contracts are estimated by obtaining quotes from major financial institutions with verification by internal valuation models.

Fair value is defined as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants at the measurement date. U.S. GAAP establishes a three-level fair value hierarchy that prioritizes the inputs used to measure fair value. The three levels of inputs used to measure fair value are as follows:

Level 1	Quoted prices in active markets for identical assets or liabilities.
Level 2	Observable inputs other than quoted prices included in Level 1, such as quoted prices for similar assets and liabilities in active markets; quoted prices for identical or similar assets and liabilities in markets that are not active; or other inputs that are observable or can be corroborated by observable market data.
Level 3	Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities. This includes certain pricing models, discounted cash flow methodologies and similar techniques that use significant unobservable inputs.

Assets and liabilities are summarized below:

	September 30, 2014 Fair value based on		December 31, 2013 Fair value based on	
	Quoted, active markets Level 1	Other observable inputs Level 2	Quoted, active markets Level 1	Other observable inputs Level 2
Assets (Liabilities), net:				
Total long-term debt, including current portion	($ 464.4)	($ 578.5)	($ 470.9)	($ 594.3)
Foreign currency contract obligations	4.1		5.2	
Natural gas contracts		(0.3)		0.5
Interest rate swap contracts		(6.6)		(7.9)

We do not have any financial assets or liabilities that are valued using Level 3 (unobservable) inputs.

NOTE 14. DERIVATIVE FINANCIAL INSTRUMENTS

We are exposed to market risk from changes in foreign exchange rates, interest rates and commodity prices that could impact our results of operations, cash flows and financial condition. We use forward swaps and option contracts to hedge these exposures. Exposure to individual counterparties is controlled and derivative financial instruments are

entered into with a diversified group of major financial institutions. Forward swaps and option contracts are entered into for periods consistent with underlying exposure and do not constitute positions independent of those exposures. At inception, hedges that we designate as hedging instruments are formally documented as either (1) a hedge of a forecasted transaction or cash flow hedge, or (2) a hedge of the fair value of a recognized liability or asset or fair value hedge. We also formally assess both at inception and at least quarterly thereafter, whether the derivatives that are used in hedging transactions are highly effective in offsetting changes in either the fair value or cash flows of the hedged item. If it is determined that a derivative ceases to be a highly effective hedge, or if the anticipated transaction is no longer probable of occurring, we discontinue hedge accounting, and any future mark-to-market adjustments are recognized in earnings. We use derivative financial instruments as risk management tools and not for speculative trading purposes.

Counterparty Risk

We only enter into derivative transactions with established counterparties having a credit rating of BBB or better. We monitor counterparty credit default swap levels and credit ratings on a regular basis. All of our derivative transactions with counterparties are governed by master International Swap and Derivatives Association

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agreements (ISDAs) with netting arrangements. These agreements can limit our exposure in situations where we have gain and loss positions outstanding with a single counterparty. We do not post nor do we receive cash collateral with any counterparty for our derivative transactions. These ISDAs do not have any credit contingent features; however, a default under our bank credit facility would trigger a default under these agreements. Exposure to individual counterparties is controlled, and thus we consider the risk of counterparty default to be negligible.

Commodity Price Risk

We purchase natural gas for use in the manufacturing process and to heat many of our facilities. As a result, we are exposed to fluctuations in the price of natural gas. We have a policy to reduce cost volatility for North American natural gas purchases by purchasing natural gas forward contracts and swaps, purchased call options, and zero-cost collars up to 24 months forward to reduce our overall exposure to natural gas price movements. The contracts are based on forecasted usage of natural gas measured in mmBtu s. There is a high correlation between the hedged item and the hedged instrument. The gains and losses on these transactions offset gains and losses on the transactions being hedged. These instruments are designated as cash flow hedges. At September 30, 2014 and December 31, 2013, the notional amount of these hedges was $16.8 million and $20.1 million, respectively. The mark-to-market gain or loss on qualifying hedges is included in other comprehensive income to the extent effective, and reclassified into cost of goods sold in the period during which the underlying gas is consumed. The mark-to-market gains or losses on ineffective portions of hedges are recognized in cost of goods sold immediately. The earnings impact of the ineffective portion of these hedges was not material for the third quarter and first nine months of 2014 and 2013.

Currency Rate Risk Sales and Purchases

We manufacture and sell our products in a number of countries throughout the world and, as a result, we are exposed to movements in foreign currency exchange rates. To a large extent, our global manufacturing and sales provide a natural hedge of foreign currency exchange rate movement, as foreign currency expenses generally offset foreign currency revenues. We manage our cash flow exposures on a net basis and use derivatives to hedge the majority of our unmatched foreign currency cash inflows and outflows. As of September 30, 2014, our major pre-hedging foreign currency exposures are to the Canadian dollar, the Chinese Renminbi and the Euro.

We use foreign currency forward exchange contracts to reduce our exposure to the risk that the eventual net cash inflows and outflows resulting from the sale of products to foreign customers and purchases from foreign suppliers will be adversely affected by changes in exchange rates. These derivative instruments are used for forecasted transactions and are classified as cash flow hedges. Cash flow hedges are executed quarterly, generally up to 15 months forward, and allow us to further reduce our overall exposure to exchange rate movements, since gains and losses on these contracts offset gains and losses on the transactions being hedged. The notional amount of these hedges was $116.0 million and $130.9 million at September 30, 2014 and December 31, 2013, respectively. Gains and losses on these instruments are recorded in other comprehensive income, to the extent effective, until the underlying transaction is recognized in earnings. The earnings impact of the ineffective portion of these hedges was not material for the third quarter and first nine months of 2014 and 2013.

Currency Rate Risk Intercompany Loans and Dividends

We may use foreign currency forward exchange contracts to hedge exposures created by cross-currency intercompany loans and dividends. The translation adjustments related to these loans are recorded in other non-operating income or expense. The offsetting gains or losses on the related derivative contracts are also recorded in other non-operating income or expense. These contracts are decreased or increased as repayments are made or additional intercompany loans are extended or adjusted for intercompany dividend activity as necessary. The notional amount of these hedges was $68.6 million and $36.7 million at September 30, 2014 and December 31, 2013, respectively.

Interest Rate Risk

We utilize interest rate swaps to minimize the fluctuations in earnings caused by interest rate volatility. As a result of interest rate fluctuations, interest expense on variable-rate liabilities will increase or decrease. The following table summarizes our interest rate swaps (dollar amounts in millions):

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Trade Date	Notional Amount	Interest Rate Paid	Coverage Period	Risk Coverage
March 31, 2011	$ 100.0	2.303%	March 2011 to November 2015	Term Loan A
March 31, 2011	$ 200.0	2.523%	March 2011 to November 2015	Term Loan B
March 27, 2012	$ 250.0	1.928%	March 2012 to March 2018	Term Loan B
March 27, 2012	$ 200.0	2.810%	November 2015 to March 2018	Term Loan B
April 16, 2013	$ 250.0	1.398%	November 2015 to March 2018	Term Loan A

Under the terms of the Term Loan A swaps we receive 3-month LIBOR and pay a fixed rate over the hedged period. Under the terms of the Term Loan B swaps, we receive the greater of 3-month LIBOR or the 1% LIBOR Floor and pay a fixed rate over the hedged period. These swaps are designated as cash flow hedges against changes in LIBOR for a portion of our variable rate debt.

Financial Statement Impacts

The following tables detail amounts related to our derivatives as of September 30, 2014 and December 31, 2013. Our derivative assets not designated as hedging instruments were not material at September 30, 2014 and December 31, 2013. Our derivative liabilities not designated as hedging instruments were not material at September 30, 2014 and were $0.6 million at December 31, 2013. The derivative asset and liability amounts below are shown in gross amounts; we have not netted assets with liabilities.

	Derivative Assets			Derivative Liabilities		
		Fair Value			Fair Value	
	Balance Sheet Location	September 30, 2014	December 31, 2013	Balance Sheet Location	September 30, 2014	December 31, 2013
Derivatives designated as hedging instruments						
Natural gas commodity contracts	Other current assets	$ 0.2	$ 0.7	Accounts payable and accrued expenses	$ 0.5	$ 0.2
Foreign exchange contracts	Other current assets	3.8	5.2	Accounts payable and accrued expenses	0.6	
Foreign exchange contracts	Other non-current assets	0.6	0.6	Other long-term liabilities	0.1	
Interest rate swap contracts	Other non-current assets	2.8	4.6	Other long-term liabilities	9.4	12.5

Total derivatives designated as hedging instruments	$ 7.4	$ 11.1	$ 10.6	$ 12.7

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	Amount of Gain (Loss) Recognized in Accumulated Other Comprehensive Income (AOCI) (Effective Portion)(a)		Location of Gain (Loss) Reclassified from AOCI into Income (Effective Portion)	Gain (Loss) Reclassified from AOCI into Income (Effective Portion)			
	Nine Months Ended September 30,			Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013		2014	2013	2014	2013
Derivatives in Cash Flow Hedging Relationships							
Natural gas commodity contracts	($ 0.3)	($ 0.5)	Cost of goods sold	($ 0.2)	($ 0.3)	$ 0.9	($ 2.3)
Foreign exchange contracts purchases	0.6	1.9	Cost of goods sold	0.3	0.7	0.8	0.8
Foreign exchange contracts sales	3.0		Net sales	0.8		3.5	
Interest rate swap contracts	(6.6)	(10.6)	Interest Expense				
Total	($ 3.3)	($ 9.2)		$ 0.9	$ 0.4	$ 5.2	($ 1.5)

(a) As of September 30, 2014 the amount of existing gains in AOCI expected to be recognized in earnings over the next twelve months is $2.9 million.

	Location of Gain (Loss) Recognized in Income on Derivatives (Ineffective Portion) (a)
Derivatives in Cash Flow Hedging Relationships	
Natural gas commodity contracts	Cost of goods sold
Foreign exchange contracts purchases and sales	SG&A expense
Interest rate swap contracts	Interest expense

(a) The amount recognized in income related to the ineffective portion of the hedging relationships was immaterial for the third quarter and first nine months of 2014 and 2013. No gains or losses are excluded from the assessment of the hedge effectiveness.

The amount of pre-tax gain recognized in income for derivative instruments not designated as hedging instruments was $8.9 million for the third quarter and $6.5 million for the first nine months of 2014. No gain or loss was recognized in the third quarter or first nine months of 2013.

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NOTE 15. PRODUCT WARRANTIES

We provide direct customer and end-user warranties for our products. These warranties cover manufacturing defects that would prevent the product from performing in line with its intended and marketed use. The terms of these warranties vary by product. We collect and analyze warranty claims data with a focus on the historic amount of claims, the products involved, the amount of time between the warranty claims and their respective sales and the amount of current sales. The following table summarizes the activity for the accrual of product warranties for the first nine months of 2014 and 2013:

	2014	2013
Balance at January 1,	$ 9.9	$ 11.5
Reductions for payments	(10.6)	(12.3)
Current year warranty accruals	11.1	12.3
Preexisting warranty accrual changes	(0.1)	(0.3)
Effects of foreign exchange translation	(0.1)	(0.1)
Balance at September 30,	$ 10.2	$ 11.1

The warranty provision and related reserve are recorded as a reduction of sales and accounts receivable.

NOTE 16. OTHER LONG-TERM LIABILITIES

	September 30, 2014	December 31, 2013
Long-term deferred compensation arrangements	$ 21.5	$ 22.8
Long-term portion of derivative liabilities	9.5	12.5
U.S. workers compensation	5.3	8.7
Postemployment benefit liabilities	8.3	8.0
Environmental liabilities	7.2	8.3
Other	6.7	7.2
Total other long-term liabilities	$ 58.5	$ 67.5

NOTE 17. ACCUMULATED OTHER COMPREHENSIVE INCOME

	Foreign Currency Translation Adjustments [1]	Derivative Adjustments [1]	Pension and Postretirement Adjustments [1]	Total Accumulated Other Comprehensive Loss [1]
Balance, December 31, 2013	$ 21.3	($ 0.7)	($ 392.2)	($ 371.6)
Other comprehensive income before reclassifications, net of tax expense of $ -, ($1.5), ($0.3), and ($1.8)	(10.0)	2.1	1.0	(6.9)
Amounts reclassified from accumulated other comprehensive (loss) income		(3.4)	20.3	16.9
Net current period other comprehensive (loss) income	(10.0)	(1.3)	21.3	10.0
Balance at September 30, 2014	$ 11.3	($ 2.0)	($ 370.9)	($ 361.6)

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	Foreign Currency Translation Adjustments [1]	Derivative Adjustments [1]	Pension and Postretirement Adjustments [1]	Total Accumulated Other Comprehensive Loss [1]
Balance, December 31, 2012	$ 30.1	($ 19.2)	($ 482.3)	($ 471.4)
Other comprehensive income before reclassifications, net of tax (expense) benefit of $ -, ($6.6), $0.7, and ($5.9)	(8.7)	12.8	(1.3)	2.8
Amounts reclassified from accumulated other comprehensive income		1.0	20.1	21.1
Net current period other comprehensive (loss) income	(8.7)	13.8	18.8	23.9
Balance at September 30, 2013	$ 21.4	($ 5.4)	($ 463.5)	($ 447.5)

(1) Amounts are net of tax

	Amounts Reclassified from Accumulated Other Comprehensive Income Nine Months Ended September 30, 2014	2013	Affected Line Item in the Consolidated Statement of Earnings and Comprehensive Income
Derivative Adjustments:			
Natural gas commodity contracts	($ 0.9)	$ 2.3	Cost of goods sold
Foreign exchange contracts purchases	(0.8)	(0.8)	Cost of goods sold
Foreign exchange contracts sales	(3.5)		Net sales
Total (income) expense before tax	(5.2)	1.5	
Tax impact	1.8	(0.5)	Income tax expense
Total (income) expense, net of tax	(3.4)	1.0	

Pension and Postretirement Adjustments:			
Prior service cost amortization	0.4	0.6	Cost of goods sold
Prior service cost amortization	0.5	0.4	SG&A expense
Amortization of net actuarial loss	16.3	16.0	Cost of goods sold
Amortization of net actuarial loss	14.0	14.0	SG&A expense
Total expense before tax	31.2	31.0	
Tax impact	(10.9)	(10.9)	Income tax expense
Total expense, net of tax	20.3	20.1	
Total reclassifications for the period	$ 16.9	$ 21.1	

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NOTE 18. LITIGATION AND RELATED MATTERS

ENVIRONMENTAL MATTERS

Environmental Compliance

Our manufacturing and research facilities are affected by various federal, state and local requirements relating to the discharge of materials and the protection of the environment. We make expenditures necessary for compliance with applicable environmental requirements at each of our operating facilities. These regulatory requirements continually change, therefore we cannot predict with certainty future expenditures associated with compliance with environmental requirements.

Environmental Sites

Summary

We are actively involved in the investigation, closure and/or remediation of existing or potential environmental contamination under the Comprehensive Environmental Response, Compensation and Liability Act, and state or international Superfund and similar type environmental laws at several domestically- and internationally-owned, formerly owned and non-owned locations allegedly resulting from past industrial activity. In a few cases, we are one of several potentially responsible parties and have agreed to jointly fund the required investigation and remediation, while preserving our defenses to the liability. We may also have rights of contribution or reimbursement from other parties or coverage under applicable insurance policies. We are currently pursuing coverage and recoveries under those policies with respect to certain of the sites, but we are unable to predict the outcome or costs of these proceedings.

Estimates of our future liability at the environmental sites are based on evaluations of currently available facts regarding each individual site. We consider factors such as our activities associated with the site, existing technology, presently enacted laws and regulations and prior company experience in remediating contaminated sites. Although current law imposes joint and several liability on all parties at Superfund sites, our contribution to the remediation of these sites is expected to be limited by the number of other companies potentially liable for site remediation. As a result, our estimated liability reflects only our expected share. In determining the probability of contribution, we consider the solvency of other parties, the site activities of other parties, whether liability is being disputed, the terms of any existing agreements and experience with similar matters, and the effect of our Chapter 11 reorganization upon the validity of the claim.

Specific Material Events

St Helens, OR

In August 2010, we entered into a Consent Order (the Consent Order) with the Oregon Department of Environmental Quality (ODEQ), along with Kaiser Gypsum Company, Inc. (Kaiser), and Owens Corning Sales LLC (OC), with respect to our St. Helens, OR Building Products facility, which was previously owned by Kaiser and then OC. The Consent Order, which replaces a previous order of the ODEQ requiring us to investigate and remediate hazardous substances present at the facility, requires that we and Kaiser complete a remedial investigation and feasibility study (RI/FS) on the portion of the site owned by us (Owned Property), which is comprised of Upland and Lowland areas. The Consent Order further requires us, Kaiser and OC to conduct an RI/FS in the In-Water area of the adjacent Scappoose Bay. We are currently in an investigation phase for both the Owned Property and the Scappoose Bay and all draft investigative and risk assessment reports have been submitted for review to ODEQ. At this time, we have determined that it is probable that remedial action for certain portions of the Owned Property will be required. The current estimate of our future liability at the site includes the known investigation work required by the Consent Order and the current projected cost of possible remedies for certain portions of the Owned Property. At this time, we are unable to reasonably estimate any remediation costs that we may ultimately incur with respect to other portions of the Owned Property or the Scappoose Bay, although such costs may be material. If additional investigative or remedial action is required by ODEQ, it could result in additional costs greater than the amounts currently estimated and those costs may be material.

Costs and responsibilities for investigation, including the current RI/FS for the Owned Property continue to be shared with Kaiser pursuant to a cost sharing agreement with Kaiser. Contemporaneously with the execution of the Consent Order, we, Kaiser and OC also entered into a separate cost sharing agreement for both the investigation and possible remediation of the Scappoose Bay. Kaiser s shares under the cost sharing agreements are being funded by certain insurance policies, which comprise substantially all of Kaiser s assets. If Kaiser and OC are unwilling or unable to fulfill their obligations under the cost sharing agreements, or seek to

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Notes to Condensed Consolidated Financial Statements (Unaudited)

(dollar amounts in millions)

contest or challenge the allocations, or if Kaiser s insurance policies are unable to fund Kaiser s shares, it could result in additional cost to us greater than the amounts currently estimated and those costs may be material.

The principal contaminants at the St. Helens site are arsenic and dioxin compounds from historic operations by prior owners of the plant. As part of the investigation on the site pursuant to the Consent Order, we conducted an analysis of the raw materials used in our manufacturing processes at the St. Helens facility to identify possible sources of these same contaminants. Our testing found low levels of naturally occurring dioxin in sourced clay, known as ball clay, used in the production of some of our fire-retardant products at our St. Helens manufacturing facility. Based on the data from the soil and sediment samples from our St. Helens property and the data from the ball clay, we do not believe that the presence of dioxin in our raw material will have a material impact on our ultimate liability at the site. In addition, consistent with our health and safety policies, we tested employee exposure levels at two facilities representative of our handling procedures at all plants that use this ball clay and, as a result of such testing, do not believe that the ball clay poses a hazard to our employees based on applicable regulatory standards. Based on the manufacturing process and the amount of raw material utilized, we also believe that the dioxin levels in our finished products do not pose a hazard to installers or consumers. While we have not received any claims related to this raw material or our fire-retardant products, there can be no assurance that the raw material or the finished products will not become the subject of legal claims or regulatory actions or that such claims or actions will not have a material adverse effect on our financial condition or results of operations.

Macon, GA

The U.S. Environmental Protection Agency (EPA) has listed two landfills located on a portion of our Building Products facility in Macon, GA, along with the former Macon Naval Ordnance Plant landfill adjacent to our property, and portions of Rocky Creek (collectively, the Macon Site) as a Superfund site on the National Priorities List due to the presence of contaminants, most notably PCBs.

In September 2010, we entered into an Administrative Order on Consent for a Removal Action with the EPA to investigate PCB contamination in one of the landfills on our property, the Wastewater Treatment Plant Landfill (the WWTP Landfill). We concluded the investigative phase of the Removal Action for the WWTP Landfill and submitted our final Engineering Evaluation/Cost Analysis (EE/CA) to the EPA. The EPA approved the EE/CA and issued an Action Memorandum in July 2013 selecting our recommended remedy for the Removal Action. In July 2014, the EPA and Armstrong executed an Administrative Order on Consent for Removal Action for the WWTP Landfill. We will begin remedy design and implementation work under this Order. Our estimate of future liability includes costs for the remedial work for the WWTP Landfill.

It is probable that we will incur field investigation, engineering and oversight costs associated with a RI/FS with respect to the remainder of the Superfund site, which includes the other landfill on our property, as well as areas on and adjacent to Armstrong s property and Rocky Creek (the Remaining Site). We have not yet entered into an Order with the EPA for the Remaining Site and, as a result, have not yet commenced an investigation of this portion of the site. Accordingly, we are able to estimate only a small portion of the probable costs that may be associated with the

RI/FS for the Remaining Site. We anticipate, however, that the EPA may require significant investigative work for the Remaining Site and that we may ultimately incur costs in remediating any contamination discovered during the RI/FS. We are unable to reasonably estimate the total costs associated with the investigation work or any resulting remediation therefrom, although such amounts may be material.

Elizabeth City, NC

This site is a former cabinet manufacturing facility that was operated by Triangle Pacific Corporation, now known as Armstrong Wood Products, Inc. (Triangle Pacific) from 1977 until 1996. The site was formerly owned by the U.S. Navy (Navy) and Westinghouse, now CBS Corporation (CBS). We assumed ownership of the site when we acquired the stock of Triangle Pacific in 1998. Prior to our acquisition, the NC Department of Environment and Natural Resources listed the site as a hazardous waste site. In 1997, Triangle Pacific entered into a cost sharing agreement with Westinghouse whereby the parties agreed to share equally in costs associated with investigation and potential remediation. In 2000, Triangle Pacific and CBS entered into an RI/FS with the EPA for the site. In 2007, we and CBS entered into an agreement with the Navy whereby the Navy agreed to pay one third of defined past and future investigative costs up to a certain amount, which has now been exhausted. Although the parties initially submitted the RI/FS work plan to the EPA in 2004, the EPA did not approve the RI/FS work plan until August 2011. We submitted the draft Remedial Investigative and Risk Assessments in the

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first quarter of 2014 and will be conducting supplemental investigative work based upon agency comments to those reports. We are unable to reasonably estimate any additional investigative costs or determine whether remediation will be required. If remediation is required, the related costs may be material, although we expect these costs to be shared with CBS and the Navy.

Summary of Financial Position

Liabilities of $7.2 million at September 30, 2014 and $8.3 million at December 31, 2013 were recorded for potential environmental liabilities, on a global basis, that we consider probable and for which a reasonable estimate of the probable liability could be made. Where existing data is sufficient to estimate the liability, that estimate has been used; where only a range of probable liabilities is available and no amount within that range is more likely than any other, the lower end of the range has been used. As assessments and remediation activities progress at each site, these liabilities are reviewed to reflect new information as it becomes available. These liabilities are undiscounted.

The estimated liabilities above do not take into account any claims for recoveries from insurance or third parties. It is our policy to record probable recoveries that are either available through settlement or anticipated to be recovered through negotiation or litigation as assets in the Condensed Consolidated Balance Sheets. No material amounts were recorded for probable recoveries at September 30, 2014 or December 31, 2013.

Actual costs to be incurred at identified sites may vary from our estimates. Based on our knowledge of the identified sites, it is not possible to reasonably estimate future costs in excess of amounts already recognized.

MULTI-EMPLOYER PENSION WITHDRAWAL LIABILITY CLAIM

In February 2013, we received a demand notice from the Fund of a deemed withdrawal relating to the sale of our cabinets business to AIP in 2012. The Fund claims that the sale triggered a withdrawal liability to the Fund relating to unfunded vested plan benefits attributable to our role as a contributing employer under the Employee Retirement Income Security Act of 1974 and the Multiemployer Pension Plan Amendments Act of 1980, notwithstanding the assumption and maintenance by AIP of ongoing contribution obligations under the applicable union bargaining agreement. The claimed amount is $15.2 million, payable in a lump-sum or over 20 years on a quarterly basis. Pursuant to the demand notice, we provided information and reviewed the determination with the Fund, and made regular quarterly payments under protest pending resolution of the dispute.

In September 2013, the Fund informed us that it disagrees with our position that the sale transaction did not trigger a withdrawal liability. In March 2014, the Fund informed us that AIP withdrew from the Fund effective December 12, 2013. Under our sale agreements with AIP, we have agreed to indemnify AIP with respect to a portion (not to exceed $10.0 million) of any potential withdrawal liability that may be incurred by AIP in the event of a withdrawal by AIP from the Fund, but such indemnities only apply in the event that the sale of assets transaction itself did not trigger withdrawal liability.

Based upon the quarterly payments already made by us and initial settlement discussions with the Fund, we recorded an additional charge of $3.3 million during the second quarter of 2014 within Discontinued Operations (due to the association with the divestiture of the cabinets business).

In August 2014, we entered into a settlement agreement with the Fund to resolve this matter for $10.3 million, including a complete release of all claims against us. As a result of the settlement, we recorded an additional charge of $0.3 million during the third quarter of 2014 within Discontinued Operations. Payment was made to the Fund in the third quarter of 2014.

ANTIDUMPING AND COUNTERVAILING DUTY CASES

In October 2010, a coalition of U.S. producers of multilayered wood flooring (not including Armstrong) filed petitions seeking antidumping (AD) and countervailing duties (CVD) with the United States Department of Commerce (DOC) and the United States International Trade Commission (ITC) against imports of multilayered hardwood flooring from China. The AD petition requested duties of up to 269% on imports of multilayered hardwood flooring, which it claimed were needed to offset unfair pricing from Chinese imports that injure the U.S. industry. The CVD petition requested an unspecified level of duties be imposed on importers to offset alleged unfair subsidies provided by the Chinese government.

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(dollar amounts in millions)

We produce multilayered wood flooring domestically and import multilayered wood flooring from third party suppliers in China. We also had a plant in Kunshan, China (Armstrong Kunshan) that manufactured multilayered wood flooring for export to the U.S., which we closed in the third quarter of 2014. We were specifically mentioned in the AD and CVD petitions as an importer. Under the U.S. AD and CVD laws, a U.S. importer may be responsible for the payment of any antidumping and countervailing duties.

In response to the petitions, the DOC conducted its initial original investigations and issued CVD and AD orders in December 2011. Pursuant to the orders, Armstrong Kunshan s assigned duty deposit rates were 1.5% (CVD) and 3.31% (AD). These rates became effective in the form of additional duty deposits. These rates applied retrospectively as of April 6, 2011 (CVD) and May 26, 2011 (AD).

Following the issuance of the CVD and AD orders, appeals were filed by several parties, including Armstrong, challenging various aspects of the determinations by the DOC, including certain aspects that may impact the validity of the orders. Armstrong is participating in the remaining appeal of these orders, which is currently expected to result in additional court decisions in 2014 and 2015.

The DOC is currently conducting annual administrative reviews of the AD and CVD orders it earlier issued.

In 2013, Armstrong Kunshan was selected for individual review as a mandatory respondent in the first annual administrative review covering AD duty deposits for all entries of the subject merchandise from the original preliminary determination through November 30, 2012, which was the end of the initial period of review. In May 2014, the DOC issued a final AD rate of 0.00% for Armstrong Kunshan in that first administrative review. In June 2014, the DOC issued amended final results for that review, for which Armstrong Kunshan s AD rate remained 0.00% resulting in a duty deposit refund to us. The second annual administrative AD review is currently ongoing and Armstrong was not selected as a mandatory respondent. We are unable to predict the outcome of the AD administrative reviews, but do not expect them to have a material impact on our financial condition, results of operations or cash flows.

In January 2014, the DOC issued a preliminary CVD rate of 0.9% for Armstrong Kunshan as part of the first annual administrative review of the CVD order. In August 2014, the DOC issued a final CVD rate of 0.98% for Armstrong Kunshan, resulting in a duty deposit refund for us. The second annual administrative CVD review is currently ongoing and Armstrong was not selected as a mandatory respondent. We are unable to predict the outcome of the CVD administrative reviews, but we do not expect them to have a material impact on our financial condition, results of operations or cash flows.

The closure of Armstrong Kunshan is not expected to materially impact the annual administrative reviews or the resulting AD and CVD orders for the periods under review.

OTHER CLAIMS

We are involved in various lawsuits, claims, investigations and other legal matters from time to time that arise in the ordinary course of conducting business, including matters involving our products, intellectual property, relationships with suppliers, distributors, relationships with competitors, employees and other matters. While complete assurance cannot be given to the outcome of these proceedings, we do not believe that any of these matters, individually or in the aggregate, will have a material adverse effect on our financial condition, liquidity or results of operations.

Armstrong World Industries, Inc., and Subsidiaries

Notes to Condensed Consolidated Financial Statements (Unaudited)

(dollar amounts in millions)

NOTE 19. SPECIAL CASH DIVIDEND

On March 23, 2012, our Board of Directors declared a special cash dividend in the amount of $8.55 per share, or $508.3 million in the aggregate, of which $502.9 million was paid on April 10, 2012 to the shareholders of record as of April 3, 2012. Additional payments of $3.7 million have been made through the end of the third quarter of 2014. The remaining dividends will be paid when the underlying employee awards vest, while vested director awards will be paid upon the Director s separation from service on the Board of Directors. Most of the outstanding balance at September 30, 2014 is expected to be paid in the first quarter of 2015. The dividend was recorded as a reduction of retained earnings to the extent that retained earnings were available at the dividend declaration date. Dividends in excess of retained earnings were recorded as a reduction of capital in excess of par value.

NOTE 20. EARNINGS PER SHARE

Earnings per share (EPS) components may not add due to rounding.

The following table is a reconciliation of earnings to earnings attributable to common shares used in our basic and diluted EPS calculations for the three month and nine month periods ended September 30, 2014 and 2013:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
Earnings from continuing operations	$ 31.8	$ 55.9	$ 69.7	$ 89.7
Earnings allocated to participating non-vested share awards	(0.2)	(0.3)	(0.4)	(0.5)
Earnings from continuing operations attributable common shares	$ 31.6	$ 55.6	$ 69.3	$ 89.2

The following table is a reconciliation of basic shares outstanding to diluted shares outstanding for the three month and nine month periods ended September 30, 2014 and 2013 (shares in millions):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
Basic shares outstanding	55.0	58.4	54.9	58.9
Dilutive effect of stock option awards	0.5	0.6	0.5	0.6

Diluted shares outstanding	55.5	59.0	55.4	59.5

Options to purchase 8,175 and 358,402 shares of common stock were outstanding at September 30, 2014 and 2013, respectively, but not included in the computation of diluted earnings per share, because they were anti-dilutive.

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Report of Independent Registered Public Accounting Firm

The Board of Directors and Shareholders

Armstrong World Industries, Inc.:

We have reviewed the accompanying condensed consolidated balance sheet of Armstrong World Industries, Inc. and subsidiaries (the Company) as of September 30, 2014 the related condensed consolidated statements of earnings and comprehensive income for the three-month and nine-month periods ended September 30, 2014 and 2013, and the related condensed consolidated statements of cash flows and shareholders equity for the nine-month periods ended September 30, 2014 and 2013. These condensed consolidated financial statements are the responsibility of the Company s management.

We conducted our reviews in accordance with the standards of the Public Company Accounting Oversight Board (United States). A review of interim financial information consists principally of applying analytical procedures and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with the standards of the Public Company Accounting Oversight Board (United States), the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

Based on our reviews, we are not aware of any material modifications that should be made to the condensed consolidated financial statements referred to above for them to be in conformity with U.S. generally accepted accounting principles.

We have previously audited, in accordance with standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheet of the Company as of December 31, 2013, and the related consolidated statements of earnings and comprehensive income, cash flows, and equity for the year then ended (not presented herein); and in our report dated February 24, 2014, we expressed an unqualified opinion on those consolidated financial statements. In our opinion, the information set forth in the accompanying condensed consolidated balance sheet as of December 31, 2013, is fairly stated, in all material respects, in relation to the consolidated balance sheet from which it has been derived.

/s/ KPMG LLP

Philadelphia, Pennsylvania

October 27, 2014

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

This discussion should be read in conjunction with the financial statements, the accompanying notes, the cautionary note regarding forward-looking statements and risk factors included in this report and our Annual Report on Form 10-K for the year ended December 31, 2013.

OVERVIEW

We are a leading global producer of flooring products and ceiling systems for use primarily in the construction and renovation of residential, commercial and institutional buildings. Through our United States (U.S.) operations and U.S. and international subsidiaries, we design, manufacture and sell flooring products (primarily resilient and wood) and ceiling systems (primarily mineral fiber, fiberglass and metal) around the world. As of September 30, 2014 we operated 34 manufacturing plants in eight countries, including 20 plants located throughout the U.S. During the third quarter, we ceased operations at a Resilient Flooring plant in Australia.

Reportable Segments

Building Products produces suspended mineral fiber, soft fiber and metal ceiling systems for use in commercial, institutional and residential settings. In addition, our Building Products segment sources complementary ceiling products. Our products, which are sold worldwide, are available in numerous colors, performance characteristics and designs, and offer attributes such as acoustical control, rated fire protection and aesthetic appeal. Commercial ceiling materials and accessories are sold to resale distributors and to ceiling systems contractors. Residential ceiling products are sold in North America primarily to wholesalers and retailers (including large home centers). Suspension system (grid) products manufactured by Worthington Armstrong Venture (WAVE) are sold by both us and WAVE.

Resilient Flooring produces and sources a broad range of floor coverings primarily for homes and commercial and institutional buildings. Manufactured products in this segment include vinyl sheet, vinyl tile and linoleum flooring. In addition, our Resilient Flooring segment sources and sells laminate flooring products, vinyl tile products, vinyl sheet products, adhesives, and installation and maintenance materials and accessories. Resilient Flooring products are offered in a wide variety of types, designs, and colors. We sell these products worldwide to wholesalers, large home centers, retailers, contractors and to the manufactured homes industry.

Wood Flooring produces and sources wood flooring products for use in new residential construction and renovation, with some commercial applications in stores, restaurants and high-end offices. The product offering includes pre-finished solid and engineered wood floors in various wood species, and related accessories. Virtually all of our Wood Flooring sales are in North America. Our Wood Flooring products are generally sold to independent wholesale flooring distributors and large home centers.

Unallocated Corporate includes assets, liabilities, income and expenses that have not been allocated to the business units. Balance sheet items classified as Unallocated Corporate are primarily income tax related accounts, cash and cash equivalents, the Armstrong brand name, the U.S. prepaid pension cost and long-term debt. Expenses for our corporate departments and certain benefit plans are allocated to the reportable segments based on known metrics, such as specific activity or headcount. The remaining items, which cannot be attributed to the other reportable segments without a high degree of generalization, are reported in Unallocated Corporate.

The financial results related to our formerly owned cabinets business are classified as discontinued operations for all periods presented.

See Note 2 to the Condensed Consolidated Financial Statements for additional financial information on our consolidated company and our reportable segments.

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Management s Discussion and Analysis of Financial Condition and Results of Operations

Factors Affecting Revenues

Markets. We compete in building material markets around the world. The majority of our sales are in North America and Europe. We closely monitor publicly available macroeconomic trends that provide insight to commercial and residential market activity including Gross Domestic Product, the Architecture Billings Index and the Consumer Confidence Index. In addition, we noted several factors and trends within our markets that directly affected our business performance during the third quarter of 2014, including:

Americas

We noted softness in commercial markets, particularly healthcare and, to a lesser extent, education, as public spending remained constrained. In addition, we saw some regional variability in the office market, and some softening in retail markets. These trends impacted both our Building Products and Resilient Flooring businesses, but with greater impact on Resilient Flooring, as a significant portion of our commercial sales in Resilient Flooring originate from the education and healthcare markets.

Residential markets softened as builder activity weakened while renovation activity was constrained. Softer market conditions drove consumers to trade down to lower value products and led to more aggressive actions by competitors, resulting in pressure on mix and price. These trends, as well as accelerating share shifts within product categories and excess industry capacity, impacted our Wood and Resilient Flooring businesses.

Revenues for the first nine months for our Resilient Flooring business were negatively impacted by severe weather conditions experienced during the first quarter of 2014.

Europe, Middle East and Africa (EMEA)

The majority of our sales in EMEA are to commercial markets in sectors dependent on public spending. Continued softness in commercial sectors, such as office, education and healthcare, contributed to mixed results across EMEA. These trends impacted our Building Products and Resilient Flooring businesses. Our Resilient Flooring business is also negatively impacted by excess industry capacity.

Pacific Rim

We noted commercial markets for our Building Products businesses in India and Australia grew, while markets in China softened. Commercial markets for our Resilient Flooring businesses grew in China but declined in Australia.

Pricing Initiatives. We periodically modify prices in each of our business segments due to changes in costs for raw materials and energy, and to market conditions and the competitive environment. In certain cases, realized price increases are less than the announced price increases because of competitive reactions and changing market conditions. We estimate that pricing actions increased our third quarter 2014 total consolidated net sales by $14 million and in the first nine months of 2014 by $42 million, compared to the same periods of 2013.

In response to continued rising raw material prices, we implemented a price increase in our Building Products business in the Americas in the third quarter of 2014. We also recently announced price increases in our Building Products business in India and Russia to offset foreign currency devaluations. The increases will be effective in the fourth quarter of 2014. We also announced a price increase on select resilient products in the Americas that will be

effective in the first quarter of 2015. We may implement additional pricing actions based upon future movements in raw material prices or foreign currency valuations.

Mix. Each of our businesses offers a wide assortment of products that are differentiated by style, design and performance attributes. Pricing and margins for products within the assortment vary. Changes in the relative quantity of products purchased at the different price points can impact year-to-year comparisons of net sales and operating income. We estimate that mix improvements increased our total consolidated

net sales in the third quarter of 2014 by $14 million and in the first nine months of 2014 by $35 million, compared to the same periods of 2013.

Factors Affecting Operating Costs

Operating Expenses. Our operating expenses are comprised of direct production costs (principally raw materials, labor and energy), manufacturing overhead costs, freight, costs to purchase sourced products and selling, general, and administrative (SG&A) expenses.

Our largest individual raw material expenditures include lumber and veneers, PVC resins and plasticizers. Natural gas is also a significant input cost. Fluctuations in the prices of these inputs are generally beyond our control and have a direct impact on our financial results. In the third quarter and first nine months of 2014 costs for raw materials, sourced products and energy negatively impacted operating income by $8 million and $30 million, respectively, when compared to the same periods of 2013.

We continue to evaluate the efficiency of our manufacturing footprint and may take additional actions to improve profitability. The charges associated with any additional cost reduction initiatives could include severance and related termination benefits, fixed asset write-downs, asset impairments and accelerated depreciation and may be material to our financial statements.

During the second quarter of 2014, we decided to close the Thomastown, Australia resilient flooring plant and the Kunshan, China engineered wood flooring plant. Production ceased at the Thomastown and Kunshan plants on July 31, 2014 and September 30, 2014, respectively, with production activity shifting to existing Armstrong facilities in the United States. Total charges for these actions recorded in the third quarter were $7 million. The charges associated with the Thomastown facility were $1 million for estimated severance and other related costs and $2 million for fixed asset accelerated depreciation. The charges associated with the Kunshan facility were $1 million for estimated severance related costs and $3 million for fixed asset accelerated depreciation. All of the charges were recorded to Cost of Goods Sold. For the first nine months of 2014 we recorded $12 million of severance and other charges related to the two plant closures.

Our European Resilient Flooring business continues to report disappointing operating results. As a result, we recorded an asset impairment charge of $12 million in the third quarter of 2014. We continue to evaluate strategic alternatives for this business. No strategic alternative has been selected and approved by management or the Board of Directors at this time, but a decision remains possible before the end of 2014. That decision may have a further impact on the carrying value of the European Resilient Flooring assets and liabilities. The carrying value of assets was $152 million as of September 30, 2014, which included property, plant & equipment of $73 million and inventory of $57 million. The carrying value of liabilities was $171 million as of September 30, 2014, including an unfunded pension liability of $127 million.

Employees

As of September 30, 2014, we had 8,600 full-time and part-time employees worldwide, compared to 8,700 as of December 31, 2013.

In 2014, we negotiated three-year collective bargaining agreements covering 800 production and maintenance employees at two of our wood flooring plants and 250 production and maintenance employees at one of our building products plants.

RESULTS OF CONTINUING OPERATIONS

Unless otherwise indicated, net sales in these results of continuing operations are reported based upon the location where the sale was made. Please refer to Notes 2 and 3 to the Condensed Consolidated Financial Statements for a reconciliation of operating income to consolidated earnings from continuing operations before income taxes and additional financial information related to discontinued operations.

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Management s Discussion and Analysis of Financial Condition and Results of Operations

CONSOLIDATED RESULTS FROM CONTINUING OPERATIONS

(dollar amounts in millions)

	2014	2013	Change is Favorable/ (Unfavorable)
Three Months Ended September 30,			
Net sales:			
Americas	$ 524.2	$ 530.4	(1.2)%
EMEA	143.7	145.0	(0.9)%
Pacific Rim	60.4	54.3	11.2%
Total consolidated net sales	$ 728.3	$ 729.7	(0.2)%
Operating income	$ 69.0	$ 93.6	(26.3)%
Nine Months Ended September 30,			
Net sales:			
Americas	$ 1,492.7	$ 1,497.6	(0.3)%
EMEA	413.7	403.9	2.4%
Pacific Rim	166.3	157.1	5.9%
Total consolidated net sales	$ 2,072.7	$ 2,058.6	0.7%
Operating income	$ 179.3	$ 208.2	(13.9)%

The decrease in consolidated net sales during the third quarter was driven by $31 million of lower volume which more than offset favorable price and mix of $27 million. The increase in consolidated net sales during the first nine months of 2014 was driven by favorable price and mix of $77 million which more than offset $61 million of lower volume.

Net sales in the Americas declined in the third quarter and were essentially flat for the first nine months of 2014 as price and mix improvements only partially offset the impact of volume declines.

Net sales in the EMEA markets decreased during the third quarter as lower volumes were only partially offset by the favorable impact of foreign exchange of $3 million. Net sales increased during the first nine months of 2014 as the favorable impact of foreign exchange of $11 million offset lower volumes.

Net sales in the Pacific Rim increased during the third quarter and first nine months of 2014 driven primarily by higher volumes, despite unfavorable mix. Foreign exchange favorably impacted sales by $1 million in the third quarter and unfavorably by $5 million for the first nine months of 2014.

Cost of goods sold in the third quarter of 2014 was 77.5% of net sales, compared to 75.3% for the same period in 2013. Cost of goods sold in the first nine months of 2014 was 77.1% of net sales, compared to 76.3% for the same period in 2013. The increase in the third quarter and first nine months of 2014 was driven by $7 million and $12 million, respectively, of charges associated with the closure of our Thomastown, Australia resilient flooring plant and

our Kunshan, China engineered wood flooring plant, and $12 million of fixed asset impairment charges for our European Flooring business. Both periods in 2014 were also impacted by higher costs for lumber and other raw materials.

SG&A expenses in the third quarter of 2014 were $114.0 million or 15.7% of net sales and in the first nine months of 2014 were $346.0 million, or 16.7% of net sales, compared to $103.0 million, or 14.1% of net sales, and $326.9 million, or 15.9% of net sales, for the corresponding periods in 2013. The increase in both periods was due primarily to inflation, timing of promotional spending in both flooring businesses and higher spending on outside consulting services.

Equity earnings from our WAVE joint venture were $18.8 million for the third quarter of 2014, compared to $16.6 million in 2013, and $51.2 million for the first nine months of 2014 compared to $46.2 million in the

first nine months of 2013. The increase in both periods was driven primarily by the impact of favorable sales mix that more than offset a slight volume decline.

Interest expense was $11.0 million and $34.4 million for the third quarter and first nine months of 2014, compared to $11.4 million and $56.4 million for the corresponding periods of 2013. The decrease for the first nine months of 2014 was primarily due to the write-off of unamortized debt financing costs associated with the refinancing of our senior credit facility during the first quarter of 2013 (see Liquidity for further information).

Income tax expense was $26.3 million and $26.1 million for the third quarter of 2014 and 2013, respectively. The effective tax rate for the third quarter of 2014 was 45.3% as compared to a rate of 31.8% for the same period of 2013. Income tax expense was $70.2 million and $63.9 million for the first nine months of 2014 and 2013, respectively. The effective tax rate for the first nine months of 2014 was 50.2% as compared to a rate of 41.6% for the same period of 2013. The effective tax rate for the third quarter and first nine months of 2014 was higher than the comparable period of 2013 primarily due to increased losses in foreign jurisdictions which was impacted by the European Resilient Flooring fixed asset impairment charge and a decrease in consolidated pre-tax income which increased the impact of the losses on the effective tax rate. Tax benefits for foreign losses, which would have reduced consolidated income tax expense, were not recorded (unbenefitted) because our ability to utilize these tax benefits in future periods is uncertain.

In March 2014, we announced the commencement of a secondary public offering (the Offering) of 3,900,000 shares of our common stock held by Armor TPG Holdings LLC (TPG) and the Armstrong World Industries, Inc. Asbestos Personal Injury Settlement Trust (Asbestos PI Trust).

Upon completion of the Offering, TPG no longer held any of our common stock, and accordingly the shareholders agreement between the Asbestos PI Trust and TPG was automatically terminated in accordance with its terms. In addition, upon completion of the Offering, the Asbestos PI Trust owns less than 20% of our outstanding common shares. Accordingly, certain provisions of our Articles of Incorporation and Bylaws specifically relating to the rights and obligations of the Asbestos PI Trust are no longer applicable.

As disclosed in prior SEC filings, our ability to utilize deferred tax assets may be impacted by certain future events, such as changes in tax legislation, insufficient future taxable income prior to expiration of certain deferred tax assets, annual limits imposed under Section 382 of the Internal Revenue Code (Section 382) or by state law, as a result of an ownership change. This ownership change is defined as a cumulative increase in certain shareholders ownership of the Company by more than 50 percentage points during the previous rolling three year period.

The completion of the Offering did not result in an ownership change under Section 382, based on the size of the Offering and the factors discussed below. Together the Asbestos PI Trust and TPG collectively sold 5,980,000 shares, 12,057,382 shares and 6,000,000 shares of the Company s common shares during the fourth quarter of 2012, the third quarter of 2013 and the fourth quarter of 2013, respectively. Those sales, when combined with the 3,900,000 common shares sold in the Offering, significantly increase the likelihood that future sales by the Asbestos PI Trust will cause an ownership change under Section 382. At this time, we estimate that an additional sale of the Company s common shares by the Asbestos PI Trust prior to December 2015 would be reasonably likely to cause an ownership change under Section 382. An ownership change may result in limitations on the utilization of certain tax attributes, primarily our ability to deduct state net operating losses (NOLs) against future state taxable income. If such ownership change

were to occur, then we would be required to record a one-time, non-cash charge in our income statement in the period in which such ownership change occurs. We currently estimate that, if such ownership change had occurred in the third quarter of 2014, based on the factors discussed below, the one-time income tax charge that would have been taken would have reduced our net earnings by an amount between $4 million and $8 million. This pro forma estimated range of net earnings reduction is based on current management estimates and assumptions that are subject to change over time. The actual amount of the required charge, if any, may differ

materially from this current estimate. Key factors impacting the calculation include, but are not limited to, our stock price on the date of the ownership change , the applicable tax-exempt interest rate, the tax basis and fair market value of our assets, federal and state tax regulations, projections of future taxable income and prior NOL usage.

Total other comprehensive income/loss (OCI) was $0.7 million loss and $7.4 million income for the third quarters of 2014 and 2013, respectively, and was $10.0 million income and $23.9 million income for the first nine months of 2014 and 2013, respectively. Foreign currency translation adjustments represent the change in the U.S. dollar value of assets and liabilities denominated in foreign currencies. Amounts in the first nine months of 2014 were driven primarily by changes in the exchange rates of the Russian Ruble, the Euro, the British Pound, and the Chinese Renminbi, and amounts in the first nine months of 2013 were driven primarily by changes in the exchange rates of the Australian Dollar, the British Pound and the Chinese Renminbi. Amounts in the third quarter of 2014 were driven primarily by changes in the exchange rates of the British Pound and the Australian Dollar, and amounts in the third quarter of 2013 were driven primarily by changes in the exchange rates of the British Pound and the Euro. Derivative gain/loss represents the mark to market value adjustments of our derivative assets and liabilities and the recognition of gains and losses previously deferred in OCI. The period change is primarily due to the mark to market changes related to our interest rate swap derivatives. Pension and postretirement adjustments represent the amortization of actuarial gains and losses related to our defined-benefit pension and postretirement plans. The amounts in all periods primarily related to the amortization of losses on the U.S. pension plans.

REPORTABLE SEGMENT RESULTS

Building Products

(dollar amounts in millions)

	2014	2013	Change is Favorable/ (Unfavorable)
Three Months Ended September 30,			
Net sales:			
Americas	$ 219.3	$ 208.7	5.1%
EMEA	94.3	93.3	1.1%
Pacific Rim	38.1	33.5	13.7%
Total segment net sales	$ 351.7	$ 335.5	4.8%
Operating income	$ 86.6	$ 86.7	(0.1)%
Nine Months Ended September 30,			
Net sales:			
Americas	$ 611.2	$ 590.3	3.5%
EMEA	269.0	257.9	4.3%
Pacific Rim	103.2	96.4	7.1%
Total segment net sales	$ 983.4	$ 944.6	4.1%
Operating income	$ 209.3	$ 210.7	(0.7)%

The increase in Building Products net sales in the third quarter of 2014 was driven by $12 million of favorable price and mix and higher volumes of $2 million. The increase in Building Products net sales in the first nine months of 2014 was driven by $29 million of favorable price and mix and higher volumes of $10 million.

Net sales in the Americas increased in the third quarter and first nine months of 2014 driven by the benefits from improved mix and price.

Table of Contents

Management s Discussion and Analysis of Financial Condition and Results of Operations

Net sales in the EMEA markets increased in the third quarter and first nine months of 2014, driven primarily by favorable impact from foreign exchange of $3 million and $7 million, respectively. Improved price and mix were unable to offset lower volumes. The increase in the first nine months of 2014 was aided by foreign exchange and improvements in volumes, price and mix when compared to the corresponding period of 2013.

Net sales in the Pacific Rim increased in the third quarter and first nine months of 2014 driven primarily by higher volumes in addition to favorable price and mix. Foreign exchange favorably impacted sales by $1 million in the third quarter and unfavorably by $3 million for the first nine months of 2014.

Operating income was essentially flat in the third quarter of 2014 as improved price and mix of $4 million and higher earnings from WAVE of $2 million were mostly offset by higher manufacturing and input costs of $3 million primarily due to the Russia plant construction and higher SG&A expense of $2 million. Operating income decreased slightly in the first nine months of 2014 due to higher manufacturing;width:1.46%;">

(344

)

1,308

Changes in operating assets and liabilities, net of acquisitions

Accounts receivable

66,568

(11,188

)

Inventories

5,570

(449

)

Prepaid expenses and other assets

(12,390

)

1,188

Accounts payable

(40,050

)

17,547

Accrued compensation and benefits

(3,851

)

3,734

Deferred revenue

11,568

4,446

Other current and long-term liabilities

(2,298

)

3,387

Net cash provided by operating activities

61,611

14,248

Cash flows from investing activities:

Capital expenditures

(11,140

)

(13,309

)

Business acquisitions

—

(97,581

)

Proceeds from sale of investment

727

4,922

Net cash used in investing activities

(10,413

)

(105,968

)

Cash flows from financing activities:

Borrowings under Term Loan

—

100,000

Repayments of debt

(14,750

)

(8,686

)

Loan fees on borrowings

(545

)

(1,494

)

Repurchase of stock

(15,000

)

—

Proceeds from issuance of common stock, net of tax withholding

5,005

(1,536

)

Capital lease financing

(183

)

—

Contingent consideration obligations

(3,856

)

—

Deferred payments on an acquisition

(2,000

)

—

Net cash (used in) provided by financing activities

(31,329

)

88,284

Foreign currency effect on cash

(365

)

94

Net increase (decrease) in cash

19,504

(3,342

)

Cash and cash equivalents at beginning of period	121,139	130,450
Cash and cash equivalents at end of period	$ 140,643	$ 127,108

See accompanying notes to the condensed consolidated financial statements.

EXTREME NETWORKS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

1. Description of Business and Basis of Presentation

Extreme Networks, Inc., together with its subsidiaries (collectively referred to as “Extreme” or the “Company”), is a leader in providing software-driven networking solutions for enterprise customers. The Company conducts its sales and marketing activities on a worldwide basis through distributors, resellers and the Company’s field sales organization. Extreme was incorporated in California in 1996 and reincorporated in Delaware in 1999.

The unaudited condensed consolidated financial statements of Extreme included herein have been prepared under the rules and regulations of the Securities and Exchange Commission (“SEC”). Certain information and footnote disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles have been condensed or omitted under such rules and regulations. The condensed consolidated balance sheet at June 30, 2018 was derived from audited financial statements as of that date but does not include all disclosures required by generally accepted accounting principles for complete financial statements. These interim financial statements and notes should be read in conjunction with the Company’s audited consolidated financial statements and notes thereto included in the Company’s Annual Report on Form 10-K for the fiscal year ended June 30, 2018.

The unaudited condensed consolidated financial statements reflect all adjustments, consisting only of normal recurring adjustments that, in the opinion of management, are necessary for a fair presentation of the results of operations and cash flows for the interim periods presented and the financial condition of Extreme at December 31, 2018. The results of operations for the three and six months ended December 31, 2018 are not necessarily indicative of the results that may be expected for fiscal 2019 or any future periods.

Fiscal Year

The Company uses a fiscal calendar year ending on June 30. All references herein to “fiscal 2019” or “2019” represent the fiscal year ending June 30, 2019. All references herein to “fiscal 2018” or “2018” represent the fiscal year ended June 30, 2018.

Principles of Consolidation

The consolidated financial statements include the accounts of Extreme and its wholly-owned subsidiaries. All inter-company accounts and transactions have been eliminated.

The Company predominantly uses the United States Dollar as its functional currency. The functional currency for certain of its foreign subsidiaries is the local currency. For those subsidiaries that operate in a local currency functional environment, all assets and liabilities are translated to United States Dollars at current month end rates of exchange; and revenue and expenses are translated using the monthly average rate.

Accounting Estimates

The preparation of financial statements and related disclosures in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from these estimates.

2. Summary of Significant Accounting Policies

For a description of significant accounting policies, see Note 3, Summary of Significant Accounting Policies, to the consolidated financial statements included in the Company's Annual Report on Form 10-K for the fiscal year ended June 30, 2018. There have been no material changes to the Company's significant accounting policies since the filing of the Annual Report on Form 10-K.

Recently Adopted Accounting Pronouncements

In January 2016, the Financial Accounting Standards Board ("FASB") issued ASU No. 2016-01, Recognition and Measurement of Financial Assets and Financial Liabilities, which provides guidance for the recognition, measurement, presentation, and disclosure of financial assets and liabilities. The guidance was adopted effective July 1, 2018 and the Company reclassified a $0.5 million unrealized gain, net of tax, related to its available-for-sale investments from accumulated other comprehensive loss to accumulated deficit as a cumulative-effect adjustment in the accompanying condensed consolidated balance sheets. Future changes in fair value will be included in earnings in each period.

In August 2016, the FASB issued ASU 2016-15, Classification of Certain Cash Receipts and Cash Payments to provide guidance on the classification of eight cash flow issues in order to reduce diversity in practice. The Company adopted the new guidance effective July 1, 2018. The amendments in this update have been applied on a retrospective transition method to each period presented. The adoption of this guidance did not have a material effect on the Company's presentation of cash flows.

In October 2016, the FASB issued ASU 2016-16, Income Taxes (Topic 740) - Intra-Entity Transfers of Assets Other Than Inventory, which requires an entity to recognize the income tax consequences of an intra-entity transfer of an asset other than inventory when the transfer occurs. Historically GAAP had prohibited the recognition of current and deferred income taxes for an intra-entity asset transfer until the asset has been sold outside the consolidated group. The new guidance is effective for interim and annual reporting periods beginning after December 15, 2017. The Company adopted ASU 2016-16 effective July 1, 2018 on a modified retrospective basis. The adoption of this guidance did not have a material effect on the Company's financial statements.

In May 2017, the FASB issued ASU 2017-09, Compensation—Stock Compensation (Topic 718): Scope of Modification Accounting, which amends the scope of modification accounting for share-based payment arrangements and provides guidance on the types of changes to the terms or conditions of share-based payment awards to which an entity would be required to apply modification accounting under Topic 718. Specifically, an entity would not apply modification accounting if the fair value, vesting conditions, and classification of the awards are the same immediately before and after the modification. The Company adopted this guidance effective July 1, 2018, on a prospective basis. The adoption of this guidance did not have a material effect on the Company's financial statements.

Recently Issued Accounting Pronouncements

In February 2016, the FASB issued ASU No. 2016-02, Leases (Topic 842), which requires the identification of arrangements that should be accounted for as leases by lessees. In general, for lease arrangements exceeding a twelve-month term, these arrangements must now be recognized as assets and liabilities on the balance sheet of the lessee. Under Topic 842, a right-of-use asset and lease obligation will be recorded for all leases, whether operating or financing, while the statement of operations will reflect lease expense for operating leases and amortization/interest expense for financing leases. The balance sheet amount recorded for existing leases at the date of adoption of Topic 842 must be calculated using the applicable incremental borrowing rate at the date of adoption. In addition, Topic 842 is applied on the modified retrospective method through a cumulative-effect adjustment directly to retained earnings as of the beginning of the period of adoption. The Company is currently assessing the impact that adopting this new accounting standard will have on its consolidated financial statements and footnote disclosures. The Company believes that Topic 842 will have a material impact on its financial position, as a result of recognizing right-of-use assets and lease liabilities on its consolidated balance sheets. In addition, in December 2018, the FASB issued ASU No. 2018-20, Leases (Topic 842), which includes narrow-scope improvements for lessors to increase transparency and comparability about leasing transactions. The Company continues to evaluate the impact these new standards will have on its condensed consolidated statement of operations and statement of cash flows. This guidance will become effective for the Company beginning with its fiscal year 2020, beginning on July 1, 2019.

In August 2017, the FASB issued ASU 2017-12, Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities, which is intended to allow companies to better align risk management activities and financial reporting for hedging relationships through changes to both the designation and measurement guidance for qualifying hedging relationships and the presentation of hedge results by expanding and refining hedge accounting for both nonfinancial and financial risk components and aligning the recognition and presentation of the effects of the hedging instrument and the hedged item in the financial statements. In addition, in October 2018, the FASB issued ASU 2018-16, Derivatives and Hedging (Topic 815), which amends Topic 815 to add the overnight index swap (OIS) rate based on the secured overnight financing rate as a fifth U.S. benchmark interest rate. These standards are effective

for interim and annual reporting periods beginning after December 15, 2018. The Company is continuing to evaluate the accounting, transition and disclosure requirements of these standards, but does not believe it will have a material impact on the Company's financial statements upon adoption. This guidance is effective for the Company beginning with its fiscal year 2020, beginning on July 1, 2019.

In February 2018, the FASB issued ASU 2018-02, Income Statement - Reporting Comprehensive Income (Topic 220), this standard that allows the reclassification from AOCI to retained earnings for stranded tax effects resulting from the 2017 Tax Cuts and Jobs Act ("Tax Reform Act"). The amount of the reclassification is the effect of the change in the U.S. federal corporate income tax rate on the gross deferred tax amounts and related valuation allowances related to items remaining in AOCI. This standard is effective for fiscal years beginning after December 15, 2018, and interim periods within those fiscal years. Early adoption is permitted, including adoption in any interim period, for reporting periods for which financial statements have not yet been issued. The new standard is to be applied either in the period of adoption or retrospectively to each period (or periods) in which the effects of the change in the income tax rate in the Tax Reform Act are recognized. Management is currently evaluating implementation options and impact on the Company's financial statements and related disclosures. This guidance is effective for the Company beginning with its fiscal year 2020, beginning on July 1, 2019.

In August 2018, the FASB issued ASU 2018-13, Fair Value Measurement (Topic 820), which removes, modifies and adds various disclosure requirements around the topic in order to clarify and improve the cost-benefit nature of disclosures. For example, disclosures around transfers between fair value hierarchy levels will be removed and further detail around changes in unrealized gains and losses for the period and unobservable inputs determining Level 3 fair value measurements will be added. This standard is effective for interim and annual reporting periods beginning after December 15, 2019, and early adoption is permitted. The Company is currently evaluating the impact the new standard will have on its condensed consolidated financial statements. This guidance is effective for the Company beginning with its fiscal year 2021, beginning on July 1, 2020.

In August 2018, the FASB issued ASU 2018-15, Intangibles - Goodwill and Other - Internal-Use Software (Subtopic 350-40), which aligns the requirements for capitalizing implementation costs incurred in a service contract hosting arrangement with those of developing or obtaining internal-use software. This standard is effective for interim and annual reporting periods beginning after December 15, 2019, and early adoption is permitted. The Company is currently evaluating the impact the new standard will have on its condensed consolidated financial statements. This guidance is effective for the Company beginning with its fiscal year 2021, beginning on July 1, 2020.

3. Revenues

The Company accounts for revenue in accordance with ASC Topic 606, Revenue from Contracts with Customers, which the Company adopted on July 1, 2017, using the retrospective method. The Company derives the majority of its revenue from sales of its networking equipment, with the remaining revenue generated from service fees primarily relating to maintenance contracts with additional revenues from professional services, and training for its products. The Company sells its products and maintenance contracts direct to customers and to partners in two distribution channels, or tiers. The first tier consists of a limited number of independent distributors that stock its products and sell primarily to resellers. The second tier of the distribution channel consists of a non-stocking distributors and value-added resellers that sell directly to end-users. Products and services may be sold separately or in bundled packages.

Revenue Recognition

Performance Obligations. A performance obligation is a promise in a contract to transfer a distinct good or service to the customer and is the unit of account in Topic 606. A contract’s transaction price is allocated to each distinct performance obligation and recognized as revenue when, or as, the performance obligation is satisfied. Certain of the Company’s contracts have multiple performance obligations, as the promise to transfer individual goods or services is separately identifiable from other promises in the contracts and, therefore, is distinct. For contracts with multiple performance obligations, the Company allocates the contract’s transaction price to each performance obligation based on its relative standalone selling price. The stand-alone selling prices are determined based on the prices at which the Company separately sells these products. For items that are not sold separately, the Company estimates the stand-alone selling prices using the best estimated selling price approach.

The Company’s performance obligations are satisfied at a point in time or over time as work progresses. Substantially all of the Company’s product sales revenues as reflected on the condensed consolidated statements of operations for the three and six months ended December 31, 2018 and 2017 are recognized at a point in time. Substantially all of the Company’s service revenue is recognized over time. For revenue recognized over time, the Company uses an input measure, days elapsed, to measure progress.

On December 31, 2018, the Company had $186.1 million of remaining performance obligations, which is comprised of deferred maintenance revenue and services not yet delivered. The Company expects to recognize approximately 48

percent of its remaining performance obligations as revenue in fiscal 2019, an additional 35 percent in fiscal 2020 and 17 percent of the balance thereafter.

Contract Balances. The timing of revenue recognition, billings and cash collections results in billed accounts receivable and deferred revenue in the consolidated balance sheet. Services provided under renewable support arrangements of the Company are billed in accordance with agreed-upon contractual terms, which are typically at periodic intervals (e.g., quarterly or annually). The Company sometimes receives payments from its customers in advance of services being provided, resulting in deferred revenues. These liabilities are reported on the consolidated balance sheet on a contract-by-contract basis at the end of each reporting period.

Revenue recognized for the three months ended December 31, 2018 and 2017 that was included in the deferred revenue balance at the beginning of each period was $59.9 million and $36.9 million, respectively. Revenue recognized for the six months ended December 31, 2018 and 2017 that was included in the deferred revenue balance at the beginning of each period was $88.8 million and $52.9 million, respectively.

Contract Costs. The Company recognizes the incremental costs of obtaining contracts as an expense when incurred if the amortization period of the assets that the Company otherwise would have recognized is one year or less. Management expects that commission fees paid to sales representative as a result of obtaining service contracts and contract renewals are recoverable and therefore the Company's capitalized balances in the amount of $5.3 million and $3.2 million at December 31, 2018 and 2017, respectively. Capitalized commission fees are amortized on a straight-line basis over the average period of service contracts of approximately three years, and are included in "Sales and marketing" in the accompanying condensed consolidated statements of operations. Amortization recognized during the three months ended December 31, 2018 and 2017, was $0.7 million and $0.5 million, respectively. Amortization recognized during the six months ended December 31, 2018 and 2017 was $1.4 million and $0.9 million, respectively. There was no impairment loss in relation to the costs capitalized.

Estimated Variable Consideration. There were no material changes in the current period to the estimated variable consideration for performance obligations which were satisfied or partially satisfied during previous periods.

Revenue by Category

The following table sets forth the Company's revenue disaggregated by sales channel and geographic region based on the customer's ship-to locations (in thousands):

	Three Months Ended December 31,			December 31,		
	2018			2017		
	Distributor	Direct	Total	Distributor	Direct	Total
Americas:						
United States	$44,141	$55,326	$99,467	$56,269	$54,559	$110,828
Other	8,269	5,380	13,649	1,155	5,698	6,853
Total Americas	52,410	60,706	113,116	57,424	60,257	117,681
EMEA	79,876	32,773	112,649	55,956	33,624	89,580
APAC	4,767	22,148	26,915	5,131	18,731	23,862
Total net revenues	$137,053	$115,627	$252,680	$118,511	$112,612	$231,123

	Six Months Ended December 31,			December 31,		
	2018			2017		
	Distributor	Direct	Total	Distributor	Direct	Total
Americas:						
United States	$100,883	$115,262	$216,145	$98,661	$105,549	$204,210
Other	12,762	10,904	23,666	15,491	12,093	27,584
Total Americas	113,645	126,166	239,811	114,152	117,642	231,794
EMEA	141,207	63,611	204,818	107,188	61,527	168,715
APAC:	7,116	40,821	47,937	8,395	33,934	42,329
Total net revenues	$261,968	$230,598	$492,566	$229,735	$213,103	$442,838

Customer Concentrations

The Company performs ongoing credit evaluations of its customers and generally does not require collateral in exchange for credit.

The following table sets forth major customers accounting for 10% or more of the Company's net revenues:

	Three Months Ended		Six Months Ended	
	December 31, 2018	December 31, 2017	December 31, 2018	December 31, 2017
Tech Data Corporation	22%	12%	19%	12%
Westcon Group Inc.	15%	14%	14%	15%
Jenne Corporation	12%	*	12%	10%

10

The following table sets forth major customers accounting for 10% or more of the Company's accounts receivable balance:

	December 31, 2018	June 30, 2018
Westcon Group Inc.	23%	*
Tech Data Corporation	22%	17%
Jenne Corporation	*	13%

* Less than 10% of accounts receivable

4. Business Combinations

Fiscal 2018 Acquisitions

Data Center Business

The Company completed its acquisition of the data center business (the "Data Center Business") of Brocade Communication Systems, Inc.'s ("Brocade") on October 27, 2017 (the "Data Center Closing Date"), pursuant to an Asset Purchase Agreement (the "Data Center Business APA") dated as of October 3, 2017, by and between the Company and Brocade for an aggregate purchase consideration of $84.3 million. Under the terms and conditions of the Data Center Business APA, the Company acquired customers, employees, technology and other assets of the Data Center Business as well as assumed certain contracts and other liabilities of the Data Center Business.

The following table below summarizes the final allocation of the tangible and identifiable intangible assets acquired and liabilities assumed (in thousands):

		Final Allocation
Accounts receivables		$ 33,488
Inventories		19,934
Prepaid expenses and other current assets		988
Property and equipment	(a)	20,220
Other assets		4,734
Accounts payable and accrued expenses		(16,494)
Deferred revenue		(33,025)
Net tangible assets acquired		29,845
Identifiable intangible assets		32,800
Goodwill	(a)	21,692
Total intangible assets acquired		54,492
Total net assets acquired		$ 84,337

(a) Includes an adjustment after the measurement period to record $1.3 million of additional property and equipment acquired at an international location.

Campus Fabric Business

The Company completed its acquisition of Avaya Inc.'s ("Avaya") fabric-based secure networking solutions and network security solutions business (the "Campus Fabric Business") on July 14, 2017, (the "Campus Fabric Business Closing Date") pursuant to an Asset Purchase Agreement (the "Campus Fabric Business APA") dated March 7, 2017. Under the terms and conditions of the Campus Fabric Business APA, the Company acquired the customers, employees, technology and other assets of the Campus Fabric Business, as well as assumed certain contracts and other liabilities of the Campus Fabric Business, for total consideration of $79.4 million.

The following table below summarizes the final allocation of the tangible and identifiable intangible assets acquired and liabilities assumed (in thousands):

	Final Allocation
Accounts receivables	$ 19,527
Inventories	14,165
Prepaid expenses and other current assets	240
Property and equipment	5,406
Other assets	7,009
Accounts payable and accrued expenses	(31,670)
Deferred revenue	(8,994)
Other long-term liabilities	(5,849)
Net tangible assets acquired	(166)
Identifiable intangible assets	41,300
In-process research and development	2,400
Goodwill	35,892
Total intangible assets acquired	79,592
Total net assets acquired	$ 79,426

Capital Financing Business

On December 1, 2017, Company completed its acquisition of a capital financing business (the “CF Business”), pursuant to a Bill of Sale and Assignment and Assumption Agreement (the “Assumption Agreement”) between the Company and Broadcom. Under the terms and conditions of the Assumption Agreement, the Company acquired customers, employees, contracts and lease equipment of the CF Business equal to the earn out payments to Broadcom of 90% of acquired financing receivables to be collected commencing at the closing date.

Net assets acquired included financing receivables of $13.7 million, lease equipment of $3.5 million and identifiable intangible assets of $0.8 million, and the fair value of the contingent consideration was $13.0 million. As the preliminary fair value of the net assets acquired exceeded the fair value of the purchase consideration, the Company recorded a bargain purchase gain of $5.0 million.

Pro forma financial information

The following unaudited pro forma results of operations are presented as though the acquisitions of the Data Center Business, CF Business and Campus Fabric Business had occurred as of the beginning of fiscal 2017 presented after giving effect to purchase accounting adjustments relating to inventories, deferred revenue, depreciation and amortization on acquired property and equipment and intangibles, acquisition costs, interest income and expense and related tax effects.

The pro forma results of operations are not necessarily indicative of the combined results that would have occurred had the acquisition been consummated as of the beginning of fiscal 2017, nor are they necessarily indicative of future operating results. The unaudited pro forma results do not include the impact of synergies, nor any potential impacts on current or future market conditions which could alter the unaudited pro forma results.

The unaudited pro forma financial information for the three and six months ended December 31, 2017, combines the historical results for Extreme for those periods, which include the results of the Data Center Business and CF Business subsequent to the acquisition date, with their historical results up to the acquisition date.

Pro forma results of operations from the Data Center Business, CF Business and Campus Fabric Business acquisitions included in the pro forma results of operations for the three and six months ended December 31, 2017, have not been adjusted for the adoption of Topic 606 because the Company determined it is impractical to estimate the impact of the adoption.

The following table summarizes the unaudited pro forma financial information (in thousands, except per share amounts):

	Three Months Ended December 31, 2017	Six Months Ended December 31, 2017
Net revenues	$ 252,532	$ 537,040
Net income (loss)	$ 1,152	$ (7,622)
Net income (loss) per share - basic	$ 0.01	$ (0.07)
Net income (loss) per share - diluted	$ 0.01	$ (0.07)
Shares used in per share calculation - basic	113,621	112,931
Shares used in per share calculation - diluted	119,656	112,931

5. Balance Sheet Accounts

Cash and Marketable Securities

The following is a summary of cash and marketable securities (in thousands):

	December 31, 2018	June 30, 2018
Cash	$ 140,643	$ 121,139
Marketable securities (consisting of available-for-sale securities)	428	1,459
Total cash and marketable securities	$ 141,071	$ 122,598

Marketable equity securities are recorded in “Prepaid expense and other current assets” in the accompanying condensed consolidated balance sheets as these securities are publicly-traded with readily determinable values. Marketable equity securities are classified as available-for-sale and reported at fair value with unrealized gains and losses included in “Other (expense) income, net” in the accompanying condensed consolidated statements of operations.

Inventories

The Company values its inventory at lower of cost or net realizable value. Cost is computed using standard cost, which approximates actual cost, on a first-in, first-out basis. The Company has established inventory allowances when conditions exist that suggest that inventory may be in excess of anticipated demand or is obsolete based upon assumptions about future demand. At the point of the loss recognition, a new, lower-cost basis for that inventory is established, and subsequent changes in facts and circumstances do not result in the restoration or increase in that newly established cost basis. Any written down or obsolete inventory subsequently sold has not had a material impact on gross margin for any of the periods presented.

Inventories consist of the following (in thousands):

	December 31, 2018	June 30, 2018
Finished goods	$ 44,179	$49,393
Raw materials	14,118	14,474
Total Inventories	$ 58,297	$63,867

Property and Equipment, Net

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

	December 31, 2018	June 30, 2018
Computers and equipment	$ 70,121	$60,677
Purchased software	22,968	21,389
Office equipment, furniture and fixtures	11,564	14,980
Leasehold improvements	51,167	50,070
Total property and equipment	155,820	147,116
Less: accumulated depreciation and amortization	(81,321)	(68,597)
Property and equipment, net	$ 74,499	$78,519

Deferred Revenue

Deferred revenue represents amounts for (i) deferred maintenance and support revenue and (ii) other deferred revenue including professional services and training when the revenue recognition criteria have not been met.

Guarantees and Product Warranties

The Company's standard hardware warranty period is typically 12 months from the date of shipment to end-users and 90 days for software. For certain products, the Company offers a limited lifetime hardware warranty commencing on the date of shipment from the Company and ending five (5) years following the Company's announcement of the end of sale of such product. Upon shipment of products to its customers, the Company estimates expenses for the cost to repair or replace products that may be returned under warranty and accrue a liability in cost of product revenue for this amount. The determination of the Company's warranty requirements is based on actual historical experience with the product or product family, estimates of repair and replacement costs and any product warranty problems that are identified after shipment. The Company estimates and adjusts these accruals at each balance sheet date in accordance with changes in these factors.

The following table summarizes the activity related to the Company's product warranty liability during the three and six months ended December 31, 2018 and 2017 (in thousands):

	Three Months Ended		Six Months Ended	
	December 31, 2018	December 31, 2017	December 31, 2018	December 31, 2017
Balance beginning of period	$12,601	$ 13,499	$12,807	$ 10,584
Warranties assumed due to acquisitions	—	526	—	3,682
New warranties issued	4,145	1,657	7,867	3,929
Warranty expenditures	(3,938)	(2,672)	(7,866)	(5,185)
Balance end of period	$12,808	$ 13,010	$12,808	$ 13,010

To facilitate sales of its products in the normal course of business, the Company indemnifies its resellers and end-user customers with respect to certain matters. The Company has agreed to hold the customer harmless against losses arising from a breach of intellectual property infringement or other. These agreements may limit the time within which an indemnification claim can be made and the amount of the claim. It is not possible to estimate the maximum potential amount under these indemnification agreements due to the limited history of prior indemnification claims and the unique facts and circumstances involved in each particular agreement. Historically, payments made by the Company under these agreements have not had a material impact on its operating results or financial position.

Other long-term liabilities

The following is a summary of long-term liabilities (in thousands):

	December 31, 2018	June 30, 2018
Acquisition related deferred payments, less current portion	$ 11,442	$13,251
Contingent consideration obligations, less current portion	4,095	4,898
Other contractual obligations, less current portion	29,647	31,200
Other	15,527	9,751
Total other long-term liabilities	$ 60,711	$59,100

Concentrations

The Company may be subject to concentration of credit risk as a result of certain financial instruments consisting of accounts receivable and marketable securities. The Company does not invest an amount exceeding 10% of its combined cash or cash equivalents in the securities of any one obligor or maker, except for obligations of the United States government, obligations of United States government agencies and money market accounts.

6. Fair Value Measurements

A three-tier fair value hierarchy is utilized to prioritize the inputs used in measuring fair value. The hierarchy gives the highest priority to quoted prices in active markets (Level 1) and the lowest priority to unobservable inputs (Level 3). The three levels are defined as follows:

- Level 1 Inputs - unadjusted quoted prices in active markets for identical assets or liabilities;
- Level 2 Inputs - quoted prices for similar assets and liabilities in active markets or inputs that are observable for the asset or liability, either directly or indirectly through market corroboration, for substantially the full term of the financial instrument; and
- Level 3 Inputs - unobservable inputs reflecting the Company’s own assumptions in measuring the asset or liability at fair value.

The following table presents the Company’s fair value hierarchy for its financial assets and liabilities measured at fair value on a

recurring basis (in thousands):

December 31, 2018	Level 1	Level 2	Level 3	Total
Assets				
Investments:				
Marketable securities	$428	$ —	$—	$428
Total assets measured at fair value	$428	$ —	$—	$428
Liabilities				
Acquisition-related contingent consideration obligations	$—	$ —	$8,649	$8,649
Total liabilities measured at fair value	$—	$ —	$8,649	$8,649

June 30, 2018	Level 1	Level 2	Level 3	Total
Assets				
Investments:				
Marketable securities	$1,459	$ —	$—	$1,459
Total assets measured at fair value	$1,459	$ —	$—	$1,459
Liabilities				
Acquisition-related contingent consideration obligations	$—	$ —	$12,749	$12,749
Total liabilities measured at fair value	$—	$ —	$12,749	$12,749

Level 1 investments:

The Company holds an investment in marketable equity securities which is classified as available-for-sale marketable securities at Level 1 as the investments have readily determinable fair value (see below, Level 3 investments). An unrealized holding gain on the investments of $0.5 million as of June 30, 2018 was reclassified from accumulated other comprehensive loss to accumulated deficit on July 1, 2018 upon the adoption of ASU 2016-01 (see Note 3)..

Level 2 assets and liabilities:

The Company includes U.S. government and sovereign obligations, most government agency securities, investment-grade corporate bonds, and state, municipal and provincial obligations for which quoted prices are available as Level 2. There were no transfers of assets or liabilities between Level 1 and Level 2 for the periods presented.

The fair value of the borrowings under the Credit Agreement is estimated based on valuations provided by alternative pricing sources supported by observable inputs which is considered Level 2. Due to the short duration until maturity of the Credit Agreement, the fair value approximates the face amount of the Company’s indebtedness of $185.3 million and $200.0 million as of December 31, 2018 and June 30, 2018, respectively.

Level 3 assets and liabilities:

Certain of the Company’s assets, including intangible assets and goodwill are measured at fair value on a non-recurring basis if impairment is indicated.

At June 30, 2018, the Company reflected a liability for contingent consideration related to a certain acquisition completed in fiscal 2018. The fair value measurement of the contingent consideration obligation is determined using Level 3 inputs. These fair value measurements represent Level 3 measurements as they are based on significant inputs not observable in the market. Significant judgment is employed in determining the appropriateness of these assumptions as of the acquisition date and for each subsequent period. Accordingly, changes in assumptions could have a material impact on the amount of contingent consideration expense the Company records in any given period. Changes in the value of the contingent consideration obligations would be recorded in general and administrative expenses in the accompanying condensed consolidated statements of operations.

The change in the acquisition-related contingent consideration obligations is as follows (in thousands):

	Six Months Ended December 31, 2018
Beginning balance	$ 12,749
Payments	(4,222)
Accretion on discount	122
Ending balance	$ 8,649

There were no transfers of assets or liabilities between Level 2 and Level 3 during the three and six months ended December 31, 2018 or 2017. There were no impairments recorded for the three and six months ended December 31, 2018 or 2017.

7.Goodwill and Intangible Assets

The following table reflects the changes in the carrying amount of goodwill (in thousands):

	December 31, 2018
Balance as of June 30, 2018	$ 139,082
Changes due to additional property and equipment acquired (See Note 4)	(1,283)
Balance at end of period	$ 137,799

The following tables summarize the components of gross and net intangible asset balances (dollars in thousands):

	Weighted Average Remaining Amortization Period	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount

December 31, 2018				
Developed technology	2.8 years	$ 117,000	$ 67,888	$ 49,112
Customer relationships	2.5 years	51,639	42,522	9,117
Maintenance contracts	0.1 years	17,000	17,000	-
Trade names	2.9 years	9,100	4,871	4,229
License agreements	5.6 years	2,232	1,313	919
Other intangibles	1.1 years	1,382	1,215	167
Total intangibles, net		$ 198,353	$ 134,809	$ 63,544

	Weighted Average Remaining Amortization Period	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
June 30, 2018				
Developed technology	3.3 years	$ 117,000	$ 58,299	$ 58,701
Customer relationships	3.0 years	51,639	40,634	11,005
Maintenance contracts	0.3 years	17,000	15,866	1,134
Trade names	3.4 years	9,100	4,141	4,959
Backlogs	— years	1,800	1,800	—
License agreements	5.8 years	2,445	1,390	1,055
Other intangibles	1.6 years	1,382	1,144	238
Total intangibles, net		$ 200,366	$ 123,274	$ 77,092

The amortization expense of intangibles for the periods presented is summarized below (in thousands):

	Three Months Ended		Six Months Ended	
	December 31,	December 31,	December 31,	December 31,
	2018	2017	2018	2017
Amortization in “Cost of revenues: Product”	$4,904	$ 3,866	$9,836	$ 6,663
Amortization of intangibles in "Operations"	1,575	2,746	3,716	4,360
Total amortization	$6,479	$ 6,612	$13,552	$ 11,023

The amortization expense that is recognized in “Cost of revenues: Product” is comprised of amortization for developed technology, license agreements and other intangibles.

8.Debt

The Company’s debt is comprised of the following (in thousands):

	December 31,	June 30,
	2018	2018
Current portion of long-term debt:		
Term Loan	$ 9,500	$9,500
Less: unamortized debt issuance costs	(491)	(493)
Current portion of long-term debt	$ 9,009	$9,007
Long-term debt, less current portion:		
Term Loan	$ 175,750	$180,500
Revolving Facility	—	10,000
Less: unamortized debt issuance costs	(1,504)	(1,751)
Total long-term debt, less current portion	174,246	188,749
Total debt	$ 183,255	$197,756

On May 1, 2018, the Company entered into a Credit Agreement (the “Credit Agreement”), by and among the Company, as borrower, BMO Harris Bank N.A., as an issuing lender and swingline lender, Bank of Montreal, as administrative and collateral agent, and the financial institutions or entities that are a party thereto as lenders. The Credit Agreement provides for i) a $40 million five-year revolving credit facility (the “New Revolving Facility”) ii) a $190 million five-year term loan (the “New Term Loan”) and iii) an uncommitted additional incremental loan facility in the principal amount of up to $100 million (“New Incremental Facility”). On May 1, 2018, the Company borrowed $200 million under the Credit Agreement to pay off existing debt and for general corporate purposes.

Borrowings under the Credit Agreement will bear interest, at the Company’s election, as of May 1, 2018, at a rate per annum equal to LIBOR plus 1.50% to 2.75%, or the adjusted base rate plus 0.50% to 1.75%, based on the Company’s consolidated leverage ratio. In addition, the Company is required to pay a commitment fee of between 0.25% and 0.40% quarterly (currently 0.35%) on the unused portion of the New Revolving Facility, also based on the Company’s consolidated leverage ratio. Principal installments are payable on the New Term Loan in varying percentages

quarterly starting September 30, 2018 and to the extent not previously paid, all outstanding balances are to be paid at maturity. The Credit Agreement is secured by substantially all of the Company’s assets.

The Credit Agreement requires the Company to maintain certain minimum financial ratios at the end of each fiscal quarter. The Credit Agreement also includes covenants and restrictions that limit, among other things, the Company’s ability to incur additional indebtedness, create liens upon any of its property, merge, consolidate or sell all or substantially all of its assets. The Credit Agreement also includes customary events of default which may result in acceleration of the outstanding balance.

Financing costs incurred in connection with obtaining long-term financing are deferred and amortized over the term of the Credit Agreement. Amortization of deferred financing costs included in “Interest expense” in the accompanying condensed consolidated statements of operations totaled $0.2 million for each of the three months ended December 31, 2018 and 2017 and totaled $0.3 million for each of the six months ended December 31, 2018 and 2017, respectively.

The Company had $39.0 million of availability under the New Revolving Facility as of December 31, 2018. The Company had $1.0 million of outstanding letters of credit as of December 31, 2018.

9.Commitments and Contingencies

Purchase Commitments

The Company currently has arrangements with contract manufacturers and suppliers for the manufacture of its products. Those arrangements allow the contract manufactures to procure long lead-time component inventory based upon a rolling production forecast provided by the Company. The Company is obligated to purchase long lead-time component inventory that its contract manufacturer procures in accordance with the Company's forecast, unless the Company gives notice of order cancellation outside of applicable component lead-times. As of December 31, 2018, the Company had commitments to purchase $172.6 million of such inventory. As of December 31, 2018, the Company had commitments to purchase $111.6 million of software and new product support services.

Legal Proceedings

The Company may from time to time be party to litigation arising in the course of its business, including, without limitation, allegations relating to commercial transactions, business relationships or intellectual property rights. Such claims, even if not meritorious, could result in the expenditure of significant financial and managerial resources. Litigation in general, and intellectual property and securities litigation in particular, can be expensive and disruptive to normal business operations. Moreover, the results of legal proceedings are difficult to predict.

In accordance with applicable accounting guidance, the Company records accruals for certain of its outstanding legal proceedings, investigations or claims when it is probable that a liability will be incurred and the amount of loss can be reasonably estimated. The Company evaluates, at least on a quarterly basis, developments in legal proceedings, investigations or claims that could affect the amount of any accrual, as well as any developments that would result in a loss contingency to become both probable and reasonably estimable. When a loss contingency is not both probable and reasonably estimable, the Company does not record a loss accrual. However, if the loss (or an additional loss in excess of any prior accrual) is at least a reasonable possibility and material, then the Company would disclose an estimate of the possible loss or range of loss, if such estimate can be made, or disclose that an estimate cannot be made. The assessment whether a loss is probable or a reasonable possibility, and whether the loss or a range of loss is estimable, involves a series of complex judgments about future events. Even if a loss is reasonably possible, the Company may not be able to estimate a range of possible loss, particularly where (i) the damages sought are substantial or indeterminate, (ii) the proceedings are in the early stages, or (iii) the matters involve novel or unsettled legal theories or a large number of parties. In such cases, there is considerable uncertainty regarding the ultimate resolution of such matters, including the amount of any possible loss, fine or penalty. Accordingly, for current proceedings, except as noted below, the Company is currently unable to estimate any reasonably possible loss or range of possible loss. However, an adverse resolution of one or more of such matters could have a material adverse effect on the Company's results of operations in a particular quarter or fiscal year.

Brazilian Tax Assessment Matter

On May 28, 2007, the Public Treasury Department of the State of Sao Paolo, Brazil (the "Tax Authority") assessed the Company's Brazilian subsidiary, Enterasys Networks do Brasil Ltda. ("Enterasys Brasil"), based on an alleged underpayment of taxes. The Tax Authority also charged interest and penalties with respect to the assessment (collectively, the "ICMS Tax Assessment"). The Tax Authority denied Enterasys Brasil the use of certain presumed tax credits granted by the State of Espirito Santo, Brazil under the terms of the FUNDAP program for the period from February 2003 to December 2004. The value of the disallowed presumed tax credits is BRL 3.4 million (USD $0.8 million), excluding interest and penalties. All currency conversions in this Legal Proceedings section are as of December 31, 2018.

Unable to resolve the matter at the administrative level, on October 1, 2014, Enterasys Brasil filed a lawsuit in the 11th Public Treasury Court of the Sao Paolo State Court of Justice (Judiciary District of Sao Paolo) to overturn or reduce the ICMS Tax Assessment. As part of this lawsuit, Enterasys Brasil requested a stay of execution, so that no tax foreclosure could be filed and no guarantee would be required until the court issued its final ruling. On or about October 6, 2014, the court granted a preliminary injunction staying any execution on the assessment, but requiring that Enterasys Brasil deposit the assessed amount with the court. Enterasys Brasil appealed this ruling and, on or about January 28, 2015, the appellate court ruled that no cash deposit (or guarantee) was required. In a decision dated August 28, 2017, and published on October 3, 2017, the court validated the assessment and penalty imposed by the Tax Authority but ruled that the Tax Authority was charging an unlawfully high interest rate on the tax assessment and penalty amounts and ordered the interest rate reduced to the maximum Federal rate. The August 28, 2017 decision, were it to become final, would require Enterasys Brasil to pay a total of BRL 19.6 million (USD $4.8 million), which includes penalties, court costs, attorneys' fees, and accrued interest as of December 31, 2018. The Company believes the ICMS Tax Assessment against Enterasys Brasil is without merit and has appealed the lower court's decision. The appellate court ruled that no cash deposit (or guarantee) is required during the pendency of the appeal.

Based on the currently available information, the Company believes the ultimate outcome of the ICMS Tax Assessment litigation will not have a material adverse effect on the Company's financial position or overall results of operations. However, due to the complexities and uncertainty surrounding the judicial process in Brazil and the nature of the claims asserted, there can be no assurance of a favorable outcome for Enterasys Brasil, which recorded an accrual of BRL 9.4 million (USD $2.3 million) as of the date the Company acquired Enterasys Networks.

The Company made a demand on April 11, 2014 for a defense from, and indemnification by, the former equity holder of Enterasys Networks, Inc. (“Seller”) in connection with the ICMS Tax Assessment. Seller agreed to assume the defense of the ICMS Tax Assessment on May 20, 2014. In addition, through the settlement of an indemnification-related lawsuit with the Seller on June 18, 2015, Seller agreed to continue to defend the Company with respect to the ICMS Tax Assessment and to indemnify the Company for losses related thereto subject to certain conditions. These conditions include the offsetting of foreign income tax benefits realized by the Company in connection with the acquisition of Enterasys. Based upon current projections of the foreign income tax benefits to be realized, and the potential liability in the event of an adverse final judgment in the ICMS Tax Assessment litigation, the Company does not presently anticipate that any amounts under the indemnification will be due from the Seller in connection with the ICMS Tax Assessment.

In re Extreme Networks, Inc. Securities Litigation

On October 23 and 29, 2015, punitive class action complaints alleging violations of securities laws were filed in the U.S. District Court for the Northern District of California against the Company and three of its former officers (Charles W. Berger, Kenneth B. Arola, and John T. Kurtzweil). Subsequently, the cases were consolidated (In re Extreme Networks, Inc. Securities Litigation, No. 3:15-CY-04883-BLF). Plaintiffs allege that defendants violated the securities laws by disseminating materially false and misleading statements and concealing material adverse facts regarding the Company’s financial condition, business operations and growth prospects. Plaintiffs seek unspecified damages on behalf of a purported class of investors who purchased the Company’s common stock from September 12, 2013 through April 9, 2015. On June 28, 2016, the Court appointed a lead plaintiff. On September 26, 2016, the lead plaintiff filed a consolidated complaint. On November 10, 2016, defendants filed a motion to dismiss, which the Court granted with leave to amend on April 27, 2017. On June 2, 2017, the lead plaintiff filed an amended complaint, which, on July 10, 2017, defendants again moved to dismiss. In a March 21, 2018 Order (the “March 2018 Order”), the Court granted in part and denied in part the defendants’ motion. The March 2018 Order narrowed the scope of the case, but allowed certain claims to proceed. The parties have agreed to settle the litigation. On November 30, 2018, plaintiffs filed an unopposed motion for preliminary approval of the settlement, and on December 6, 2018, Extreme filed a statement of non-opposition. The motion presently is set for hearing on April 25, 2019

On February 18, 2016, a shareholder derivative case was filed in the Superior Court of California, Santa Clara County (Shaffer v. Kispert et al., No. 16 CV 291726). The complaint names current and former officers and directors as defendants, and seeks recovery on behalf of the Company based on substantially the same allegations as the securities class action litigation described above. As a result of the March 2018 Order, the stipulated stay of the derivative litigation ended. The parties have agreed to settle the litigation. On November 26, 2018, plaintiff filed an unopposed motion for preliminary approval of the settlement, and on December 6, 2018, Extreme filed a statement of non-opposition. On January 18, 2019 the Court entered an order granting preliminary approval of the settlement and approving the notice to shareholders. The Court set the final approval hearing for May 3, 2019.

XR Communications, LLC d/b/a Vivato Technologies v. Extreme Networks, Inc. Patent Infringement Suit

On April 19, 2017, XR Communications, LLC (“XR”) (d/b/a Vivato Technologies) filed a patent infringement lawsuit against the Company in the Central District of California (XR Communications, LLC, dba Vivato Technologies v. Extreme Networks, Inc., No. 2:17-cv-2953-AG). The operative Second Amended Complaint asserts infringement of

U.S. Patent Nos. 7,062,296, 7,729,728, and 6,611,231 based on the Company's manufacture, use, sale, offer for sale, and/or importation into the United States of certain access points and routers supporting multi-user, multiple-input, multiple-output technology. XR seeks unspecified damages, on-going royalties, pre- and post-judgment interest, and attorneys' fees (but no injunction). In orders dated April 10 and May 22, 2018, the Court stayed the case pending a resolution by the Patent Trial and Appeal Board ("PTAB") of inter partes review (IPR) petitions filed by several defendants in other XR-related patent lawsuits challenging the validity of the asserted patents. The PTAB has now instituted IPR proceedings as to all three patents and all patent claims asserted in the litigation. Given the stay, the Court took off calendar all previously scheduled events (including a Markman hearing and potential trial date). During a status conference on October 22, 2018, the Court continued the stay and set a status conference for February 11, 2019. The Company believes the claims are without merit and intends to defend them vigorously.

Orckit IP, LLC v. Extreme Networks, Inc., Extreme Networks Ireland Ltd., and Extreme Networks GmbH

On February 1, 2018, Orckit IP, LLC (“Orckit”) filed a patent infringement lawsuit against the Company and its Irish and German subsidiaries in the District Court in Dusseldorf, Germany. The lawsuit alleges direct and indirect infringement of the German portion of European Patent EP 1 958 364 B1 based on the offer, distribution, use, possession and/or importation into Germany of certain network switches equipped with the ExtremeXOS operating system. Orckit is seeking injunctive relief, an accounting, and an unspecified declaration of liability for damages and costs of the lawsuit. On May 3, 2018, Extreme Networks GmbH filed a separate nullity action in the Federal Patent Court in Munich, seeking to invalidate the asserted patents, and on May 4, 2018, the defendants answered the complaint, denying any infringement and seeking a stay of the action pending the conclusion of the nullity action. The Company believes the claims are without merit and intends to defend them vigorously.

Indemnification Obligations

Subject to certain limitations, the Company may be obligated to indemnify its current and former directors, officers and employees. These obligations arise under the terms of its certificate of incorporation, its bylaws, applicable contracts, and applicable law. The obligation to indemnify, where applicable, generally means that the Company is required to pay or reimburse, and in certain circumstances the Company has paid or reimbursed, the individuals' reasonable legal expenses and possibly damages and other liabilities incurred in connection with certain legal matters. For example, the Company currently is paying or reimbursing legal expenses being incurred by certain current and former officers and directors in connection with the shareholder litigation described above. The Company also procures Directors and Officers insurance to help cover its defense and/or indemnification costs, although its ability to recover such costs through insurance is uncertain. While it is not possible to estimate the maximum potential amount that could be owed under these indemnification agreements due to the Company’s limited history with prior indemnification claims, indemnification (including defense) costs could, in the future, have a material adverse effect on the Company’s consolidated financial position, results of operations and cash flows. As of December 31, 2018, the Company has the outstanding indemnification claims described above.

10.Stockholders’ Equity

Stockholders’ Rights Agreement

On April 26, 2012, the Company entered into an Amended and Restated Rights Agreement between the Company and Computershare Shareholder Services LLC as the rights agent (the “Restated Rights Plan”). The Restated Rights Plan governs the terms of each right (“Right”) that has been issued with respect to each share of common stock of Extreme Networks. Each Right initially represents the right to purchase one one-thousandth of a share of the Company’s Preferred Stock. The Restated Rights Plan replaces in its entirety the Rights Agreement, dated as of April 27, 2001, as subsequently amended, between the Company and Mellon Investor Services LLC (the “Prior Rights Plan”).

The Company’s Board of Directors (“the Board”) adopted the Restated Rights Plan to preserve the value of deferred tax assets, including net operating loss carry forwards of the Company, with respect to its ability to fully use its tax benefits to offset future income which may be limited if the Company experiences an “ownership change” for purposes of Section 382 of the Internal Revenue Code of 1986 as a result of ordinary buying and selling of its common stock. Following its review of the terms of the plan, the Board decided it was necessary and in the best interests of the Company and its stockholders to enter into the Restated Rights Plan. The Restated Rights Plan incorporates the Prior Rights Plan and the amendments thereto into a single agreement and extended the term of the Prior Rights Plan to April 30, 2013. Each year since 2013 the Board and stockholders have approved an amendment providing for a one-year extension of the term of the Restated Rights Plan. The Board unanimously approved an amendment to the Restated Rights Plan on May 9, 2018 to extend the Restated Rights Plan through May 31, 2019 which was ratified by the stockholders of the Company at the Company’s annual shareholders meeting held on November 8, 2018.

Employee Stock Purchase Plan

Our Board of Directors unanimously approved an amendment to the 2014 Employee Stock Purchase Plan to increase the maximum number of shares that will be available for sale thereunder by 7,500,000 shares which was ratified by the stockholders of the Company at the annual meeting of stockholders held on November 8, 2018.

Common Stock Repurchases

On November 2, 2018, the Company announced that the Board had authorized management to repurchase up to $60.0 million of the Company’s common stock for two years from the date of authorization. Purchases may be made from time to time in the open market or in privately negotiated transactions. A maximum of $35.0 million of the Company’s common stock may be repurchased in any calendar year.

The following table summarizes the Company's shares repurchases under its stock repurchase program (in thousands, except per share amounts):

	Three Months Ended December 31, 2018	Six Months Ended December 31, 2018
Total number of shares repurchased	2,366	2,366
Average price paid per share	$ 6.34	$ 6.34
Dollar value of shares repurchased	$ 15,000	$ 15,000
Dollar value of shares that may yet be repurchased under program	$ 45,000	$ 45,000

11.Employee Benefit Plans

Shares reserved for issuance

The Company had reserved for issuance for the periods noted (in thousands):

	December 31, 2018	June 30, 2018
2013 Equity Incentive Plan shares available for grant	7,558	9,957
Employee stock options and awards outstanding	11,577	12,060
2014 Employee Stock Purchase Plan	4,084	5,365
Total shares reserved for issuance	23,219	27,382

Share-based compensation expense recognized in the condensed consolidated financial statements by line item caption is as follows (in thousands):

	Three Months Ended		Six Months Ended	
	December 31, 2018	December 31, 2017	December 31, 2018	December 31, 2017
Cost of product revenue	$217	$ 134	$395	$ 226
Cost of service revenue	677	296	1,022	429
Research and development	2,797	1,829	5,139	2,880
Sales and marketing	2,983	2,699	5,342	4,342
General and administrative	2,026	2,067	3,627	3,951
Total share-based compensation expense	$8,700	$ 7,025	$15,525	$ 11,828

During the three and six months ended December 31, 2018 or 2017, the Company did not capitalize any share-based compensation expense in inventory, as the amounts were immaterial.

Stock Awards

Stock awards may be granted under the 2013 Equity Incentive Plan (the "2013 Plan") on terms approved by the Compensation Committee of the Board. Stock awards generally provide for the issuance of restricted stock units ("RSUs") including performance or market-based RSUs which vest over a fixed period of time or based upon the satisfaction of certain performance criteria. The Company uses the straight-line method for expense attribution, and beginning with fiscal 2017, the Company does not estimate forfeitures, but accounts for them as incurred.

The following table summarizes stock award activity for the six months ended December 31, 2018 (in thousands, except grant date fair value):

	Number of Shares	Weighted-Average Grant Date Fair Value	Aggregate Fair Market Value
Non-vested stock awards outstanding at June 30, 2018	7,764	$ 8.60	$ 61,804
Granted	4,042	6.40	
Released	(2,271)	7.75	
Cancelled	(738)	8.66	
Non-vested stock awards outstanding at December 31, 2018	8,797	$ 7.80	$ 53,661

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The following table summarizes stock option activity for the six months ended December 31, 2018 (in thousands, except per share and contractual term):

	Number of Shares	Weighted-Average Exercise Price Per Share	Weighted-Average Remaining Contractual Term (years)	Aggregate Intrinsic Value
Options outstanding at June 30, 2018	2,193	$ 3.88	2.90	$ 8,996
Granted	852	6.40		
Exercised	(178)	3.56		
Cancelled	(87)	6.01		
Options outstanding at December 31, 2018	2,780	$ 4.60	3.70	$ 4,414
Vested and expected to vest at December 31, 2018	2,780	$ 4.60	3.70	$ 4,414
Exercisable at December 31, 2018	1,962	$ 3.94	2.53	$ 4,234

The fair value of each stock option grant under the 2013 Plan and 2005 Equity Incentive Plan is estimated on the date of grant using the Black-Scholes-Merton option valuation model with the weighted average assumptions noted in the following table. The Company uses the Monte-Carlo simulation model to determine the fair value and the derived service period of stock awards with market conditions, on the date of the grant. The expected term of options granted is derived from historical data on employee exercise and post-vesting employment termination behavior. The risk-free rate is based upon the estimated life of the option and the U.S. Treasury yield curve in effect at the time of grant. Expected volatility is based on the historical volatility on the Company's stock.

The fair value of each RSU grant with performance-based vesting criteria ("PSUs") under the 2013 Plan is estimated on the date of grant using the Monte-Carlo simulation model to determine the fair value and the derived service period of stock awards with market conditions, on the date of the grant.

During the second quarter of fiscal 2019, the Company approved the grant of 705,009 stock awards, including 357,142 stock awards to its Chief Financial Officer, and 347,867 stock awards to its other employees. During the first quarter of fiscal 2019, the Company approved the grant of 1,269,800 stock awards to its vice president level employees or above ("VPs"), which includes 278,000 stock awards to its Executive Officers. The Company also approved 2,067,074 stock awards to its other employees. Fifty percent (50%) of the stock awards granted to the VPs and the chief executive officer, were in the form of PSUs, with grant date fair values of $6.40, and fifty percent (50%) of the stock awards granted were in the form of service-based RSUs. The RSUs vest from the original grant date as to one-third (1/3) on the one-year anniversary and one-twelfth (1/12) each quarter thereafter, subject to continued service to the Company. No PSUs were granted during the second quarter of fiscal 2018.

For the PSUs referenced in the preceding paragraph, they will be considered earned once the Company's combined earnings per share equals or exceeds $0.20 over two consecutive quarters (the "FY19 Performance Threshold"). Upon satisfying the FY19 Performance Threshold, the PSUs shall vest with respect to the same number of RSUs that have vested which were granted on the same date and thereafter, shall vest on the same schedule as the RSUs, subject to continued service to the Company. If the FY19 Performance Threshold is not met by the third anniversary of the grant date the award is canceled. In addition, the FY19 Performance Threshold shall be deemed satisfied upon the closing of a Change in Control (within the meaning of the Company's 2013 Equity Incentive Plan) in the event the per share consideration received by the Company's stockholders equals or exceeds $10.00 per share.

During the six months ended December 31, 2018, the Performance Thresholds were not achieved for fiscal 2018 or fiscal 2019.

During the first quarter of fiscal 2019, the Company granted 851,700 Performance Stock Options ("PSOs") to certain officers and executive vice presidents that will vest if the Company's stock price achieves a price hurdle of $10.00 during the three-year performance period from August 29, 2018 through August 31, 2021. The price hurdle will be deemed to have been achieved if, at any time over the performance period, the Company's stock maintains a price of $10.00 for 30 consecutive days. If the price hurdle is achieved, the PSOs will vest as follows:

If the price hurdle is met before or on August 31, 2019, one-third of the PSOs will vest on August 31, 2019 and the remainder will vest quarterly over two years.

If the price hurdle is met after August 31, 2019, a number of the PSOs will vest (ratably calculated based upon the time elapsed between August 31, 2018 and the date the hurdle is met) and the remainder will vest quarterly through August 31, 2021. The grant date fair value was $2.62.

No PSUs were granted during the second quarter of fiscal 2019.

2014 Employee Stock Purchase Plan

The fair value of each share purchase option under the Company's 2014 Employee Stock Purchase Plan ("ESPP") is estimated on the date of grant using the Black-Scholes-Merton option valuation model with the weighted average assumptions noted in the following table. The expected term of the ESPP represents the term of the offering period of each option. The risk-free rate is based upon the estimated life and on the U.S. Treasury yield curve in effect at the time of grant. Expected volatility is based on the historical volatility on the Company's stock.

There were no shares granted under the ESPP during the three months ended December 31, 2018 and 2017. There were 1,280,708 and 1,267,930 shares issued under the ESPP during the six months ended December 31, 2018 and 2017, respectively. The following assumptions were used to calculate the fair value of shares granted under the ESPP during the following periods:

	Employee Stock Purchase Plan Six Months Ended			
	December 31, 2018		December 31, 2017	
Expected life	0.5 years		0.5 years	
Risk-free interest rate	2.20	%	1.15	%
Volatility	63	%	42	%
Dividend yield	—	%	—	%

The weighted-average fair value of shares granted under the ESPP during the six months ended December 31, 2018 and 2017 was $2.73 and $2.41, respectively.

12. Information about Segments of Geographic Areas

The Company operates in one segment, the development and marketing of network infrastructure equipment. The Company conducts business globally and is managed geographically. Revenue is attributed to a geographical area based on the location of its customers. The Company operates in three geographical areas: Americas, which includes the United States, Canada, Mexico, Central America and South America; EMEA, which includes Europe, Russia, Middle East and Africa; and APAC which includes Asia Pacific, South Asia, India, Australia and Japan. The Company's chief operating decision maker, who is its CEO, reviews financial information presented on a consolidated basis for purposes of allocating resources and evaluating financial performance.

See Note 3 Net Revenues for the Company's revenues by geographic regions and channel based on the customer's ship-to location.

The Company's long-lived assets are attributed to the geographic regions as follows (in thousands):

Long-lived Assets	December 31,	June 30,

	2018	2018
Americas	$ 142,580	$178,251
EMEA	36,384	15,106
APAC	12,249	9,896
Total long-lived assets	$ 191,213	$203,253

13. Foreign Exchange Forward Contracts

The Company uses derivative financial instruments to manage exposures to foreign currency. The Company's objective for holding derivatives is to use the most effective methods to minimize the impact of these exposures. The Company does not enter into derivatives for speculative or trading purposes. The fair value of the Company's derivatives in a gain position are recorded in "Prepaid expenses and other current assets" and derivatives in a loss position are recorded in "Other accrued liabilities" in the accompanying condensed consolidated balance sheets. Changes in the fair value of derivatives are recorded in "Other income (expense), net" in the accompanying condensed consolidated statements of operations. The Company enters into foreign exchange forward contracts to mitigate the effect of gains and losses generated by foreign currency transactions related to certain operating expenses and re-measurement of certain assets and liabilities denominated in foreign currencies. These derivatives do not qualify as hedges.

As of December 31, 2018, the Company did not have any forward foreign currency contracts. As of December 31, 2017 forward foreign currency contracts had a notional principal amount of $1.5 million and an immaterial unrealized gain. These contracts typically have maturities of less than 90 days. Changes in the fair value of these foreign exchange forward contracts are offset largely by re-measurement of the underlying assets and liabilities.

Foreign currency transactions losses from operations was less than $0.1 million and $0.6 million for the three months ended December 31, 2018 and 2017, respectively. Foreign currency transactions gains and losses from operations was a gain of $0.2 million and a loss of $1.1 million for the six months ended December 31, 2018 and 2017, respectively.

14.Restructuring Charges, net of reversals

Restructuring liabilities consisted of obligations pertaining to the estimated future obligations for non-cancelable lease payments, as well as severance and benefits obligations. The restructuring liabilities are recorded in “Other accrued liabilities” and “Other long-term liabilities” in the accompanying condensed consolidated balance sheets.

The Company recorded $0.5 million and $1.3 million of restructuring charges, net of reversals during the three and six months ended December 31, 2018, respectively, associated with a reduction-in-force in the fourth quarter of fiscal 2018 and additional excess facilities obligations.

Cash payments of $4.7 million were paid during the first six months of fiscal 2019. The balance of the severance and benefits obligations are expected to be paid by the end of fiscal 2019. The excess facilities obligations will continue through fiscal year 2023.

Total restructuring and related liabilities consist of (in thousands):

	Excess Facilities	Severance Benefits	Total
Balance as of June 30, 2018	$ 1,797	$ 4,658	$ 6,455
Period charges	104	1,524	1,628
Period reversals	—	(346)	(346)
Period payments	(101)	(4,569)	(4,670)
Balance as of December 31, 2018	$ 1,800	$ 1,267	$ 3,067
Less: current portion included in Other accrued liabilities			1,830
Restructuring accrual included in Other long-term liabilities			$ 1,237

15.Income Taxes

For the three months ended December 31, 2018 and 2017, the Company recorded an income tax benefit of $5.3 million and $1.6 million, respectively. For the six months ended December 31, 2018 and 2017, the Company recorded a tax benefit of $3.9 million and a tax provision of $0.1 million, respectively.

The income tax provisions for the three months ended December 31, 2018 and 2017, consisted of (1) taxes on the income of the Company’s foreign subsidiaries, (2) tax expense associated with the establishment of a U.S. deferred tax liability for amortizable goodwill resulting from the acquisition of Enterasys Networks, Inc., the WLAN Business, the Campus Fabric Business the Data Center Business, (3) foreign withholding taxes and (4) state taxes in jurisdictions where the Company has no available state Net Operating Losses (“NOLs”).

The tax provision for the three months ended December 31, 2018, is offset by a tax benefit of $2.6 million resulting from the release of a valuation allowance for the Company's Australian NOLs given consistent and sufficient profitability following the recent acquisitions as well as a tax benefit of $4.7 million for the release of valuation allowance given changes introduced by recently enacted U.S. tax legislation as discussed below. This legislation changed the U.S. NOL rules to afford an indefinite carryforward period for NOLs generated in tax years beginning after December 31, 2017. In evaluating the realizability of Deferred Tax Assets ("DTAs"), historically the Company was unable to consider the Deferred Tax Liability ("DTL") related to amortizable goodwill as a source of future income for reversing deductible differences with fixed lives. The change to the NOL rules creates an indefinite lived DTA and as such the indefinite lived DTL related to goodwill can now be viewed as a source of income for the newly created indefinite lived DTA. These two indefinite lived items can now be netted in determining the amount of valuation allowance needed.

The tax provision for the three months ended December 31, 2017, is offset by a tax benefit of $2.5 million resulting from the reduction of the U.S. Federal tax rate from 35% to 21% applied to the Company's deferred tax liability related to amortizable goodwill as required by the U.S. tax legislation discussed below. The income tax provisions for both fiscal years were calculated based on the actual results of operations for the three months ended December 31, 2018 and 2017, respectively and therefore may not reflect the annual effective tax rate.

The income tax benefit and provision for the six months ended December 31. 2018 and 2017, respectively consisted primarily of taxes on the income of the Company's foreign subsidiaries as well as tax expense associated with the establishment of a U.S. deferred tax liability for amortizable goodwill resulting from the acquisition of Enterasys Networks, Inc., the WLAN Business, the Campus Fabric Business and the Data Center Business. The income tax provision for the six months ended December 31, 2018 was offset by the two valuation allowance releases referenced above. The income tax provision for the six months ended December 31, 2017 is offset by a tax benefit of $2.5 million resulting from U.S. tax legislation which reduced the corporate federal tax rate from 35% to 21%. As a result of this change, the Company recognized a tax benefit associated with the revaluation of the Company's deferred tax liability related to amortizable goodwill to reflect the lower statutory tax rate.

On December 22, 2017, the President of the United States signed and enacted into law H.R. 1, the Tax Cuts and Jobs Act ("TCJA"), which, except for certain provisions, is effective for the Company's fiscal year ended 2019. As a fiscal year taxpayer, the Company was not subject to the majority of the tax law provisions until the first quarter of fiscal year 2019; however, there were certain significant items of impact that were recognized in fiscal year 2018, the year the TCJA was enacted.

The TCJA's primary change is a reduction in the U.S. Federal statutory corporate tax rate from 35% to 21%. As a result, the Company recognized a tax benefit in the amount of $2.5 million in the second quarter of fiscal 2018 due to the revaluation of the Company's deferred tax liability related to amortizable goodwill to reflect the lower statutory rate. Because the U.S. deferred tax assets are offset by a full valuation allowance, the reduction in deferred tax assets for the lower rate was fully offset by a corresponding reduction in valuation allowance resulting in no additional tax provision.

The TCJA moves the U.S. from a global taxation regime to a modified territorial regime. Under the territorial regime, the company's foreign earnings will generally not be subject to tax in the US. As part of transitioning to this new regime, U.S. companies were required to pay tax on historical earnings generated offshore that have not been repatriated to the U.S. ("Transition Tax"). The Company has determined there was no incremental tax provision related to the Transition Tax given the Company's ability to utilize existing tax attributes to offset the impact of the deemed repatriation.

The TCJA makes broad and complex changes to the U.S. tax code, and in certain instances, lacks clarity and is subject to interpretation until additional U.S. Treasury guidance is issued. Certain guidance has been released during the second quarter of the Company's Fiscal year ended June 30, 2019 and has been incorporated into the Company's related computations. On December 22, 2017, the SEC issued guidance under Staff Accounting Bulletin No. 118, Income Tax Accounting Implications of the Tax Cuts and Jobs Act ("SAB 118"), which allows registrants to record provisional amounts during a one year "measurement period" similar to that used when accounting for business combinations. However, the measurement period was deemed to have ended earlier when the registrant has obtained, prepared and analyzed the information necessary to finalize its accounting. During the measurement period, impacts of the law are expected to be recorded at the time a reasonable estimate for all or a portion of the effects can be made, and provisional amounts can be recognized and adjusted as information becomes available, prepared or analyzed. SAB 118 summarizes a three-step process to be applied at each reporting period to account for and qualitatively disclose: (1) the effects of the change in tax law for which accounting is complete; (2) provisional amounts (or adjustments to provisional amounts) for the effects of the tax law where accounting is not complete, but that a reasonable estimate has been determined; and (3) a reasonable estimate cannot yet be made and therefore taxes are reflected in accordance with law prior to the enactment of the TCJA. The measurement period ended in the Company's fiscal quarter ended December 31, 2018 and the Company has finalized all related adjustments.

Amounts recorded pursuant to Tax Reform and the provisions of SAB 118 relate to the reduction in the U.S. federal tax rate to 21 percent, which resulted in the Company reporting an income tax benefit of $2.5 million in the fiscal year ended June 30, 2018 to remeasure deferred tax liabilities associated with indefinitely lived intangible assets that will reverse at the new 21% rate. Absent this deferred tax liability, the Company has historically been in a net deferred tax asset position that is offset by a full valuation allowance. The Transition Tax introduced by TCJA has been calculated to be zero for the Company given existing tax attributes that were utilized to offset the calculated liability. As discussed below, during the quarter ended December 31, 2018 the Company completed its evaluation of whether to treat global intangible low-taxed income ("GILTI") as a component of tax expense in the period in which it is incurred or as a component of deferred income taxes. In conjunction with this determination and the completion of schedule the reversal of deferred tax assets and liabilities the Company has reduced the valuation allowance level by $4.7 million to reflect the introduction of an indefinite carryforward period for NOLs expected to be generated in tax years beginning after December 31, 2017 once deferred tax assets reverse. With respect to provisions of the TCJA effective for the Company's fiscal year ended 2019, the Company anticipates several new provisions will impact tax provisions in future periods including limitations on the deductibility of interest expense and certain executive compensation, a minimum tax on certain foreign earnings (i.e., GILTI). The GILTI provisions require the Company to include in its U.S. income tax return foreign subsidiary earnings in excess of an allowable return on the foreign subsidiary's tangible assets. Based on initial assessment and interpretation of the new provision, the Company expects that it will be subject to incremental U.S. tax on GILTI income beginning in fiscal 2019. The Company has elected to account for GILTI tax as a component of tax expense in the period in which it is incurred. The Base Erosion and Anti-Abuse Tax ("BEAT") provisions in the Tax Reform Act eliminate the deduction of certain base-erosion payments made to related foreign corporations and impose a minimum tax if greater than regular tax. There is a reasonable amount of uncertainty surrounding the interpretation of this new provision, however, based on initial assessment and a reasonable interpretation of the new provision, the Company expects that it will not be subject to the incremental U.S. tax on BEAT income beginning in fiscal 2019, due to a realignment of the Company's international structure.

In the three months ended September 30, 2018, the Company adopted ASU 2016-16, Intra-Entity Transfers of Assets Other Than Inventory, which requires an entity to recognize the income tax consequences of an intra-entity transfer of an asset at the time the transfer occurs. Historically, GAAP has prohibited the recognition of current and deferred income taxes for an intra-entity asset transfer until the asset had been sold outside the consolidated group. Effective as of July 1, 2018, the Company adopted ASU 2016-16 on a modified retrospective basis which requires an adjustment of the cumulative-effect of the adoption to retained earnings. However, the adjustment was immaterial to the financial statements and no such adjustment was necessary. As a result of adoption, the income tax consequences of future intra-entity transfer of assets will be recognized in earnings in each period rather than be deferred until the assets leave the consolidated group. In the three months ended September 30, 2018, the Company recognized a deferred tax asset relating to a transfer of certain assets from the US parent company to its wholly-owned Irish subsidiary of $3.7 million, which was fully offset by the establishment of a valuation allowance resulting in no impact to Company's statement of operations.

The Company has provided a full valuation allowance against all its U.S. federal and state deferred tax assets as well as a portion of the deferred tax assets in Ireland. A valuation allowance is determined by assessing both negative and positive evidence to determine whether it is "more likely than not" that the deferred tax assets are recoverable; such assessment is required on a jurisdiction by jurisdiction basis. The Company's inconsistent earnings in recent periods, including a cumulative loss over the last three years, coupled with its difficulty in forecasting future revenue trends as well as the cyclical nature of its business represent sufficient negative evidence to require a full valuation allowance against its U.S. federal and state net deferred tax assets as well as the above mentioned foreign jurisdictions. This valuation allowance will be evaluated periodically and can be reversed partially or in whole if business results and the economic environment have sufficiently improved to support realization of some or all of the Company's deferred tax assets.

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The acquisition of Enterasys in October 2013 included a U.S. parent company as well as its wholly-owned foreign subsidiaries. The Company elected to treat this stock acquisition as an asset purchase by filing the required election forms under IRC Sec 338(h)(10). In addition, the Company completed asset purchases of the WLAN Business, the Campus Fabric Business and the Data Center Business in October 2016, July 2017 and October 2017, respectively. The Company has estimated the value of the intangible assets from these transactions and is amortizing the amounts over 15 years for tax purposes. During the three and six months ended December 31, 2018, the Company deducted $1.8 million and $4.1 million of tax amortization expense respectively, for each period related to capitalized goodwill resulting from these acquisitions. As of December 31, 2018, the Company recorded a deferred tax liability of $6.4 million related to this goodwill amortization which now can be partially considered a future source of taxable income in evaluating the need for a valuation allowance against its deferred tax assets.

The Company had $17.5 million of unrecognized tax benefits as of December 31, 2018. The future impact of the unrecognized tax benefit of $17.5 million, if recognized, would result in adjustments to deferred tax assets and corresponding adjustments to the valuation allowance. The Company does not anticipate any events to occur during the next twelve months that would reduce the unrealized tax benefit as currently stated in the Company’s balance sheet.

The Company’s policy is to accrue interest and penalties related to the underpayment of income taxes as a component of tax expense in the accompanying condensed consolidated statements of operations.

In general, the Company’s U.S. federal income tax returns are subject to examination by tax authorities for fiscal years 2001 forward due to net operating losses and the Company's state income tax returns are subject to examination for fiscal years 2000 forward due to net operating losses. The Company recently settled an examination by the state of North Carolina for fiscal years ended 2014, 2015 and 2016. The settlement resulted in an immaterial payment to the state to close all three years.

16.Net Loss Per Share

Basic earnings per share is calculated by dividing net earnings by the weighted average number of common shares outstanding during the period. Dilutive earnings per share is calculated by dividing net earnings by the weighted average number of common shares used in the basic earnings per share calculation plus the dilutive effect of shares subject to repurchase, options, warrants and unvested restricted stock units.

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

	Three Months Ended		Six Months Ended	
	December 31,	December 31,	December 31,	December 31,
	2018	2017	2018	2017
Net loss	$7,199	$ (31,923)	$(1,866)	$ (27,547)
Weighted-average shares used in per share calculation - basic	117,544	113,621	117,456	112,931
Effect of potentially dilutive shares:				
Options to purchase common stock	657	—	—	—
Restricted stock units	1,129	—	—	—
Employee Stock Purchase Plan shares	214	—	—	—
Weighted-average shares used in per share calculation - diluted	119,544	113,621	117,456	112,931

Net income (loss) per share - basic	$0.06	$ (0.28)	$(0.02)	$ (0.24)
Net income (loss) per share - diluted	$0.06	$ (0.28)	$(0.02)	$ (0.24)

The following securities were excluded from the computation of net loss per diluted share of common stock for the periods presented as their effect would have been anti-dilutive (in thousands):

	Three Months Ended December 31,		Six Months Ended December 31,	
	2018	2017	2018	2017
Options to purchase common stock	781	2,622	543	2,781
Restricted stock units	6,341	7,950	1,369	7,162
Employee Stock Purchase Plan shares	1,286	834	1,286	906
Total shares excluded	8,408	11,406	3,198	10,849

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

This quarterly report on Form 10-Q, including the following sections, contains forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995, including in particular, our expectations regarding market demands, customer requirements and the general economic environment, future results of operations, and other statements that include words such as "may," "will," "should," "expect," "plan," "intend," "anticipate," "believe," "estimate," " "potential," "continue" and similar expressions. These forward-looking statements involve risks and uncertainties. We caution investors that actual results may differ materially from those projected in the forward-looking statements as a result of certain risk factors identified in the section entitled "Risk Factors" in this Quarterly Report on Form 10-Q for the second quarter ended December 31, 2018, our Annual Report on Form 10-K for the fiscal year ended June 30, 2018, and other filings we have made with the Securities and Exchange Commission. These risk factors, include, but are not limited to: fluctuations in demand for our products and services; a highly competitive business environment for network switching equipment; our effectiveness in controlling expenses; the possibility that we might experience delays in the development or introduction of new technology and products; customer response to our new technology and products; fluctuations in the global economy; risks related to pending or future litigation; a dependency on third parties for certain components and for the manufacturing of our products and our ability to receive the anticipated benefits of acquired businesses.

Business Overview

The following discussion is based upon our consolidated financial statements included elsewhere in this Report, which have been prepared in accordance with U.S. generally accepted accounting principles ("U.S. GAAP"). In the course of operating our business, we routinely make decisions as to the timing of the payment of invoices, the collection of receivables, the manufacturing and shipment of products, the fulfillment of orders, the purchase of supplies, and the building of inventory and service parts, among other matters. Each of these decisions has some impact on the financial results for any given period. In making these decisions, we consider various factors including contractual obligations, customer satisfaction, competition, internal and external financial targets and expectations, and financial planning objectives. For further information about our critical accounting policies and estimates, see "Critical Accounting Policies and Estimates" section included in this "Management's Discussion and Analysis of Financial Condition and Results of Operations."

Extreme Networks, Inc., together with its subsidiaries (collectively referred to as "Extreme" and as "we", "us" and "our") is a leading provider of network infrastructure equipment and software and offers related maintenance contracts for extended warranty and maintenance to our enterprise, data center and service provider customers. We were incorporated in California in May 1996 and reincorporated in Delaware in March 1999. Our corporate headquarters are located in San Jose, California. We derive substantially all of our revenue from the sale of our networking equipment and related maintenance contracts.

Extreme is a leader in providing software-driven networking solutions for enterprise customers. Providing a combined end-to-end solution from the data center to the access point, Extreme designs, develops and manufactures wired and wireless network infrastructure equipment and develops the software for network management, policy, analytics, security and access controls. We strive to help our customers and partners Connect Beyond the Network by building world-class software and network infrastructure solutions that solve the wide range of problems faced by IT departments.

Enterprise network administrators from the data center to the access layer need to respond to the rapid digital transformational trends of cloud, mobility, big data, social business and the ever-present need for network security. Accelerators such as Internet of Things ("IoT"), artificial intelligence ("AI"), bring your own device ("BYOD"), machine learning, cognitive computing, and robotics add complexity to challenge the capabilities of traditional

networks. Technology advances have a profound effect across the entire enterprise network placing unprecedented demands on network administrators to enhance management capabilities, scalability, programmability, agility, and analytics of the enterprise networks they manage.

A trend affecting the Enterprise Network Equipment market is the continued adoption of the cloud-managed enterprise WLAN in the enterprise market. Hybrid cloud is a cloud computing environment which uses a mix of on-premises, private cloud and third-party, public cloud services with orchestration between the two platforms.

We believe that understanding the following key developments is helpful to an understanding of our operating results for the fiscal quarter ended December 31, 2018.

To facilitate the readers understanding, the following is a list of common terms in our industry used in the discussion of our business:

- Access: Network access is the closest point of entry to a network whether it is a wireless access point, Ethernet connection, or Wi-Fi device.

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- Access Point: A wireless access point, or more generally just access point ("AP"), is a networking hardware device that allows a Wi-Fi device to connect to a wired network. (Source: Industry term)
- Aggregation: In computer networking, the term aggregation applies to various methods of combining (aggregating) multiple network connections in parallel in order to increase throughput beyond what a single connection could sustain, and to provide redundancy in case one of the links should fail.
- Artificial Intelligence: Artificial Intelligence ("AI") is a set of technologies that enable computers to simulate the cognitive knowledge-processing capabilities of humans. Because it is artificial, the objective of most work in AI is to augment the capabilities of humans, not to replace them. Just as computers in general are applied to the tedious and repetitive tasks that humans find tedious, AI-based solutions can deal with often large ("Big Data") volumes of digitally-encoded information dispassionately, unemotionally, rapidly, and, depending upon the parameters of a specific application and implementation, accurately. In network administration, AI can be applied to dealing with the "more-variables-than-equations nature" of radio frequency settings in even very- large-scale Wi-Fi installations. The goal is to achieve optimal network-wide performance more accurately and at lower cost than would be possible with humans alone.
- Campus Network: A campus network, or campus area network, or corporate area network ("CAN") is a computer network made up of an interconnection of local area networks ("LANs") within a limited geographical area, such as a college campus, company campus, hospital, hotel, convention center or sports venue.
- CloudStack: CloudStack is an open source cloud computing software for creating, managing, and deploying infrastructure cloud services. It uses existing hypervisors such as KVM, VMware ESXi and XenServer/XCP for virtualization.
- Core: A core network, or network core, is the central part of a telecommunications network that provides various services to customers who are connected by the access network.
- Data Center: A data center is a facility used to house computer systems and associated components, such as telecommunications and storage systems. It generally includes redundant or backup power supplies, redundant data communications connections, environmental controls (e.g. air conditioning, fire suppression) and various security devices.
- Data Center Fabric technologies: Also known as IP Fabric, is the basic topology of how a network is laid out and connected to switch traffic on a data or circuit-switched network.
- Edge: An edge device is a device which provides an entry point into enterprise or service provider core networks. Examples include routers, routing switches, integrated access devices ("IADs"), multiplexers, and a variety of metropolitan area network ("MAN") and wide area network ("WAN") access devices.
- Fabric Attach: Extreme's Fabric Attach ("FA") fundamentally introduces autonomic/automatic attachment to network services for end users IoT devices to a network infrastructure. Fabric Attach and Fabric Connect are key building blocks of the Extreme Fabric architecture.
- Fabric Connect: Fabric Connect is an extended implementation of the IEEE/IEFT standards for Shortest Path Bridging ("SPB"). It offers a full-service network virtualization technology that combines the best of Ethernet and the best of IP using a single network protocol instead of the multiple required for competitive solutions.
- Flipped Classroom: Flipped classroom is an instructional strategy and a type of blended learning that reverses the traditional learning environment by delivering instructional content, often online, outside of the classroom.
- Internet Protocol: Internet Protocol ("IP") is the principal set (or communications protocol) of digital message formats and rules for exchanging messages between computers across a single network or a series of interconnected networks, using the Internet Protocol Suite (often referred to as TCP/IP)
- Layer 3 Data Center Interconnect; A Data Center Interconnect ("DCI") refers to the networking of two or more different data centers to achieve business or IT objectives. This interconnectivity between separate data centers enables them to work together, share resources and/or pass workloads between one another. A Layer 3 DCI refers to interconnection made through layer 3 of the commonly-referenced multilayered communication model, Open Systems Interconnection ("OSI").
- Machine Learning: Machine Learning ("ML") is a set of technologies, and itself a branch of AI, that enables computers to simulate human learning, with learning defined here as the ability to change behavior and/or essential capabilities

(again, simulated as a digital process on a computer) in response to new information suitably encoded for consumption by the algorithms implementing ML. In other words, ML enables AI-based processes to "learn" from past behaviors and consequently to improve future results, in much the same way as experiential education benefits humans.

- Network Automation: Network Automation (“NA”) is a methodology in which software automatically configures, provisions, manages and tests network devices. It is used by enterprises and service providers to improve efficiency and reduce human error and operating expenses.
    - OpenStack: OpenStack software controls large pools of compute, storage, and networking resources throughout a datacenter, managed through a dashboard or via the OpenStack API. OpenStack works with popular enterprise and open source technologies making it ideal for heterogeneous infrastructure. (Source: OpenStack.org)
- Single Pane of Glass: Single pane of glass is a term used to describe a management display console that integrates all parts of a computer infrastructure.
- Stackstorm: A platform for integration and automation across services and tools. It ties existing infrastructure and application environment to automate that environment. It has a particular focus on taking actions in response to events.
- Wi-Fi: Wireless Access points using Radio Frequency and protocols to allow computers, smartphones, or other devices to connect to the Internet or communicate with one another wirelessly within an area.
- Workflow Composer: Extreme’s event-driven automation tool that allows for customizable workflows and automation to drive provisioning, configuration, and troubleshooting actions in a multi-vendor environment

Industry Background

Enterprises are adopting new IT delivery models and applications that require fundamental network alterations and enhancements spanning from device access point to the network core. AI and ML technologies have the potential to vastly improve the network experience. When AI and ML are used in conjunction with an NA technology, administrators can make significant advances in productivity, availability, accessibility, manageability, security and speed of their network infrastructure. These emerging technologies are driving administrators to a mindset of change toward agile processes that allow a versatile workforce to improve the rate of innovation of the enterprise safely, securely and with confidence.

AI, ML and NA have increased the relevance and importance of the network in the enterprise. Traditional network offerings are not well-suited to fulfill enterprise expectations for rapid delivery of new services, more flexible business models, real-time response and massive scalability.

The networking industry appears to be invigorated by this wave of technological change:

- Ethernet (wired and wireless) has solidified its role in both public and private networks through its scalability, adaptability and cost-effectiveness. At the same time, the enterprises and service providers expect the technology to follow a price-performance curve that mandates continued innovation by Ethernet vendors.
- The mobile workforce continues to proliferate. Employees expect high-quality and secure access to corporate resources in a BYOD world across a diversity of endpoints such as laptops, tablets, smart phones and wearables, whether they are within the corporate firewall or on-the-go. With ExtremeManagement, IT departments focus their investment decisions on this mobile workforce, taking a unified view of wireless access, from the campus core and the data center. Extreme offers end-to-end solutions that permit IT managers to meet employee expectations and to maximize IT return on investment.
- Verticals such as retail, finance, healthcare, education, manufacturing, government and hospitality (which includes sports and entertainment venues) are connecting with their customers and guests beyond the network. These enterprises are investing in guest and location technologies that connect with their customers via their mobile devices over their WLAN. This allows them to obtain rich analytics for contextual marketing, which in turn, enables them to deliver a personalized brand experience. ExtremeGuest and ExtremeLocation have been built on cloud-based technology for simple implementation and fast release to market to better provide necessary insights into guest demographics and location-based analytics.
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The Internet of Things. The Internet of Things is having dramatic effects on network infrastructure in healthcare, education, manufacturing, government and retail as more “smart” devices are entering the networks. These devices pose opportunities as well as threats to the network.

- Growing usage of the cloud. Enterprises have migrated increasing numbers of applications and services to either private clouds or public clouds offered by third parties. In either case, the network infrastructure must adapt to this new dynamic environment. Intelligence and automation are key if enterprises are to derive maximum benefit from their cloud deployments. Ethernet speeds, scaling from 10 Gigabits per second ("G") to 100G, provide the infrastructure for both private and public clouds. In addition, there is growing interest in SDN approaches that may include technologies such as OpenFlow, OpenStack, and CloudStack for increased network agility.

- Vendor consolidation is expected to continue. Consolidation of vendors within the enterprise network equipment market and between adjacent markets (storage, security, wireless & voice software and applications) continues to gain momentum. Further, we believe customers are demanding more end-to-end, integrated networking solutions. To address this demand, we acquired the WLAN Business of Zebra in October 2016, the Campus Fabric Business from Avaya in July 2017, and the Data Center Business from Brocade in October 2017.

Our strategy, product portfolio and research and development are closely aligned with what we have identified as the following trends in our industry:

The software segment of the worldwide enterprise network equipment market has continued to evolve and demands for improvements in Network Management will continue.

We announced our Extreme Management Console in Fiscal 2017. This innovative software helps IT network administrators to navigate the unprecedented demands caused by the surge of IoT devices and technology.

Enterprise adoption of the cloud and open-source options are disrupting traditional license and maintenance business models.

We announced cloud offerings in April 2016 and enhanced those offerings in 2017. Extreme began participation in the OpenSwitch program in May 2016 and now participates in the StackStorm community with the acquisition from Brocade in November 2017.

o Enterprise adoption of new financing solutions allows for increased flexibility, limited investment and zero long-term commitments. These offerings are changing the traditional CAPEX model to (OPEX) models using financing purchases over time are disrupting traditional sell-in business models.

We announced Extreme Capital Solutions in April 2018. The offering includes subscription, capital leasing and usage business models that provide flexibility for partners and customers.

Growth of wireless devices continues to outpace hardwire switch growth.

We announced our 802.11ac Wave 2 wireless offering in late 2015 and plans to continue to advance our wireless portfolio of indoor and outdoor access points, supported by the January 2019, announcement of our Wi-Fi 6 (802.11ax) portfolio of access points.

The Extreme Strategy

We are focused on delivering end-to-end IP networking solutions for today’s enterprise environments. From wireless and wired access technologies, through the campus, core and into the datacenter, Extreme is developing solutions to deliver outstanding business outcomes for our customers. Leveraging a unified management approach, both on premise and in the cloud, we continue to accelerate adoption and delivery of new technologies in support of emerging trends in enterprise networking.

In fiscal 2017, we completed the acquisition of the WLAN Business from Zebra. In fiscal 2018, we completed the acquisitions of the Campus Fabric Business from Avaya and the Data Center Business from Brocade. These acquisitions support our growth strategy to lead the enterprise network equipment market with end-to-end software-driven solutions for enterprise customers from the data center to the wireless edge. After the closing of the acquisitions of the Campus Fabric Business and Data Center Business, Extreme immediately became a networking industry leader with more than 30,000 customers. As a network switching leader in enterprise, datacenter and cloud, after closing of the Campus Fabric Business, we combine and extend our world-class products and technologies to provide customers with some of the most advanced, high performance and open solutions in the market as well as a superb overall customer experience. The combination of Extreme, the Campus Fabric Business and the Data Center Business is significant in that it brings together distinct strengths addressing the key areas of the network, from unified wired and wireless edge, to the enterprise core, to the data center and cloud to offer a complete, unified portfolio of software-driven network access solutions.

Provider of high quality, software-driven, secure networking solutions and the industry’s #1 customer support organization

- Only multi-vendor network management with “single pane of glass”.
- Delivering new releases of next generation portfolio organically and through acquisition.

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Key elements of our strategy include:

- Focus on being nimble and responsive to customers and partners, we call this "Customer-Driven Networking™." We work with our customers to deliver software-driven solutions from the enterprise edge to the cloud that are agile, adaptive, and secure to enable digital transformation for our customers. We help our customers move beyond just "keeping the lights on", so they can think strategically and innovate. By allowing customers to access critical decision-making intelligence, we are able reduce their daily tactical work, so they can spend their time on learning and understanding how to innovate their business with IT.
- Enable a common fabric to simplify and automate the network. With the acquisition of the Campus Fabric Business, Extreme now has access to field driven Campus and Data Center Fabric technologies. Fabric technologies virtualize the network infrastructure (decoupling network services from physical connectivity) which enables network services to be turned up faster, with lower likelihood of error. They make the underlying network much easier to design, implement, manage and troubleshoot.
- Software-driven networking services-led solutions. Our software-driven solutions provide visibility, control and strategic intelligence from the Edge to the Data Center, across networks and applications. Our solutions include wired switching, wireless switching, wireless access points and controllers. We offer a suite of products that are tightly integrated with access control, network and application analytics as well as network management. All can be managed, assessed and controlled from one single pane of glass.
- Offer customers choice – cloud or on premise. We leverage cloud where it makes sense for our customers and provide on premise solutions where customers need it. Our hybrid approach gives our customers options to adapt the technology to their business. At the same time, all of our solutions have visibility, control and strategic information built in, all tightly integrated with one single pane of glass. Our customers can understand what's going on across the network and applications in real time – who, when, and what is connected to the network, which is critical for BYOD and IoT.
- Enable IoT without additional IT resources. In a recent IoT IT infrastructure survey, enterprise IT decision makers across industry verticals indicated their preference to opt for their existing wireless connectivity infrastructure to support IoT devices. These preferences will place unprecedented demand on network administrators to enhance management capabilities, scalability and programmability of the enterprise networks they manage without additional IT resources. Extreme introduced the Defender for IoT in mid-2018, to address the growing concern of connected things, providing centralized visibility and management and enable IT to analyze traffic flows and pinpoint anomalies. The solution works with the Extreme Fabric Connect solution or over third-party networks to protect IoT devices and is ideal for healthcare environments.
- Provide a strong value proposition for our customers. Our cloud-managed wired and wireless networking solutions that provide additional choice and flexibility with on or off premise network, device and application management coupled with our award-winning services and support provide a strong value proposition to the following customers and applications:
  Enterprises and private cloud data centers use our products to deploy automated next-generation virtualized and high-density infrastructure solutions.
  Enterprises and organizations in education, healthcare, manufacturing, hospitality, transportation and logistics and government agencies use our solutions for their mobile campus and backbone networks.
  Enterprises, universities, healthcare and hospitality organizations use our solutions to enable better visibility and control of their data processing and analytics requirements.
- Provide high-quality customer service and support. We seek to enhance customer satisfaction and build customer loyalty through high-quality service and support. This includes a wide range of standard support programs that provide the level of service our customers require, from standard business hours to global 24-hour-a-day, 365-days-a-year real-time response support.
- Extend switching and routing technology leadership. Our technological leadership is based on innovative switching, routing and wireless products, the depth and focus of our market experience and our operating systems - the software that runs on all of our hardware platforms. Our products reduce operating expenses for our customers and enable a

more flexible and dynamic network environment that will help them meet the upcoming demands of IoT, mobile, and cloud, etc. Furthermore, our network operating systems, our primary merchant silicon vendor, and select manufacturing partners permit us to leverage our engineering investment. We have invested in engineering resources to create leading-edge technologies to increase the performance and functionality of our products, and as a direct result, the value of our solution to our current and future customers. We look for maximum synergies from our engineering investment in our targeted verticals.

- Expand Wi-Fi technology leadership. Wireless is today's network access method of choice and every business must deal with scale, density and BYOD challenges. The increase in demand being seen today, fueled by more users with multiple devices, increases the expectation that everything will just work. The network edge landscape is changing as the explosion of mobile devices increases the demand for mobile, transparent and always-on wired to wireless edge services. This new "unified access layer" requires distributed intelligent components to ensure that access control and resiliency of business services are available across the entire infrastructure and manageable from a single console. Our unified access layer portfolio provides intelligence for the wired/wireless edge
- Continue to deliver unified management and a common fabric across the wired/wireless environment from the Data Center to the mobile Edge. Our rich set of integrated management capabilities provides centralized visibility and highly efficient anytime, anywhere control of enterprise wired and wireless network resources.
- Offer a superior quality of experience. Our network-powered application analytics provide actionable business insight by capturing and analyzing context-based data about the network and applications to deliver meaningful intelligence about applications, users, locations and devices. With an easy to comprehend dashboard, our applications help businesses to turn their network into a strategic business asset that helps executives make faster and more effective decisions.

Data can be mined to show how applications are being used enabling a better understanding of user behavior on the network, identifying the level of user engagement and assuring business application delivery to optimize the user experience. Application adoption can be tracked to determine the return on investment associated with new application deployment.

Visibility into network and application performance enables our customers to pinpoint and resolve performance bottlenecks in the infrastructure whether they are caused by the network, application or server. This saves both time and money for the business and ensures critical applications are running at the best possible performance.

- Software-driven networking solutions for the enterprise. We are a software-driven networking solution company focused on the enterprise. We focus our R&D team and our sales teams to execute against a refined set of requirements for optimized return on investment, faster innovation, and clearer focus on mega trends and changes in the industry. As a software-driven networking company, we offer solutions for the entire enterprise network, the data center, the campus, the core and the WLAN.
- Expand market penetration by targeting high-growth market segments. Within the Campus, we focus on the mobile user and connected devices, leveraging our automation capabilities and tracking WLAN growth. Our Data Center approach leverages our product portfolio to address the needs of public and private Cloud Data Center providers. Within the Campus we also target the high-growth physical security market, converging technologies such as Internet Protocol ("IP") video across a common Ethernet infrastructure in conjunction with technology partners.
- Leverage and expand multiple distribution channels. We distribute our products through select distributors, a large number of resellers and system-integrators worldwide, and several large strategic partners. We maintain a field sales force to support our channel partners and to sell directly to certain strategic accounts. As an independent Ethernet switch vendor, we seek to provide products that, when combined with the offerings of our channel partners, create compelling solutions for end-user customers.
- Maintain and extend our strategic relationships. We have established strategic relationships with a number of industry-leading vendors to both provide increased and enhanced routes to market, but also to collaboratively develop unique solutions.

Key Financial Metrics

During the second quarter of fiscal 2019, we reflected the following results:

- Net revenues of $252.7 million compared to $231.1 million in the second quarter of fiscal 2018.
- Product revenue of $189.6 million compared to $174.9 million in the second quarter of fiscal 2018.
- Service revenue of $63.1 million compared to $56.3 million in the second quarter of fiscal 2018.

- Total gross margin of 55.9% of net revenues compared to 55.8% of net revenues in the second quarter of fiscal 2018.
- Operating income of $4.8 million compared to an operating loss of $31.1 million in the second quarter of fiscal 2018.
- Net income of $7.2 million compared to a net loss of $31.9 million in the second quarter of fiscal 2018.

During the first six months of fiscal 2019, we reflected the following results:

- Cash flow provided by operating activities of $61.6 million compared to $14.2 million in the six months ended December 31, 2017. Cash, cash equivalents and marketable securities of $141.1 million compared to $122.6 million as of June 30, 2018.

Net Revenues

The following table presents net product and service revenue for the periods presented (dollars in thousands):

	Three Months Ended				Six Months Ended			
	December 31, 2018	December 31, 2017	$ Change	% Change	December 31, 2018	December 31, 2017	$ Change	% Change
Net Revenues:								
Product	$189,567	$ 174,850	$14,717	8.4 %	$367,287	$ 339,624	$27,663	8.1 %
Percentage of net revenue	75.0 %	75.7 %			74.6 %	76.7 %		
Service	63,113	56,273	6,840	12.2 %	125,279	103,214	22,065	21.4 %
Percentage of net revenue	25.0 %	24.3 %			25.4 %	23.3 %		
Total net revenues	$252,680	$ 231,123	$21,557	9.3 %	$492,566	$ 442,838	$49,728	11.2 %

Product revenue increased $14.7 million or 8.4% for the three months ended December 31, 2018 and increased $27.7 million or 8.1% for the six months ended December 31, 2018 as compared to the corresponding periods of fiscal 2018. The increase in product revenues for both periods of fiscal 2019 were attributable to a full period of sales of the Data Center Business and increased sales in EMEA.

Service revenue increased $6.8 million, or 12.2% for the three months ended December 31, 2018 and increased $22.1 million or 21.4% as compared to the corresponding periods of fiscal 2018. The increase in service revenue was driven primarily by a higher number of maintenance contracts related to the Data Center Business acquisition.

The following table presents the product and service, gross profit and the respective gross profit percentages for the periods presented (dollars in thousands):

	Three Months Ended				Six Months Ended			
	December 31, 2018	December 31, 2017	$ Change	% Change	December 31, 2018	December 31, 2017	$ Change	% Change
Gross profit:								
Product	$103,080	$96,378	$6,702	7.0 %	$197,257	$181,107	$16,150	8.9 %
Percentage of product revenue	54.4 %	55.1 %			53.7 %	53.3 %		
Service	38,219	32,608	5,611	17.2%	76,113	60,260	15,853	26.3%
Percentage of service revenue	60.6 %	57.9 %			60.8 %	58.4 %		
Total gross profit	$141,299	$128,986	$12,313	9.5 %	$273,370	$241,367	$32,003	13.3%

Percentage of net revenues	55.9	%	55.8	%	55.5	%	54.5	%

Product gross profit increased $6.7 million or 7.0% for the three months ended December 31, 2018 as compared to the corresponding period in fiscal 2018. Increases in product gross profit were primarily due to higher revenue levels and higher intangible amortization expenses of $1.0 million. These increases were partially reduced by increased distribution costs of $2.9 million, warranty charges of $2.7 million and additional operations costs of $1.5 million mainly driven by higher personnel costs due to additional headcount.

Product gross profit increased $16.2 million or 8.9% for the six months ended December 31, 2018 as compared to the corresponding period in fiscal 2018. Increases in product gross profit were primarily due to higher revenue levels and to a lesser extent, lower production costs. These increases were offset by higher distribution costs of $6.2 million, amortization of developed technology intangibles due to the acquisition of the Campus Fabric and Data Center Businesses of $3.2 million warranty charges of $4.5 million and additional operations costs of $3.2 million mainly driven by higher personnel costs due to additional headcount.

Service gross profit increased $5.6 million and $15.9 million or 17.2% and 26.3% for the three and six months ended December 31, 2018, respectively, as compared to the corresponding periods in fiscal 2018. The increases were primarily due to a higher number of maintenance contracts related to the acquisition of the Data Center Business, partially offset by higher service material costs and personnel costs due to increased headcount to support acquired contracts.

Operating Expenses

The following table presents operating expenses for the periods presented (dollars in thousands):

	Three Months Ended				Six Months Ended			
	December 31,	December 31,	$	%	December 31,	December 31,	$	%
	2018	2017	Change	Change	2018	2017	Change	Change
Research and development	$52,204	$ 45,907	$6,297	13.7 %	$103,445	$ 80,192	$23,253	29.0 %
Sales and marketing	68,342	65,659	2,683	4.1 %	135,924	121,220	14,704	12.1 %
General and administrative	13,886	11,669	2,217	19.0 %	26,657	23,854	2,803	11.8 %
Acquisition and integration costs, net of bargain purchase gain	67	34,115	(34,048)	(99.8)%	2,613	38,359	(35,746)	(93.2)%
Restructuring charges, net of reversals	474	—	474	N/A	1,282	—	1,282	N/A
Amortization of intangibles	1,575	2,746	(1,171)	(42.6)%	3,716	4,360	(644)	(14.8)%
Total operating expenses	$136,548	$ 160,096	$(23,548)	(14.7)%	$273,637	$ 267,985	$5,652	2.1 %

Research and Development Expenses

Research and development expenses consist primarily of personnel costs (which consists of compensation, benefits and stock-based compensation), consultant fees and prototype expenses related to the design, development, and testing of our products.

Research and development expenses increased by $6.3 million or 13.7% for the three months ended December 31, 2018 as compared to the corresponding period of fiscal 2018. The increase in research and development expenses was due to higher personnel costs of $2.9 million due to increased headcount related to the acquisition of the Data Center Business, $1.7 million in increased facility and information technology costs, $1.2 million in increased supplies and equipment costs and $3.6 million in increased software royalty costs. The quarterly expenses were partially offset by a $3.1 million reduction in contractor and professional fees.

Research and development expenses increased by $23.3 million or 29.0% for the six months ended December 31, 2018, as compared to the corresponding period of fiscal 2018. The increase in research and development expenses was due to higher personnel costs of $10.6 million due to increased headcount related to the acquisition of the Data Center Business, $4.1 million in increased facility and information technology costs, $2.2 million in increased supplies and equipment costs and $6.8 million in increased software royalty costs, which was partially offset by a $0.4 million reduction in contractor and professional fees.

Sales and Marketing Expenses

Sales and marketing expenses consist primarily of personnel costs (which consists of compensation, benefits and stock-based compensation), as well as trade shows and promotional expenses.

Sales and marketing expenses increased by $2.7 million or 4.1% for the three months ended December 31, 2018, as compared to the corresponding period of fiscal 2018, primarily as a result of the acquisition of the Data Center Business. The increase consisted of higher personnel costs of $2.0 million and $1.0 million in increased software, supplies and equipment costs, partially offset by a $0.3 million reduction in travel, marketing, meeting and conference costs.

Sales and marketing expenses increased by $14.7 million or 12.1% for the six months ended December 31, 2018, as compared to the corresponding period of fiscal 2018, primarily as a result of the acquisition of the Data Center Business. The increase consisted of higher personnel costs of $12.1 million, $2.0 million in increased software, supplies and equipment costs, $0.3 million in increased travel, marketing, meeting and conference costs and $0.3 million in increased facility and information technology costs.

General and Administrative Expenses

General and administrative expense consists primarily of personnel costs (which consists of compensation, benefits and stock-based compensation), legal and professional service costs, travel and facilities and information technology costs.

General and administrative expenses increased by $2.2 million or 19.0% for the three months ended December 31, 2018, as compared to the corresponding period of fiscal 2018, primarily due to $1.7 million in higher personnel costs, $0.6 million in professional fees and $0.4 million in higher facility and information technology costs. This was partially offset by a $0.3 million reduction in the bad debt provision and a $0.2 million reduction in other costs.

General and administrative expenses increased by $2.8 million or 11.8% for six months ended December 31, 2018, as compared to the corresponding period of fiscal 2018, primarily due to $2.4 million in higher personnel costs and $0.7 million in higher facility and information technology costs, partially offset by a $0.3 million reduction in the bad debt provision.

Acquisition and Integration Costs, Net of Bargain Purchase Gain

During the three and six months ended December 31, 2018, we incurred $0.1 million and $2.6 million, respectively, of operating integration costs related to the acquisitions of the Campus Fabric and Data Center Businesses.

For the three months ended December 31, 2017, we incurred $4.6 million of acquisition and $1.9 million of integration costs related to the acquisition of the Campus Fabric Business and $30.3 million of acquisition and $2.2 million of integration costs related to the acquisition of the Data Center Business. The Data Center Business acquisition costs included a $25.0 million consent fee paid to Broadcom, to terminate a previous asset purchase agreement entered into by us to purchase the Data Center Business from Broadcom, in anticipation of Broadcom's acquisition of Brocade. The fee was paid to Broadcom to allow us to buy the Data Center Business directly from Brocade. Included in Acquisition and integration costs is a gain on bargain purchase of $4.9 million related to the acquisition of the capital financing business ("CF Business").

For the six months ended December 31, 2017, we incurred $5.9 million of acquisition and $3.4 million of integration costs related to the acquisition of the Campus Fabric Business and $31.6 million of acquisition and $2.2 million of integration costs related to the acquisition of the Data Center Business. We also recorded a gain on bargain purchase of $4.9 million related to the acquisition of the CF Business.

Restructuring Charges, Net of Reversals

For the three and six months ended December 31, 2018, we recorded restructuring charges of $0.5 million and $1.3 million, respectively, associated with a reduction-in-force in the fourth quarter of fiscal 2018 and additional excess facility charges.

Amortization of Intangibles

During the three months ended December 31, 2018 and 2017, we recorded $1.6 million and $2.7 million, respectively, of amortization expense as operating expenses and in the accompanying condensed consolidated statements of operations. The decrease was mainly due to amortization related to the acquired intangibles from the Enterasys acquisition becoming fully amortized.

During the six months ended December 31, 2018 and 2017, we recorded $3.7 million and $4.4 million, respectively, of amortization expense as operating expenses in the accompanying condensed consolidated statements of operations. The decrease was mainly due to amortization related to the acquired intangibles from the Enterasys acquisition becoming fully amortized.

Interest Expense

During the three months ended December 31, 2018 and 2017, we recorded $3.1 million and $2.5 million, respectively, in interest expense. The increase in interest expense was due to higher outstanding loan balances and other charges on our Credit Agreement as compared to the corresponding period of fiscal 2018, as well as additional imputed interest charges associated with various long-term contracts.

During the six months ended December 31, 2018 and 2017, we recorded $6.6 million and $4.7 million, respectively, in interest expense. The increase in interest expense was due to higher outstanding loan balances and other charges on of our Credit Agreement as compared to the corresponding period of fiscal 2018, as well as additional imputed interest charges associated with various long-term contracts.

Other Income (Expense), Net

During the three months ended December 31, 2018 and 2017, we recorded an expense of $0.4 million and $0.6 million, respectively, in other income (expense), net. The expense for the three months ended December 31, 2018 was primarily due to losses on equity investments. The expense for the three months ended December 31, 2017 was primarily due to foreign exchange gains and losses from the revaluation of certain assets and liabilities denominated in foreign currencies into U.S. Dollars.

During the six months ended December 31, 2018 and 2017, we recorded income of $0.1 million and $2.5 million, respectively, in other income (expense), net. For fiscal 2019, the income was primarily due to foreign exchange gains and losses from the revaluation of certain assets and liabilities denominated in foreign currencies into U.S. Dollars partially offset by losses on equity investments. For fiscal 2018, other income (expense), net was primarily driven by a gain of $3.8 million related to the sale of a non-marketable equity investment, partially offset by foreign exchange losses.

Provision for Income Taxes

For the three months ended December 31, 2018 and 2017, we recorded an income tax benefit of $5.3 million and $1.6 million, respectively. The three month periods ended December 31, 2018 and 2017 tax benefits included a provisions for income taxes for the following items: 1) taxes on the income of our foreign subsidiaries, 2) tax expense associated with the establishment of a U.S. deferred tax liability for amortizable goodwill resulting from the acquisition of Enterasys Networks, Inc., the WLAN, Campus Fabric and Data Center Businesses, 3) foreign withholding taxes, and 4) state taxes in jurisdictions where we do not have state net operating loss (NOL) carryforwards available. The tax provision for the three months ended December 31, 2018 was offset by a tax benefit of $2.6 million resulting from the release of a valuation allowance for our Australian subsidiary's NOLs given that entity's consistent and sufficient profitability following recent acquisitions. Additionally, we recorded a tax benefit of $4.7 million for the release of valuation allowances due to changes introduced by US tax legislation signed in December 2017 as discussed below. This legislation changed the US NOL rules to afford an indefinite carryforward period for NOLs generated in tax years beginning after December 31, 2017. In evaluating the realizability of Deferred Tax Assets ("DTAs"), historically the Company was unable to consider the Deferred Tax Liability ("DTL") related to amortizable goodwill as a source of future income for reversing deductible differences with fixed lives. The change to the NOL rules creates an indefinite lived DTA and as such the indefinite lived DTL related to goodwill can now be viewed as a source of income for the newly created indefinite lived DTA. These two indefinite lived items can now be netted in determining the amount of valuation allowance needed.

For the three months ended December 31, 2017, we recorded a tax provision for the various items as outlined above in the amount of $0.9 million, offset by a tax benefit of $2.5 million resulting from U.S. tax legislation which reduced the corporate federal tax rate from 35% to 21%. As a result of this change, we recognized a tax benefit associated with the revaluation of our deferred tax liability related to amortizable goodwill to reflect the lower statutory tax rate.

For the six months ended December 31, 2018 and 2017 we recorded a tax benefit of $3.9 million and a tax provision of $0.1 million, respectively, which consisted primarily of tax provisions on the income of our foreign subsidiaries as well as tax expense associated with the establishment of a U.S. deferred tax liability for amortizable goodwill resulting from the acquisitions of Enterasys Networks, Inc., the WLAN, Campus Fabric and Data Center Businesses. The income tax provision for the six months ended December 31, 2018 and 2017, were offset by the valuation allowance releases and revaluation of our deferred tax liability related to the amortizable goodwill referenced above.

On December 22, 2017, the President of the United States signed and enacted into law H.R. 1, the Tax Cuts and Jobs Act ("TCJA"), which, except for certain provisions, was effective for tax years beginning on or after January 1, 2018. As a fiscal year taxpayer, we were not subject to the majority of the tax law provisions until fiscal year 2019; however, there were certain significant items of impact that were recognized in fiscal year 2018. Because a change in tax law is accounted for in the period of enactment, the effects of the TCJA, a tax benefit of $2.5 million, was reflected in the second quarter of fiscal 2018. An additional impact has been reflected in the second quarter of fiscal year 2019 in the amount of $4.7 million relating to a valuation allowance release in conjunction with the finalization of evaluating the impacts of the TCJA change pursuant to SAB 118. See Note 15 to the condensed consolidated financial statements which includes a detailed discussion of the various provisions of the new U.S. tax legislation.

Critical Accounting Policies and Estimates

Our unaudited condensed consolidated financial statements and the related notes included elsewhere in this report are prepared in accordance with accounting principles generally accepted in the United States. The preparation of these unaudited condensed consolidated financial statements requires us to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenue, costs and expenses, and related disclosures. We base our estimates on historical experience and on various other assumptions that we believe to be reasonable under the circumstances. In

many instances, we could have reasonably used different accounting estimates, and in other instances changes in the accounting estimates are reasonably likely to occur from period to period. Accordingly, actual results could differ significantly from the estimates made by our management. On an ongoing basis, we evaluate our estimates and assumptions. To the extent that there are material differences between these estimates and actual results, our future financial statement presentation, financial condition, results of operations and cash flows will be affected.

As discussed in Part II, Item 7, "Management's Discussion and Analysis of Financial Condition and Results of Operations" of our Annual Report on Form 10-K for the year ended June 30, 2018, we consider the following accounting policies to be the most critical in understanding the judgments that are involved in preparing our consolidated financial statements:

- Revenue Recognition
- Business Combinations
- Inventory Valuation and Purchase Commitments

There have been no changes to our critical accounting policies since the filing of our last Annual Report on Form 10-K.

New Accounting Pronouncements

See Note 2 of the accompanying condensed consolidated financial statements for a full description of new accounting pronouncements, including the respective expected dates of adoption and effects on results of operations and financial condition.

Liquidity and Capital Resources

The following summarizes information regarding our cash, cash equivalents, marketable securities and working capital (in thousands):

	December 31, 2018	June 30, 2018
Cash	$ 140,643	$121,139
Marketable securities	428	1,459
Total cash and marketable securities	$ 141,071	$122,598
Working capital	$ 71,369	$68,041

As of December 31, 2018, our principal sources of liquidity consisted of cash, cash equivalents and marketable securities of $141.1million, accounts receivable, net of $144.9 million and availability of borrowings from our five-year New Revolving Facility of $39.0 million. Our principal uses of cash include the purchase of finished goods inventory from our contract manufacturers, payroll and other operating expenses related to the development and marketing of our products, purchases of property and equipment, stock repurchase program and repayments of debt and related interest. We believe that our $141.1 million of cash and marketable securities at December 31, 2018 and the availability of borrowings from the New Revolving Facility will be sufficient to fund our principal uses of cash for at least the next 12 months.

On November 2, 2018, our Board of Directors announced that it had authorized management to repurchase up to $60.0 million of its common stock for two years from the date of authorization, of which $15.0 million was used for repurchases in the second quarter of fiscal 2019. Purchases may be made from time to time in the open market or in privately negotiated transactions. The manner, timing and amount of any future purchases will be determined by the Company's management based on their evaluation of market conditions, stock price, Extreme’s ongoing determination that it is the best use of available cash and other factors. The repurchase program does not obligate Extreme to acquire any common stock, may be suspended or terminated at any time without prior notice and will be subject to regulatory considerations. During the three months ended December 31, 2018, we repurchased 2.4 million shares at an aggregate cost of $15.0 million.

On May 1, 2018, we entered into a Credit Agreement (the “Credit Agreement”), BMO Harris Bank N.A., as an issuing lender and swingline lender, Bank of Montreal, as administrative and collateral agent, and the financial institutions or entities that are a party thereto as lenders. The Credit Agreement provides for i) a $40 million five-year revolving credit facility (the “New Revolving Facility”), ii) a $190 million five-year term loan (the “New Term Loan”) and, iii) an uncommitted additional incremental loan facility in the principal amount of up to $100 million (“New Incremental Facility”). On May 1, 2018, we borrowed $200 million under the Credit Agreement.

Borrowings under the Credit Agreement will bear interest, at our election, as of May 1, 2018, at a rate per annum equal to LIBOR plus 1.50% to 2.75%, or the adjusted base rate plus 0.50% to 1.75%, based on our consolidated leverage ratio. In addition, we are required to pay a commitment fee of between 0.25% and 0.40% quarterly (currently 0.35%) on the unused portion of the New Revolving Facility, also based on our consolidated leverage ratio. Principal installments are payable on the New Term Loan in varying percentages quarterly starting September 30, 2018 and to the extent not previously paid, all outstanding balances are to be paid at maturity. The obligations under the Credit Agreement is secured by substantially all of our assets.

Financial covenants under the Credit Agreement require us to maintain a minimum consolidated fixed charge and consolidated leverage ratio at the end of each fiscal quarter through maturity. The Credit Agreement also includes covenants and restrictions that limit, among other things, our ability to incur additional indebtedness, create liens upon any of our property, merge, consolidate or sell all or substantially all of our assets. The Credit Agreement also includes customary events of default which may result in acceleration of the outstanding balance. At December 31, 2018, we were in compliance with the covenants of the Credit Agreement.

Key Components of Cash Flows and Liquidity

A summary of the sources and uses of cash and cash equivalents is as follows (in thousands):

	Six Months Ended	
	December 31,	December 31,
	2018	2017
Net cash provided by operating activities	$61,611	$ 14,248
Net cash used in investing activities	(10,413)	(105,968)
Net cash (used in) provided by financing activities	(31,329)	88,284
Foreign currency effect on cash	(365)	94
Net increase (decrease) in cash	$19,504	$ (3,342)

Net Cash Provided by Operating Activities

Cash flows provided by operations in the six months ended December 31, 2018 were $61.6 million, including our net loss of $1.9 million and non-cash expenses of $38.4 million for items such as amortization of intangibles, stock-based compensation, depreciation, deferred income taxes and imputed interest. Other sources of cash for the current quarter included a decrease in accounts receivables, inventories and increases in deferred revenues. This was partially offset by decreases in accounts payable, accrued compensation and other current and long-term liabilities, and increases in prepaid expenses and other current assets.

Cash flows provided by operations in the six months ended December 31, 2017 were $14.2 million, including net loss of $27.5 million and non-cash expenses of $23.1 million for items such as amortization of intangibles, stock-based compensation, depreciation, deferred income taxes, gain on bargain purchase and gain on sale of non-marketable equity investment as well as increases in accounts payable, accrued compensation, deferred revenue and other current and long-term liabilities and a decrease in prepaid expenses and other assets. This was partially offset by increases in accounts receivable and inventories.

Net Cash Used in Investing Activities

Cash flows used in investing activities in the six months ended December 31, 2018 were $10.4 million which consisted of purchases of property and equipment of $11.1 million partially offset by proceeds of $0.7 million related to the sale of investments.

Cash flows used in investing activities in the six months ended December 31, 2017 were $106.0 million which consisted of expenditures for acquisitions of $97.6 million consisting of $69.6 million for the acquisition of the Campus Fabric Business and $29.5 million for the acquisition of the Data Center Business, less receipt of $1.6 million as final settlement of a working capital adjustment related to the WLAN Business acquisition, purchases of property and equipment of $13.3 million and proceeds of $4.9 million related to the sale of non-marketable equity investment.

Net Cash (Used in) Provided by Financing Activities

Cash flows used in financing activities in the six months ended December 31, 2018 were $31.3 million consisting of repayments of debt totaling $14.8 million, contingent consideration of $3.9 million, and $2.0 million for deferred payments on acquisitions. This was partially offset by $5.0 million of proceeds from the issuance of shares of our common stock under our Employee Stock Purchase Plan (“ESPP”), the exercise of stock options and net of taxes paid

on vested and released stock awards.

Cash flows used in financing activities for the period also included repurchasing of our common shares valued at $15.0 million during the six months ended December 31, 2018, in accordance with our approved share repurchase plan. The share repurchases were executed through open market purchases, and future share repurchases may be completed through the combination of individually negotiated transactions, accelerated share buyback, and/or open market purchases. As of December 31, 2018, we have $45.0 million available under our share repurchase plan. Our Credit Facility does not contain any restrictions on the amount of borrowings that can be used to make share repurchases, as long as we are in compliance with our financial and non-financial covenants.

Cash flows provided by financing activities in the six months ended December 31, 2017 were $88.3 million, including new borrowings of $100.0 million to fund our acquisitions of the Campus Fabric Business and the Data Center Business, $5.6 million proceeds from issuance of shares of our common stock under our 2014 Employee Stock Purchase Plan and the exercise of stock options less $7.1 million of taxes paid on vested and released stock awards, partially offset by repayments of debt totaling $8.7 million and $1.5 million of loan fees incurred in connection with the Second Amendment of our Credit Facility.

Foreign Currency Effect on Cash

Foreign currency effect on cash decreased in the six months ended December 31, 2018 and 2017, primarily due to changes in foreign currency exchange rates between the U.S. Dollar and particularly the Brazilian Real, Indian Rupee and the EURO.

Contractual Obligations

The following summarizes our contractual obligations as of December 31, 2018, and the effect such obligations are expected to have on our liquidity and cash flow in future periods (in thousands):

	Total	Less than 1 Year	1-3 years	3-5 years
Contractual Obligations:				
Debt obligations	$185,250	$9,500	$26,125	$149,625
Interest on debt obligations	32,142	9,192	16,720	6,230
Inventory purchase commitments	172,597	172,597	—	—
Contractual commitments	111,625	29,375	47,000	35,250
Non-cancellable operating lease obligations	95,939	19,160	34,895	41,884
Deferred payments for an acquisition	17,000	4,000	8,000	5,000
Contingent consideration for an acquisition	8,649	4,068	4,581	—
Other liabilities	485	137	273	75
Total contractual cash obligations	$623,687	$248,029	$137,594	$238,064

The contractual obligations referenced above are more specifically defined as follows:

Debt obligations relate to amounts owed under our Credit Agreement.

Inventory purchase commitments represent the purchase of long lead-time component inventory that our contract manufacturers procure in accordance with our forecast. We expect to honor the inventory purchase commitments within the next 12 months.

Contractual commitments to suppliers for future services.

Non-cancelable operating lease obligations represent base rents and operating expense obligations to landlords for facilities we occupy at various locations.

Deferred payments for the acquisition of the Data Center Business represent a $1.0 million per quarter.

Contingent consideration for the Capital Financing Business acquisition, at fair value. Actual payments could be different.

Other liabilities include our commitments towards debt related fees and specific arrangements other than inventory.

The amounts in the table above exclude immaterial income tax liabilities related to uncertain tax positions as we are unable to reasonably estimate the timing of settlement.

We did not have any material commitments for capital expenditures as of December 31, 2018.

Off-Balance Sheet Arrangements

We did not have any off-balance sheet arrangements as of December 31, 2018.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

Interest Rate Sensitivity

Our exposure to market risk for changes in interest rates relates primarily to our financial investments and debt. We usually invest our cash in investments with short maturities or with frequent interest reset terms. Accordingly, our interest income fluctuates with short-term market conditions. As of December 31, 2018, we did not have any financial investments that were exposed to interest rate risk.

Debt

At certain points in time we are exposed to the impact of interest rate fluctuations, primarily in the form of variable rate borrowings from our credit facility.

At certain points in time we are exposed to the impact of interest rate fluctuations, primarily in the form of variable rate borrowings from our Credit Agreement. Our debt and Credit Agreement are described in the Note 8. Debt, of our Notes to the Consolidated Financial Statements in our annual report on Form 10-K. At December 31, 2018, we had $185.3 million of debt outstanding, all of which was from our Credit Agreement. Through the quarter ended December 31, 2018, the average daily outstanding amount was $187.6 million with a high of $187.6 million and a low of $185.3 million.

The following table presents hypothetical changes in interest expense for the quarter ended December 31, 2018, on outstanding Credit Agreement borrowings as of December 31, 2018, that are sensitive to changes in interest rates (in thousands):

Change in interest expense given a decrease in interest rate of X bps*		Average daily outstanding debt	Change in interest expense given an increase in interest rate of X bps	
(100 bps)	(50 bps)		100 bps	50 bps
$ (463)	$ (232)	$ 187,599	$ 463	$ 232

* Underlying interest rate was 4.65% during the quarter.

Exchange Rate Sensitivity

A majority of our sales and expenses are denominated in United States Dollars. While we conduct some sales transactions and incur certain operating expenses in foreign currencies and expect to continue to do so, we do not anticipate that foreign exchange gains or losses will be significant, in part because of our foreign exchange risk management process discussed below.

Foreign Exchange Forward Contracts

We record all derivatives on the balance sheet at fair value. Changes in the fair value of derivatives are recognized in earnings as Other expense, net. From time to time, we enter into foreign exchange forward contracts to mitigate the effect of gains and losses generated by the foreign currency forecast transactions related to certain operating expenses and re-measurement of certain assets and liabilities denominated in foreign currencies. These derivatives do not qualify as hedges. Changes in the fair value of these foreign exchange forward contracts are offset largely by re-measurement of the underlying assets and liabilities. At December 31, 2018, we did not have any forward foreign currency contracts outstanding.

Foreign currency transaction gains and losses from operations was an immaterial loss and a loss of $0.6 million for the three months ended December 31, 2018 and 2017, respectively. Foreign currency transaction gains and losses from operations was a gain of $0.2 million and a loss of $1.1 million for the six months ended December 31, 2018 and 2017, respectively.

Item 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

Disclosure controls and procedures are controls and procedures designed to reasonably assure that information required to be disclosed in our reports filed under the Securities Exchange Act of 1934 as amended, such as this Report, is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms and to reasonably assure that such information is accumulated and communicated to our management, including the Chief Executive Officer (“CEO”) and the Chief Financial Officer (“CFO”), as appropriate to allow timely decisions regarding required disclosure.

Under the supervision and with the participation of our management, including our CEO and CFO, we evaluated the effectiveness of the design and operation of our disclosure controls and procedures as of the end of the period covered by this Report. Based on this evaluation, our CEO and CFO concluded that our disclosure controls and procedures were effective as of the end of the period covered by this Report.

Changes in Internal Control over Financial Reporting

There were no changes in our internal control over financial reporting (as defined in Rules 13a – 15(f) and 15(d) – 15(f) during the December 31, 2018 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

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Inherent Limitations on Effectiveness of Controls

Our management, including our CEO and CFO, does not expect that our disclosure controls or our internal control over financial reporting will prevent or detect all error and all fraud. A control system, no matter how well designed and operated, can provide only reasonable, not absolute, assurance that the control system's objectives will be met. Our controls and procedures are designed to provide reasonable assurance that our control system's objective will be met and our CEO and CFO have concluded that our disclosure controls and procedures are effective at the reasonable assurance level. The design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. Further, because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that misstatements due to error or fraud will not occur or that all control issues and instances of fraud, if any, within Extreme Networks have been detected. These inherent limitations include the realities that judgments in decision-making can be faulty and that breakdowns can occur because of simple error or mistake. Controls can also be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the controls. The design of any system of controls is based in part on certain assumptions about the likelihood of future events. Projections of any evaluation of the effectiveness of controls in future periods are subject to risks. Over time, controls may become inadequate because of changes in conditions or deterioration in the degree of compliance with policies or procedures. Notwithstanding these limitations, our disclosure controls and procedures are designed to provide reasonable assurance of achieving their objectives. Our CEO and CFO have concluded that our disclosure controls and procedures are, in fact, effective at the "reasonable assurance" level.

PART II. Other Information

Item 1. Legal Proceedings

For information regarding litigation matters required by this item, refer to Part I, Item 3, Legal Proceedings of our Annual Report on Form 10-K for the fiscal year ended June 30, 2018, and Note 9 to our Notes to Condensed Consolidated Financial Statements, included in Part I, Item 1 of this Report which are incorporated herein by reference.

Item 1A. Risk Factors

Our operations and financial results are subject to various risks and uncertainties, including those described in Part I, Item 1A, "Risk Factors" in our Annual Report on Form 10-K for the year ended June 30, 2018 and in Part II, Item 1A, “Risk Factors” in our Quarterly Report on Form 10-Q for the quarter ended September 30, 2018, which could adversely affect our business, financial condition, results of operations, cash flows, and the trading price of our common stock. There have been no material changes to our risk factors since our Annual Report on Form 10-K for the year ended June 30, 2018 and our Quarterly Report on Form 10-Q for the quarter ended September 30, 2018.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

There were no sales of unregistered equity securities during the three months ended December 31, 2018.

The following table provides stock repurchase activity during the three months ended December 31, 2018 (in thousands, except per share amounts).

	Total Number of Shares Purchased	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Approximate Dollar Value of Shares That May yet Be Purchased Under the Plans or Programs
Original Purchase Authority (1)				$ 60,000
October 1, 2018 - October 31, 2018	—	$ -	—	—
November 1, 2018 - November 30, 2018	2,366	6.34	2,366	15,000
December 1, 2018 - December 31, 2018	—	—	—	—
Total	2,366	$ 6.34	2,366	$ 45,000

(1) On November 2, 2018, we announced that our Board of Directors had authorized management to repurchase up to $60.0 million of our common stock for two years from the date of authorization. Purchases may be made from time

to time in the open market or in privately negotiated transactions. A maximum of $35.0 million of our common stock may be repurchased in any calendar year.

Item 3. Defaults Upon Senior Securities - Not applicable

Item 4. Mine Safety Disclosure - Not Applicable

Item 5. Other Information – Not Applicable

Item 6. Exhibits

(a) Exhibits:

Exhibit Number	Description of Document	Incorporated by Reference Form	Filing Date	Number	Filed Herewith
10.1*	Offer Letter, executed November 15, 2018, between Extreme Networks, Inc. and Remi Thomas.	8-K	11/20/2018	10.1	
31.1	Section 302 Certification of Chief Executive Officer.				X
31.2	Section 302 Certification of Chief Financial Officer.				X
32.1**	Section 906 Certification of Chief Executive Officer.				X
32.2**	Section 906 Certification of Chief Financial Officer.				X
101.INS	XBRL Instance Document.				X
101.SCH	XBRL Taxonomy Extension Schema Document.				X
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document.				X
101.LAB	XBRL Taxonomy Extension Label Linkbase Document.				X
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document.				X
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document.				X

* Indicates management or board of directors contract or compensatory plan or arrangement.

** Furnished herewith. Exhibits 32.1 and 32.2 are being furnished and shall not be deemed to be “filed” for purposes of section 18 of the Securities Exchange Act of 1934, as amended (the “Exchange Act”), or otherwise subject to the liability of that section, nor shall such exhibits be deemed to be incorporated by reference in any registration statement or other document filed under the Securities Act of 1933, as amended, or the Exchange Act, except as otherwise specifically stated in such filing.

SIGNATURES

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

EXTREME NETWORKS, INC.

(Registrant)

/ S / REMI THOMAS
Remi Thomas
Executive Vice President, Chief Financial Officer

(Principal Accounting Officer)

January 30, 2019

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