LEGATO SYSTEMS INC
Form 10-Q
November 14, 2002
Table of Contents

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, 2002

OR

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

For the transition period from_________ to ___________

Commission File Number: 000-26130

LEGATO SYSTEMS, INC.
(Exact name of registrant as specified in its charter)

Delaware	**94-3077394**
(State of Incorporation)	**(I.R.S. Employer Identification No.)**

2350 West El Camino Real, Mountain View, CA 94040
(Address of principal executive offices)

Registrant s telephone number, including area code: (650) 210-7000

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 ¨

The number of shares outstanding of the Registrant s Common Stock as of November 4, 2002 was 116,024,476.

Table of Contents

LEGATO SYSTEMS, INC

INDEX

Table of Contents

PART I FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

LEGATO SYSTEMS, INC.
Consolidated Balance Sheets
(in thousands, except per share data)

	September 30, 2002	December 31, 2001
	(unaudited)	
ASSETS		
Current assets:		
Cash and cash equivalents	$ 27,182	$ 63,281
Short-term investments	18,136	82,414
Accounts receivable, net	52,552	39,581
Deferred tax assets		61,136
Other current assets	9,685	12,373
Total current assets	107,555	258,785
Property and equipment, net	47,886	42,884
Intangible assets, net	33,281	15,616
Goodwill	270,709	16,026
Deferred tax assets		19,754
Other assets	5,264	2,196
	$ 464,695	$ 355,261
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 14,735	$ 8,316
Accrued liabilities	55,623	41,440
Deferred revenue	56,115	41,748
Total current liabilities	126,473	91,504
Deferred revenue net of current portion	3,095	3,798
	129,568	95,302
Stockholders equity:		
Common stock and capital in excess of par, $0.0001 par value; 115,267 and 89,613 issued and outstanding, respectively	624,562	329,951
Deferred stock compensation	(540)	
Accumulated other comprehensive income	535	684
Accumulated deficit	(289,430)	(70,676)
Total stockholders equity	335,127	259,959
	$ 464,695	$ 355,261

See accompanying notes to consolidated financial statements.

Table of Contents

LEGATO SYSTEMS, INC.
Consolidated Statements of Operations
(in thousands, except per share data)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2002	**2001**	**2002**	**2001**
		(unaudited)		
Revenue:				
License	$ 33,203	$ 32,681	$ 92,582	$ 111,267
Service and support	34,885	24,332	92,694	69,304
Total revenue	68,088	57,013	185,276	180,571
Cost of revenue:				
License	3,320	2,055	7,246	3,986
Service and support	11,284	11,297	33,204	37,015
Cost of revenue	14,604	13,352	40,450	41,001
Gross profit	53,484	43,661	144,826	139,570
Operating expenses:				
Sales and marketing	34,595	32,302	100,533	93,330
Research and development	19,390	17,055	52,162	48,285
General and administrative	8,739	8,092	25,414	22,767
Amortization of acquired intangibles	2,695	7,516	6,293	24,270
In-process research and development			33,200	
Litigation settlement charge			67,000	
Restructuring charges (recoveries)		(1,329)		4,758
Total operating expenses	65,419	63,636	284,602	193,410
Loss from operations	(11,935)	(19,975)	(139,776)	(53,840)
Interest and other income, net	665	1,281	2,527	6,124
Loss before provision for (benefit from) income taxes	(11,270)	(18,694)	(137,249)	(47,716)
Provision for (benefit from) income taxes	114,889	(5,710)	81,505	(14,155)
Net loss	$ (126,159)	$ (12,984)	$ (218,754)	$ (33,561)
Net loss per share:				
Basic and diluted	$ (1.10)	$ (0.15)	$ (2.13)	$ (0.38)
Weighted average common shares outstanding	115,153	89,288	102,790	88,624

See accompanying notes to consolidated financial statements.

Table of Contents

LEGATO SYSTEMS, INC.
Consolidated Statements of Cash Flows
(in thousands)

	Nine Months Ended September 30, 2002	Nine Months Ended September 30, 2001
	(unaudited)	
Cash flows from operating activities:		
Net loss	$ (218,754)	$ (33,561)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:		
Deferred taxes	77,972	(27,991)
Depreciation and amortization	19,649	39,105
Write-off of in-process research and development	33,200	
Amortization of deferred stock compensation	289	
Provision for doubtful accounts and product returns	1,453	1,562
Tax benefit (provision) from stock option exercises	(307)	5,434
Changes in assets and liabilities:		
Accounts receivable	(344)	10,646
Other assets	2,520	8,743
Accounts payable	2,323	3,289
Accrued liabilities	(16,819)	3,492
Deferred revenue	4,820	(10,169)
Net cash provided by (used in) operating activities	(93,998)	550
Cash flows from investing activities:		
Purchases of available-for-sale securities	(17,801)	(391,614)
Maturities and sales of available-for-sale securities	82,546	373,760
Purchase of technology and workforce	(3,250)	
Acquisition of OTG Software, net of cash acquired	(1,609)	
Acquisition of Software Clearing House, net of cash acquired		(8,697)
Purchase of property and equipment	(11,460)	(17,493)
Net cash provided by (used in) investing activities	48,426	(44,044)
Cash flows from financing activities		
Proceeds from issuance of common stock	10,089	13,203
Effect of exchange rate changes on cash	(616)	
Net change in cash and cash equivalents	(36,099)	(30,291)
Cash and cash equivalents at beginning of period	63,281	110,274
Cash and cash equivalents at end of period	$ 27,182	$ 79,983

See accompanying notes to consolidated financial statements.

Table of Contents

LEGATO SYSTEMS, INC.

Notes to Consolidated Financial Statements
(unaudited)

1. Basis of Presentation

The accompanying unaudited consolidated financial statements have been prepared by Legato Systems, Inc. (the Company or Legato) in accordance with the rules and regulations of the Securities and Exchange Commission. Certain information and footnote disclosures normally included in consolidated financial statements prepared in accordance with accounting principles generally accepted in the United States have been condensed or omitted in accordance with such rules and regulations. In the opinion of management, the accompanying unaudited consolidated financial statements reflect all adjustments, consisting only of normal recurring adjustments, necessary to present fairly the financial position, results of operations and cash flows of the Company and its subsidiaries. The results of operations for the interim periods presented are not necessarily indicative of the results that may be expected for any future interim period or for the year ending December 31, 2002, and the Company makes no representations related thereto. These financial statements should be read in conjunction with the annual audited consolidated financial statements and notes as of and for the year ended December 31, 2001, included in the Company s Form 10-K dated March 14, 2002.

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires us to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

The financial statements for the three and nine months ended September 30, 2002 include the results of OTG Software, Inc. (OTG) since May 14, 2002, the date of acquisition (see Note 6).

2. Balance Sheet Components

	September 30, 2002	December 31, 2001
Accounts receivable:		
Trade accounts receivable	$ 60,019	$ 47,449
Allowances for doubtful accounts and sales returns	(7,467)	(7,868)
	$ 52,552	$ 39,581
Property and equipment:		
Computer hardware	$ 50,978	$ 43,801
Computer software	26,524	18,978
Office equipment, furniture and fixtures	18,446	16,193
Leasehold improvements	14,726	13,344
	110,674	92,316
Accumulated depreciation and amortization	(62,788)	(49,432)
	$ 47,886	$ 42,884
Accrued liabilities:		
Accrued compensation and benefits	$ 18,486	$ 19,202
Income taxes payable	10,261	7,354
Other accrued liabilities	26,876	14,884
	$ 55,623	$ 41,440

6

Table of Contents

3. Revenue Recognition

Revenue is derived from primarily two sources: (i) license revenue, derived from the sale of software licenses to resellers and end users, including large-scale enterprises, and royalty revenue, derived from initial license fees and ongoing royalties from licenses of source code to OEMs; and (ii) service and support revenue, derived from providing software updates, support and education and consulting services to end users.

License revenue is generally recognized when a signed contract or other persuasive evidence of an arrangement exists, the software has been shipped or electronically delivered, the license fee is fixed or determinable and collection of resulting receivables is probable. Estimated product returns are recorded upon recognition of revenue from customers having rights of return, including exchange rights for unsold products and product upgrades. Provisions for estimated warranty costs and anticipated retroactive price adjustments are recorded at the time products are shipped. For sales to domestic distributors, license revenue is recognized upon sale by the distributor to the end-user. License revenue from royalty payments is recognized upon receipt of royalty reports from OEMs related to their product sales. Revenue from subscription license agreements, which include software, rights to future products and maintenance, is recognized ratably over the term of the subscription period.

Service and support revenue consists primarily of revenue received for providing software updates, technical support for software products, on-site support, consulting and training. Revenue from updates and support is recognized ratably over the term of the agreements. Revenue allocated to education and consulting services, or derived from the separate sales of these services, is recognized as the related services are provided.

When contracts contain multiple obligations (e.g., products, updates, technical support and other services) wherein vendor specific objective evidence exists for all undelivered elements, we account for revenue associated with the delivered elements in accordance with the residual method prescribed by Statement of Position 98-9. Any revenue related to updates or technical support in these arrangements is recognized ratably over the term of the maintenance arrangement.

4. Comprehensive Loss

Comprehensive loss includes unrealized gains (losses) on investments and reflects the effect of foreign currency translation adjustments on the accounts of our foreign operations. The impacts of which are excluded from net loss and are included in stockholders equity. A summary of comprehensive loss is as follows (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2002	2001	2002	2001
Net loss	$ (126,159)	$ (12,984)	$ (218,754)	$ (33,561)
Unrealized gain (loss) on investments	(122)	606	(765)	627
Foreign currency translation adjustments	23		616	
	$ (126,258)	$ (12,378)	$ (218,903)	$ (32,934)

5. Computation of Net Income (Loss) Per Share

Basic net income (loss) per share is computed by dividing net income (loss) by the weighted average shares of common stock outstanding during the period. Diluted net income per share is computed by dividing net income by the weighted average shares of common stock and potential common shares outstanding during the period. Potential common shares outstanding consist of dilutive shares issuable upon the exercise of outstanding options to purchase common stock as computed using the treasury stock method. For periods in which Legato incurs a loss, potential common shares outstanding are excluded from the computation of diluted net loss per share as their effect is anti-dilutive.

Table of Contents

Options to purchase 26.4 million shares and 21.6 million shares of common stock at a weighted average price of $10.41 per share and $12.51 per share were outstanding as of September 30, 2002 and 2001, respectively, but were not included in the computation of diluted net loss per share because their effect would be anti-dilutive.

6. Acquisition of OTG Software, Inc.

On May 14, 2002, we completed our acquisition of OTG for cash and stock at a value of $382.5 million. OTG, based in Rockville, Maryland, provides data management and collaboration solutions that virtualize storage for any type of data, including files, messages and databases, while providing easy and transparent access. Each share of OTG common stock was exchanged for 0.6876 of a share of Legato common stock and $2.50 per share in cash. We also assumed all outstanding options to purchase OTG common shares. OTG provides us with complementary channels, markets and technology, which will enable us to expand our opportunities by offering robust storage, content and email management solutions. The combined company will have the scale, scope and worldwide channel access to leverage OTG s strengths in data access and business applications such as email.

The total purchase price of $382.5 million consisted of cash of $87.3 million (OTG had cash and investments of $85.7 million as of the closing date), the issuance of 24.0 million shares of Legato common stock valued at $262.7 million and the issuance of 3.4 million stock options valued at $22.8 million. We also incurred $9.7 million in merger-related costs. These costs primarily consist of investment banking, legal and other professional fees and severance and duplicate facility costs.

The shares issued in the acquisition have been valued in accordance with Emerging Issue Task Force Issue No. (EITF) 99-12, Determination of the Measurement Date for the Market Price of Acquirer Securities Issued in a Purchase Business Combination. In accordance with EITF 99-12, we established that the first date on which the number of our shares and the amount of other consideration became fixed was February 21, 2002, the date we announced the acquisition. Accordingly, we have valued the common stock at $10.94 per share, which represents the average closing price for the period from February 19, 2002 to February 25, 2002. The assumed stock options were valued using the Black Scholes valuation model with a volatility factor of 100%, an average risk free interest rate of 3% and estimated lives of three to 24 months.

The OTG acquisition was accounted for under Statements of Financial Accounting Standards (SFAS) No. 141, Business Combinations, and certain specified provisions of SFAS No. 142, Goodwill and Other Intangible Assets. The results of the operations of OTG were included in our Consolidated Statement of Operations since May 15, 2002.

The following table summarizes the estimated fair value of the assets acquired and liabilities assumed at the date of the acquisition of OTG (in thousands):

Cash and investments	$ 85,728
Accounts receivable	13,916
Other current assets	2,889
Property and equipment	9,319
Total assets acquired	111,852
Accrued liabilities	(29,175)
Deferred revenue	(8,810)
	$ 73,867

The purchase price of $382.5 million has been allocated to the tangible and identifiable intangible assets acquired and liabilities assumed on the basis of their estimated fair values on the acquisition date. Deferred stock compensation is the intrinsic value associated with the 1.2 million of unvested options that were assumed and is being amortized over the options remaining vesting period. Goodwill represents the excess of the purchase price over the fair value of the net tangible and identifiable intangible assets acquired. The allocation of purchase price is as follows (in thousands):

Table of Contents

Fair value of net tangible assets acquired	$	73,867
Intangible assets acquired:		
Purchased technology		13,700
Other current assets		8,300
In-process research and development		33,200
Deferred stock compensation		1,224
Goodwill		252,251
	$	382,542

In-process research and development, relating to development projects which had not reached technological feasibility and that had no future alternative uses, was expensed upon consummation of the merger in the current period. Other identifiable intangible assets are being amortized over their useful lives of five years for developed technology and the customer base. In accordance with SFAS No. 142, goodwill relating to the OTG acquisition is not being amortized and will be tested for impairment annually or whenever events indicate that impairment may have occurred. We do not expect any of the goodwill to be deductible for tax purposes.

Purchased technology, customer relationships and in-process research and development (IPR&D) were identified and valued through interviews and analysis of data provided by management. For development projects that had reached technological feasibility, they were classified as purchased technology, and the value assigned to the purchased technology was capitalized. The income approach, which includes an analysis of the cash flows and risks associated with achieving such cash flows, was the primary technique utilized in valuing acquired intangible assets. Key assumptions included estimates of revenue growth, cost of sales, operating expenses and taxes. Discount rates used in the valuation of purchased technology, customer relationships and IPR&D were 20%, 15% and 35%, respectively.

The following unaudited pro forma financial information was prepared as if the acquisition of OTG occurred as of the beginning of each period presented. This information represents an estimate of the ongoing operations of the combined entities as if OTG was acquired at the beginning of each period presented and excludes the write-off of in-process research and development discussed above. In our opinion, all adjustments necessary to present fairly such information have been made based on the terms and structure of the transaction. The following table is presented for illustrative purposes only and does not necessarily represent the financial results that would have resulted had the acquisition actually occurred on the date indicated nor are the results indicative of the future results of operations or financial condition of the Company on a consolidated basis (in thousands).

	Nine Months Ended September 30,	
	2002	**2001**
Revenue	$ 199,497	$ 226,872
Net loss	$ (213,914)	$ (40,717)
Net loss per share basic and diluted	$ (1.86)	$ (0.36)

7. Legal Proceedings

On or about July 26, 2001, a class action lawsuit was filed in the Southern District of New York naming OTG, officers of OTG who signed the registration statement in connection with OTG s initial public offering, and the managing underwriters of the initial public offering as defendants. The complaint alleges that OTG s initial public offering registration statement and final prospectus contained material misrepresentations and/or omissions, related in part to additional, excessive and undisclosed commissions allegedly received by the underwriters from investors to whom the underwriters allegedly improperly allocated shares of the public offering. The complaint seeks relief in the form of damages and/or rescission of the plaintiff s purchase transaction. Since this initial complaint was filed, three other complaints making similar or identical allegations and seeking similar relief have been filed. All of the actions brought against OTG have been consolidated, and are being heard along with other similar actions brought against approximately 300 other issuers, issuers officers and underwriters in the Southern District of New York. On July

9

Table of Contents

19, 2002, the defendants filed a motion to dismiss the complaint. We intend to defend the action vigorously and believe that it is not possible at the current time to estimate the amount of a probable loss, if any, that might result from this matter.

On July 1, 2002, we received notice that an action captioned *Nickel v. Kay, et al.* had been filed in the Circuit Court for Montgomery County, Maryland. The action, brought by a former OTG employee, asserts claims that Richard Kay, OTG and Legato are liable under various legal theories for the alleged breach of Mr. Nickel s employment contract and breach of fiduciary duties allegedly owed to Mr. Nickel. The complaint alleges compensatory and punitive damages, to be proven at trial. The case is in its preliminary stages, and an investigation of the facts is not complete. We intend to defend this action vigorously; however the outcome is uncertain at this time. Although insurance may be available to cover some portion of any potential liability, an adverse judgment could be materially adverse to our operating results.

On September 30, 2002, we received written notice of a claim by one of OTG s resellers in Europe. The reseller alleges that OTG misrepresented information concerning the capabilities of certain OTG products during 2001, and OTG s intentions with respect to development plans for those products. On that basis, the reseller asserts that it is entitled to compensatory damages. Under the terms of the agreement with the reseller, if the parties are unable to resolve the dispute informally, the matter must be submitted to arbitration with the American Arbitration Association. The parties are currently working to resolve the matter amicably; however, the likelihood of such a resolution is uncertain at this time. Although insurance may be available to cover some portion of any potential liability, an adverse arbitral award could be materially adverse to our operating results.

In addition to the foregoing matters, we are parties to various other lawsuits and disputes regarding commercial and employment matters arising in the ordinary course of operations. We believe that the amounts in dispute in these other matters are insubstantial, and the effect of these matters, individually and in the aggregate, would not be material to our operating results.

8. Intangible Assets and Goodwill

In July 2001, the FASB issued SFAS No. 142, which addresses financial accounting and reporting for acquired goodwill and other intangible assets and supersedes Accounting Principles Board (APB) Opinion No. 17, Intangible Assets. Among other things, it requires that goodwill and certain other intangible assets no longer be amortized and be tested for impairment at least annually and written down only when impaired. Further, SFAS No. 142 required us to perform a transitional assessment of whether there is an indication that its goodwill is impaired as of the date of adoption (January 1, 2002). We are also required to review our other intangible assets for impairment and to reassess the useful lives of such assets and make any necessary adjustments.

Upon adoption of SFAS No. 142, we reclassified the remaining unamortized balance of acquired workforce, totaling $1.3 million, to goodwill. We ceased to amortize goodwill of $17.3 million as of January 1, 2002. We completed our initial impairment test and concluded that there was one reporting unit and no impairment charge was required. The following table presents the effects on net loss and net loss per share, basic and diluted, as if the goodwill had not been amortized during the periods presented (in thousands, except for per share amounts):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2002	2001	2002	2001
Net loss as reported	$ (126,159)	$ (12,984)	$ (218,754)	$ (33,561)
Adjustment:				
Amortization of goodwill		5,145		13,871
Net loss as adjusted	$ (126,159)	$ (7,839)	$ (218,754)	$ (19,690)
Net loss per share, basic and diluted as reported	$ (1.10)	$ (0.15)	$ (2.13)	$ (0.38)
Net loss per share, basic and diluted as adjusted	$ (1.10)	$ (0.09)	$ (2.13)	$ (0.22)

Table of Contents

The components of goodwill and other intangibles are as follows (in thousands):

	September 30, 2002	December 31, 2001
Goodwill	$ 306,889	$ 48,998
Less: accumulated amortization	(36,180)	(32,972)
	$ 270,709	$ 16,026
Patents and purchased technology	$ 41,539	$ 24,589
Customer relationships	30,800	22,500
Assembled workforce		4,500
	72,339	51,589
Less: accumulated amortization	(39,058)	(35,973)
	$ 33,281	$ 15,616

The changes in the carrying amount of goodwill are as follows (in thousands):

Balance as of December 31, 2001	$ 16,026
Reclass/purchase of assembled workforce	2,432
Acquisition of OTG	252,251
Balance as of September 30, 2002	$ 270,709

As of September 30, 2002, the following is the gross carrying amount and accumulated amortization for the acquired intangible assets (in thousands):

	Gross Carrying Amount	Accumulated Amortization	Net Book Value
Patents and purchased technology	$ 41,539	$ (17,056)	$ 24,483
Customer relationships	30,800	(22,002)	8,798
	$ 72,339	$ (39,058)	$ 33,281

As of September 30, 2002, the weighted-average amortization period for patents and purchased technology, and customer relationships was 5.0 years and 3.2 years, respectively. Future intangible amortization expense is estimated to be $2.7 million for the remainder of 2002, $10.8 million in 2003, $7.9 million in 2004, $5.0 million in 2005 and 2006 and $1.9 million in 2007.

9. Stock Option Program

Option Program Description. Our stock option program is a broad-based, long-term retention program that is intended to attract and retain talented employees and align stockholder and employee interests. We consider our option program critical to our operation and productivity; essentially all of our employees participate. 82% of the options we granted last year went to employees other than the five most highly compensated officers. The program consists of one plan, which was approved by our shareholders and is divided into three separate components:

Discretionary Option Grant Program, under which employees, non-employee Board members who are not serving on our Compensation Committee and consultants may, at the discretion of the Compensation Committee, be granted options to purchase shares of common stock;

Stock Issuance Program, under which such persons may, at the Compensation Committee s discretion, be issued shares of common stock directly, through the purchase of such shares or in consideration of the past performance of services; and

Automatic Option Grant Program, under which option grants will automatically be made at periodic intervals to eligible non-employee Board members to purchase shares of common stock at an exercise price

Table of Contents

equal to 100% of their fair market value on the grant date. Each individual who first becomes a non-employee Board member will receive a 96,000 share option grant on the date such individual joins the Board, provided such individual has not been previously employed by us. In addition, at each Annual Stockholders Meeting, each individual who has served as a non-employee Board member for at least six months prior to such Annual Meeting and who is to continue to serve as a non-employee Board member after the meeting will receive an additional option grant to purchase 24,000 shares of common stock, whether or not such individual has been in our prior employment.

Options generally vest over four years, whereby 25% of the shares become exercisable one year after the grant date and monthly thereafter over 36 months, and terminate ten years after their original grant date. The average vesting period is four years.

We have a goal to keep the dilution related to our option program to an average of less than three percent annually. Accordingly, the shares reserved under this program automatically increases on the first trading day in each calendar year by the lesser of (i) the number of shares equal to 3% of the total number of shares of our common stock outstanding on December 31 of the immediately preceding calendar year or (ii) 3.0 million shares. The dilution percentage is calculated as the new option grants for the year, net of options forfeited by employees leaving the company, divided by the total outstanding shares at the beginning of the year.

All stock option grants are made after a review by the Chief Executive Officer, and, for option grants in excess of 30,000 shares, with the approval of, the Compensation Committee of the Board of Directors. All members of the Compensation Committee are independent directors, as defined in the applicable rules for issuers traded on The Nasdaq Stock Market. See the Report of the Compensation Committee on Executive Compensation appearing in the Company s proxy statement dated April 12, 2002 for further information concerning the policies and procedures of the Company and the Compensation Committee regarding the use of stock options.

Distribution and Dilutive Effect of Options. Employee and executive option grants are as follows:

	Nine Months Ended September 30, 2002	Year Ended December 31,	
		2001	2000
Net grants as a % of outstanding shares at beginning of period	3.1%	8.4%	4.8%
Grants to listed officers* as a percentage of total options granted	14.4	18.3	22.7
Grants to listed officers* as a percentage of outstanding shares	0.7	2.1	2.5
Cumulative options held by listed officers* as a percentage of total options outstanding at end of period	22.1	24.1	21.1

* See below for the listed officers; they are defined by the SEC for the proxy as the CEO and each of the four other most highly compensated executive officers.

During the first nine months of 2002, we granted options to purchase 5.3 million shares of our stock to our employees, which was a net grant of options for 2.9 million shares after deducting 2.4 million shares for options forfeited. The net options granted after forfeitures represented 3.1% of our total outstanding shares of approximately 89.6 million as of the beginning of this year.

Options granted to the five most highly compensated officers as a percentage of the total options granted to all employees vary from year to year. During the first nine months of 2002, options granted to the five most highly compensated executive officers amounted to 14.4% of the grants made to all employees, which is lower than 2001 and 2000. This decrease is a result that two of the listed executive officers were hired in 2000, and one was hired 2001. In order to attract and retain these executive officers, significant initial stock grants were made. That size of initial grants are not made every year.

General Option Information. A summary of option activity is as follows (in thousands, except per share amounts):

	Nine Months Ended September 30, 2002		Year Ended December 30, 2001	
	Shares	Weighted Average Price	Shares	Weighted Average Price
Outstanding at beginning of period	20,996	$ 12.24	14,892	$ 15.43
Options granted and assumed	8,750	6.53	10,509	8.76
Options exercised	(916)	6.06	(1,421)	5.60
Options forfeited	(2,422)	13.89	(2,984)	19.26
Outstanding at end of period	26,408	10.41	20,996	12.24

During 2002, we assumed 3.4 million options in connection with our acquisition of OTG. Shares available for future grant under the option plans were 5.7 million shares as of September 31, 2002 and 6.3 million shares as of December 31, 2001.

As of September 31, 2002, the In-the-Money and Out-of-the Money option information is as follows (in thousands, except per share amounts):

	Exercisable		Unexercisable		Total	
	Shares	Weighted Average Price	Shares	Weighted Average Price	Shares	Weighted Average Price
In-the-money	494	$ 0.85	174	$ 1.99	668	$ 1.15
Out-of-the-money*	11,354	13.03	14,385	8.80	25,740	10.67
	11,848	12.52	14,559	8.72	26,408	10.43

* Out-of-the-money options are those options with an exercise price equal to or above the closing price of $2.75 at the end of the quarter. Our stock price is volatile. The high, average and low closing stock price for the nine months ended September 30, 2002 was $17.43, $7.31 and $1.88, respectively.

Executive Officer Options. A Listed Officer is defined as the CEO and each of the four other most highly compensated executive officers. This is the same definition used by the SEC for proxy statements. For the nine months ended September 30, 2002, options granted to Listed Officers were as follows:

	Individual Option Grants			
	Number of Securities Underlying Options Per Grant	Percent of Total Options Granted to Employees	Exercise of Base Price ($/Share)	Expiration Date
David Wright, Chairman, President & CEO	250,000	4.7%	$ 2.79	9/18/2012
David Beamer, COO	125,000	2.3	2.79	9/18/2012
	100,000	1.9	9.72	2/28/2012
Andrew Brown, SVP & CFO	125,000	2.3	2.79	9/18/2012
Thomas Panozzo, SVP, Service & Support	90,000	1.7	2.79	9/18/2012
James Chappell, SVP, Business Process & Development	80,000	1.5	2.79	9/18/2012

	770,000	14.4

All of these grants have standard vesting periods as defined above in Option Program Description.

13

Table of Contents

With the closing stock price of $2.75 on September 30, 2002, all the Listed Officers options were under water or out-of-the-money. As of and for the nine months ended September 30, 2002, options exercised and remaining holdings of the Listed Officers were as follows:

	Shares Acquired on Exercise	Value Realized	Number of Securities Underlying Unexercised Options as of September 30, 2002		Values of Unexercised In-the-Money Options at September 30, 2002	
			Exercisable	Unexercisable	Exercisable	Unexercisable
David Wright		$	1,356,623	1,743,377	$	$
David Beamer			179,582	530,418		
Andrew Brown			365,000	595,000		
Thomas Panozzo			182,486	237,514		
James Chappell	40,000	82,760	274,598	230,002		

10. Restructuring Charges

During 2001, we incurred $9.4 million in charges as we restructured our development operations to reduce our cost structure and to integrate and reduce selling and marketing activities. As of September 30, 2002, accrued restructuring charges related primarily to future lease commitments, which will be paid through 2004, and some severance and benefits, which will be paid in 2002. The following table summarizes the restructuring activity during 2002 (in thousands):

	Severance and Benefits	Excess Facilities	Total
Balance, December 31, 2001	$ 636	$ 1,221	$ 1,857
Cash payments	(582)	(428)	(1,010)
Balance, September 30, 2002	$ 54	$ 793	$ 847

11. Recent Accounting Pronouncements

In July 2002, the FASB issued SFAS No. 146, Accounting for Costs Associated with Exit or Disposal Activities. The standard replaces EITF Issue No. 94-3, Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring) and requires companies to recognize costs associated with exit or disposal activities when they are incurred rather than at the date of a commitment to an exit or disposal plan. SFAS No. 146 is to be applied prospectively to exit or disposal activities initiated after December 31, 2002. The Company has not yet determined the impact of SFAS No. 146 on its financial position or results of operations.

In October 2001, the FASB issued SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets. SFAS No. 144 supercedes SFAS No. 121, Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed of. SFAS No. 144 applies to all long-lived assets, including discontinued operations, and consequently amends APB Opinion No. 30, Reporting the Results of Operations, Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions. SFAS No. 144 develops one accounting model for long-lived assets that are to be disposed of by sale. SFAS No. 144 requires that long-lived assets that are to be disposed of by sale be measured at the lower of book value or fair value less cost to sell. Additionally SFAS No. 144 expands the scope of discontinued operations to include all components of an entity with operations that: (a) can be distinguished from the rest of the entity and (b) will be eliminated from the ongoing operations of the entity in a disposal transaction. The adoption of SFAS No. 144 did not impact our financial position or results of operations.

In April 2002, the Emerging Issues Task Force (EITF) issued EITF Issue No. 01-14, Income Statement Characterization of Reimbursements Received for Out-of-Pocket Expenses Incurred, which requires that all out-

Table of Contents

of-pocket expenses billed to a customer be classified as revenue. EITF Issue No. 01-14 is effective for our fiscal quarter beginning on January 1, 2002, with comparative financial statements for prior periods reclassified to conform to this presentation. We had previously treated reimbursement for out-of-pocket expenses as a reduction to cost of revenue. Our adoption of EITF Issue No. 01-14 did not have a material impact on our revenue or any effect on our gross margins, operating margins, net loss and net loss per share.

12. Income Taxes

As part of the process of preparing our consolidated financial statements, we are required to estimate our income taxes in each of the jurisdictions in which we operate. This process involves us determining our income tax expense (benefit) together with calculating our deferred income tax expense (benefit) related to temporary differences resulting from differing treatment of items, such as deferred revenue or deductibility of certain intangible assets, for tax and accounting purposes. These differences result in deferred tax assets and liabilities, which are included within our consolidated balance sheet. We must then assess the likelihood that our deferred tax assets will be recovered through the generation of future taxable income.

During the third quarter of 2002, we established a full valuation allowance of $119.2 million against our deferred tax assets because we determined that it is more likely than not that all deferred tax assets will not be realized in the foreseeable future.

Significant components of our deferred tax assets and liabilities are as follows (in thousands):

	Sept. 30, 2002	Dec. 31, 2001
Deferred tax assets:		
Allowances, accrued liabilities and other	$ 10,671	$ 8,461
Accrued compensation and benefits	1,932	1,478
Net operating loss and credit carryforwards	87,862	49,857
Intangible asset purchased technology	17,663	18,137
Deferred revenue	5,866	3,520
Other	5,368	4,887
	129,362	86,340
Deferred tax liabilities Goodwill from Vinca acquisition	(10,146)	(5,450)
Net deferred tax assets	119,216	80,890
Less: valuation allowance	(119,216)	
	$	$ 80,890

The net operating loss and R&D credit carryovers that make up the vast majority of the deferred tax assets do not begin to expire until 2019, possibly allowing sufficient time to be utilized. Going forward, we will assess the continued need for the valuation allowance. After we have demonstrated profitability for a period of time and begin utilizing a significant portion of the deferred tax assets, we may reverse the valuation allowance, likely resulting in a significant benefit to the statement of operations in some future period. At this time, we cannot reasonably estimate when this reversal might occur.

Table of Contents

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

The discussion in this report on Form 10-Q contains forward-looking statements that involve risks and uncertainties. The statements contained in this Report that are not purely historical are forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended, including statements on our expectations, beliefs, intentions or strategies regarding the future. All forward-looking statements included in this document are based on information available to us on the date hereof. We assume no obligation to update any such forward-looking statements. Our actual results could differ materially from those indicated in such forward-looking statements. Factors that could cause or contribute to such differences include, but are not limited to, fluctuations in quarterly operating results, uncertainty in future operating results, competition, the current challenging information technology spending environment, litigation, product concentration, technological changes, reliance on enterprise license transactions, modifications in the application of accounting policies, reliance on indirect sales channels, changes in marketing strategies, dependence on international revenue, management of our growth and expansion, the ability to attract and retain qualified personnel, and other risks discussed in this item under the heading Risk Factors and the risks discussed in our other Securities and Exchange Commission filings.

CRITICAL ACCOUNTING POLICIES

There have been no material changes to our critical accounting policies and estimates as disclosed in our Form 10-K for the year ended December 31, 2001.

RESULTS OF OPERATIONS

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2002	**2001**	**2002**	**2001**
Revenue:				
License	49%	57%	50%	62%
Service and support	51	43	50	38
Total revenue	100	100	100	100
Cost of revenue:				
License	5	3	4	2
Service and support	16	20	18	21
Total cost of revenue	21	23	22	23
Gross profit	79	77	78	77
Operating expenses:				
Sales and marketing	51	57	54	52
Research and development	28	30	28	27
General and administrative	13	14	14	12
Amortization of acquired intangibles	4	13	3	13
In-process research and development			18	
Restructuring charges (recoveries)		(2)		3
Litigation settlement charge			36	
Total operating expenses	96	112	153	107
Loss from operations	(17)	(35)	(75)	(30)
Interest and other income, net	1	2	1	3

Loss before benefit from income taxes	(16)	(33)	(74)	(27)
Provision for (benefit from) income taxes	169	(10)	44	(8)
Net loss	(185)%	(23)%	(118)%	(19)%

Table of Contents

Overview

Legato Systems, Inc. was incorporated in Delaware in September 1988. We develop, market and support software products and services for information management of distributed, open systems environments. Information management includes the protection, recovery and avoidance of failures of data and applications so that business users can gain access to the information that they need when they need it. Distributed, open systems are generally understood to include UNIX, Windows NT, Windows 2000 and Linux server computer systems. We offer software products for backup, recovery and archive of data; for managing the performance and operation of application services; and for optimizing the use of storage devices and media including disk and tape. Our customers use our products and services to safeguard and manage their information assets and associated applications so that their businesses can continue to operate, and do so in a more cost-effective manner.

On May 14, 2002, we acquired OTG Software, Inc. OTG provides data management and collaboration solutions that virtualize storage for any type of data, including files, messages and databases, while providing easy and transparent access. Each share of OTG common stock was exchanged for 0.6876 of a share of Legato common stock and $2.50 per share of cash. We also assumed all outstanding options to purchase OTG common shares. The aggregate purchase price of $382.5 million consisted of cash of $87.3 million, the issuance of 24.0 million shares of Legato common stock valued at $262.7 million, the issuance of 3.4 million stock options valued at $22.8 million and the payment of $9.7 million in merger-related costs. OTG provides us with complementary channels, markets and technology, which will enable us to expand our opportunities by offering robust storage, content and email management solutions. The combined company will have the scale, scope and worldwide channel access to leverage OTG s strengths in data access and business applications such as email.

Aside from the costs added by the OTG acquisition, we have been reducing costs and implementing cost controls for the past six quarters. We reduced headcount in the second quarter of 2001, the fourth quarter of 2001 and again in the third quarter of 2002. In the latest reduction in force, we eliminated approximately 70 positions throughout the classic Legato organization, which resulted in approximately $0.7 million of severance costs that were expensed in the third quarter of 2002. Our other cost containment measures include: restricting capital expenditures, limiting travel, reducing discretionary corporate marketing programs and not replacing personnel that leave voluntarily. Our integration of OTG is for the most part proceeding as planned. Much of the immediate costs savings was implemented during the third quarter of 2002. Accordingly, as we move into the fourth quarter of 2002, we should expect to see the full benefit of those actions taken.

Revenue

Total revenue increased $11.1 million, or 19%, to $68.1 million in the third quarter of 2002 from $57.0 million for the third quarter of 2001. For the first nine months of 2002, total revenue increased $4.7 million, or 3%, to $185.3 million from $180.6 million for the same period in 2001.

License revenue. License revenue increased $0.5 million, or 2%, to $33.2 million in the third quarter of 2002 from $32.7 million in the third quarter of 2001. The slight increase was impacted by a continuation of the restrained spending environment by information technology organizations. With reduced IT spending, we experienced a reduction in the number of transactions, elongated sales cycles and just-in-time buying. However, license revenue increased $2.6 million, or 8%, from $30.6 in the second quarter of 2002 and was the result of increased purchasing activity by IT organizations over the past couple of quarters. For the first nine months of 2002, license revenue decreased $18.7 million, or 17%, to $92.7 million from $111.3 million for the same period in 2001. OTG accounted for $5.3 million of license revenue in the quarter ended September 30, 2002 and $7.6 for the nine months ended September 30, 2002. Without OTG, our license revenue would have decreased by 15% for the three months ended September 30, 2002 and by 24% for the nine months ended September 30, 2002.

Service and Support Revenue. Service and support revenue increased $10.6 million, or 44%, to $34.9 million in the third quarter of 2002 from $24.3 million in the third quarter of 2001. The increase was primarily as a result of a decrease in the overall level of discounting of our update and support services. Furthermore, because we sell our products with the first year of updates included, we must allocate a portion of the license fee to the update service. The allocation is based on what we sell updates for as a renewal. As we have been able to charge a greater fee for

Table of Contents

our renewals, a larger portion of the license fee is being allocated to the update. For the first nine months of 2002, service and support revenue increased $23.4 million, or 34%, to $92.7 million from $69.3 million for the same period a year ago. OTG accounted for $5.7 million of service and support revenue in the quarter ended September 30, 2002 and $9.0 million for the nine months ended September 30, 2002. Without OTG, our service and support revenue would have increased by 20% for the three months ended September 30, 2002 and by 21% for the nine months ended September 30, 2002.

International license revenue decreased $2.6 million, or 16%, to $13.7 million in the third quarter of 2002 from $16.3 million in the third quarter of 2001. International license revenue decreased primarily as a result of the general weakness of the economy in Asia and, to a lesser extent, Europe. The majority of international license revenue came from Europe during these periods.

Gross Profit

Gross profit increased $9.8 million, or 22%, to $53.5 million, representing 79% of total revenue, in the third quarter of 2002 from $43.7 million, representing 77% of total revenue, in the third quarter of 2001. For the first nine months of 2002, gross profit increased $5.2 million, or 4%, to $144.8 million, representing 78% of total revenue, from $139.6 million, representing 77% of total revenue, in 2001.

Gross profit from license revenue consists of license revenue less the related costs of product media, documentation, third-party royalties and packaging. Gross profit from license revenue decreased $0.7 million, or 1%, to $29.9 million, representing 90% of license revenue, in the third quarter of 2002 from $30.6 million, representing 94% of license revenue, in the third quarter of 2001. For the first nine months of 2002, gross profit from license revenue decreased $22.0 million, or 21%, to $85.4 million, representing 92% of license revenue, from $107.3 million, representing 96% of license revenue, in 2001. The decrease in absolute dollars, and as a percentage, relates to the overall decrease of license revenue.

Costs of service and support revenue consist primarily of personnel-related costs incurred in providing telephone support, consulting services, training to customers and costs of providing software updates and education. Gross profit from service and support revenue increased $10.6 million, or 82%, to $23.6 million, representing 68% of service and support revenue, in the third quarter of 2002 from $13.0 million, representing 54% of service and support revenue, in the third quarter of 2001. For the first nine months of 2002, gross profit from service and support revenue increased $27.2 million, or 84%, to $59.5 million, representing 64% of service and support revenue, from $32.3 million, representing 47% of service and support revenue, in 2001. The increase in absolute dollars is primarily a result of the increase in support and update renewals as well as a reduction in the operating costs of our consulting group. OTG accounted for $1.1 million and $1.5 million of the increase in the second and third quarters of 2002. Service support personnel was 331 in 2002 and 332 in 2001. The change in headcount resulted from the addition of 70 individuals from OTG offset by reductions in consulting and support organizations of the legacy Legato.

Sales and marketing. Sales and marketing expenses consist primarily of salaries and commissions for sales and marketing personnel and promotional expenses. Sales and marketing expenses increased $2.3 million, or 7%, to $34.6 million in the third quarter of 2002 from $32.3 million in the third quarter of 2001. For the first nine months of 2002, sales and marketing expenses increased $7.2 million, or 8%, to $100.5 million from $93.3 million for the same period in 2001. The increase in sales and marketing expenses was primarily attributable to growth of our sales force and associated support personnel. OTG accounted for $2.4 million and $4.5 million of the increase in the second and third quarters of 2002, respectively. Sales and marketing personnel increased to 592 in 2002 from 515 in 2001. The net increase in headcount of 77 primarily resulted from 124 individuals added as a result of the OTG acquisition partially offset by reductions throughout the sales and marketing organizations. Going forward, we believe that sales and marketing expenses will decrease as a percentage of revenue.

Research and development. Research and development expenses consist primarily of personnel-related costs. Research and development expenses increased $2.3 million, or 14%, to $19.4 million in the third quarter of 2002 from $17.1 million in the third quarter of 2001. For the first nine months of 2002, research and development expenses increased $3.9 million, or 8%, to $52.2 million from $48.3 million for the same period in 2001. We

Table of Contents

incurred $2.7 million and $4.2 million of OTG research and development costs during the second and third quarters of 2002, respectively. The number of research and development personnel increased to 455 in 2002 from 416 in 2001. The increase in headcount of 39 resulted from 138 individuals from OTG partially offset by reductions in the research and development organization of classic Legato. We expect research and development expenses to decrease slightly in absolute dollars.

General and administrative. General and administrative expenses include personnel and other costs of our finance, human resources, facilities, information systems and other administrative departments. General and administrative expenses increased $0.6 million, or 8%, to $8.7 million in the third quarter of 2002 from $8.1 million in the third quarter of 2001. For the first nine months of 2002, general and administrative expenses increased $2.6 million, or 12%, to $25.4 million from $22.8 million for the same period in 2001. The increase in general and administrative expenses was primarily attributable to OTG, which added $1.8 million and $1.4 million of expenses in the second and third quarters of 2002, respectively. General and administrative personnel increased to 230 in 2002 from 204 in 2001. The increase in headcount of 26 resulted from 65 individuals from OTG offset by reductions in the general and administrative organization as a result of integration effort. We expect that general and administrative expenses will decrease slightly in absolute dollars in the fourth quarter of 2002 and into 2003.

Amortization of intangibles. Amortization of intangibles decreased $4.8 million, or 64%, to $2.7 million in the third quarter of 2002 from $7.5 million in the third quarter of 2001. For the first nine months of 2002, amortization of intangibles decreased $18.0 million, or 74%, to $6.3 million from $24.3 million in 2001. The decrease is primarily the result of adopting SFAS No. 142, whereby we stopped amortizing our goodwill in the first quarter of 2002 (see Note 8 for further discussion). In addition, we wrote-off $48.9 million of intangibles in the fourth quarter of 2001. We are amortizing the remaining identifiable intangibles on a straight-line basis over periods ranging from three to five years from the respective dates of acquisition. Future intangible amortization expense is estimated to be $2.7 million for the remainder of 2002, $10.8 million in 2003, $7.9 million in 2004, $5.0 million in 2005 and 2006 and $1.9 million in 2007.

In May 2002, we acquired OTG for cash and stock valued at $382.5 million. The purchase price has been allocated to the tangible and identifiable intangible assets acquired and liabilities assumed on the basis of their estimated fair values on the acquisition date. Deferred stock compensation is the intrinsic value associated with the 1.2 million of unvested options that were assumed and is being amortized over the options remaining vesting period, which is up to four years. Goodwill represents the excess of the purchase price over the fair value of the net tangible and identifiable intangible assets acquired. The allocation of purchase price is as follows (in thousands):

Fair value of net tangible assets acquired	$	73,867
Intangible assets acquired:		
Purchased technology		13,700
Other current assets		8,300
In-process research and development		33,200
Deferred stock compensation		1,224
Goodwill		252,251
	$	382,542

Purchased technology and customer relationships are being amortized over their useful lives of five years. In accordance with SFAS No. 142, goodwill relating to the OTG acquisition is not being amortized and will be tested for impairment annually or whenever events indicate that impairment may have occurred.

Purchased technology, customer relationships and in-process research and development (IPR&D) were identified and valued through interviews and analysis of data provided by management. For development projects that had reached technological feasibility, they were classified as developed technology, and the value assigned to the purchased technology was capitalized. The value associated with IPR&D was expensed in the current period. The income approach, which includes an analysis of the cash flows and risks associated with achieving such cash flows, was the primary technique utilized in valuing acquired intangible assets. Key assumptions included estimates of revenue growth, cost of sales, operating expenses and taxes. Discount rates used in the valuation of purchased technology, customer relationships and IPR&D were 20%, 15% and 35%, respectively.

In-Process Research and Development. In-process research and development, relating to development projects which had not reached technological feasibility and that had no future alternative uses, was expensed upon consummation of the merger. As a result, we wrote-off $33.2 million of the OTG purchase price associated with OTG s in-process research and development in the second quarter of 2002.

Restructuring Charges. During the second quarter of 2001, we incurred $6.1 million of charges related primarily to the closure of our facilities in Sunnyvale, California and Eden Prairie, Minnesota. During the second quarter of 2001, we subleased our facility in Sunnyvale, which reduced our expected loss on future lease commitments by $1.3 million and is reflected as a credit on our Consolidated Statements of Operations. As of September 30, 2002, we had accrued restructuring charges of $0.8 million remaining, which related primarily to future lease commitments, which will be paid through 2004, and some severance related benefits, which will be paid in 2002.

Litigation Settlement Charges. In April 2002, we settled the class action and derivative lawsuits filed in 2000 in the United States District Court for the Northern District of California and in San Mateo County Superior Court, respectively. The settlements in the federal and state litigation called for Legato to pay a total of $87.7 million, which included plaintiffs attorneys fees, in May 2002. Approximately $21 million of the settlement amount was reimbursed by our corporate insurance. The settlement was recorded as a $67 million charge to the results of operations for the quarter ended March 31, 2002 and was subsequently paid in May 2002.

Interest and other income, net. Interest and other income, net, primarily represents interest income from funds available for investment. Interest and other income, net decreased $0.6 million, or 46%, to $0.7 million in the third quarter of 2002 from $1.3 million in the third quarter of 2001 and decreased $3.6 million, or 59%, to $2.5 million in the first nine months of 2002 from $6.1 million for the same period in 2001. The decrease represents a reduction in our overall balance of cash and investments and a reduction in our yield on our cash investments. The decrease in the third quarter of 2002 was partially offset by realized gains on sales of investments. We expect that interest income will decrease in future periods.

Income taxes. As part of the process of preparing our consolidated financial statements, we are required to estimate our income taxes in each of the jurisdictions in which we operate. This process involves us determining our income tax expense (benefit) together with calculating our deferred income tax expense (benefit) related to temporary differences resulting from differing treatment of items, such as deferred revenue or deductibility of certain intangible assets, for tax and accounting purposes. These differences result in deferred tax assets and liabilities, which are included within our consolidated balance sheet. We must then assess the likelihood that our deferred tax assets will be recovered through the generation of future taxable income.

During the third quarter of 2002, we established a full valuation allowance of $119.2 million against our deferred tax assets because we determined that it is more likely than not that all deferred tax assets will not be realized in the foreseeable future.

The net operating loss and R&D credit carryovers that make up the vast majority of the deferred tax assets do not begin to expire until 2019, possibly allowing sufficient time to be utilized. Going forward, we will assess the continued need for the valuation allowance. After we have demonstrated profitability for a period of time and begin utilizing a significant portion of the deferred tax assets, we may reverse the valuation allowance, likely resulting in a significant benefit to the statement of operations in some future period. At this time, we cannot reasonably estimate when this reversal might occur.

Table of Contents

LIQUIDITY AND CAPITAL RESOURCES

Our cash, cash equivalents and investments totaled $45.3 million as of September 30, 2002, and represented 10% of total assets as compared to $145.7 million and 41% as of December 31, 2001. Cash and cash equivalents are highly liquid investments with original maturities of ninety days or less. Investments consist mainly of corporate securities and auction rate receipts. The decrease in our cash and investments primarily reflects the payment of $66.7 million (net of $21 million from our insurers) in May 2002 for the settlement of the class action and derivative lawsuits filed in 2000 and the funding of our continued losses. As of September 30, 2002, we had no long-term debt.

We have financed our operations to date primarily through cash from operations and the sale of common stock. Net cash used in operating activities was $93.6 million for the nine months ended September 30, 2002 and consisted primarily of the net loss of $218.8 million, partially offset by deferred taxes of $78.0 million, the write-off of in-process research and development of $33.2 million and depreciation and amortization of $20.0 million. For the nine months ended September 30, 2001, net cash provided by operating activities was $0.6 million and consisted primarily of a net change in assets and liabilities of $16.0 million, depreciation and amortization of $39.1 million and tax benefit from stock options exercises of $5.4 million, partially offset by the net loss of $33.6 million and deferred taxes of $28.0 million.

Net cash provided by investing activities was $48.0 million for the nine months ended September 30, 2002, which resulted primarily from the net maturities of marketable securities of $64.7 million, partially offset by the purchases of property and equipment of $11.9 million and technology and OTG of $4.9 million. For the nine months ended September 30, 2001, net cash used in investing activities was $44.0 million, which resulted from the net purchases of marketable securities of $17.9 million, the acquisition of property and equipment of $17.5 million and the purchase of SCH for $8.7 million.

Net cash provided by financing activities was $10.1 million and $13.2 million for the nine months ended September 30, 2002 and 2001, respectively, which resulted from the proceeds received from the issuance of our common stock from stock option exercises and our employee stock purchase plan.

As of September 30, 2002, the only significant contractual obligations or commercial commitments consisted of our facility lease commitments. (See Note 4 to the Notes to the Consolidated Financial Statements in our Annual Report on Form 10-K for further details.) We do not have any other off-balance sheet arrangement that could significantly reduce our liquidity. In May 2002, we paid the litigation settlement of $66.7 million (net of $21 million from our insurers), which reduced our cash position significantly.

Our current operating plan anticipates a pro forma net income for the fourth quarter of 2002. Furthermore, we expect to make further progress on collecting on our accounts receivable, which will likely result in an increase our cash and investments by $5 million to $10 million. We also are currently forecasting continued pro forma profitability in 2003. Our profitability and limited capital spending are planned to result in positive cash flow. If realized, we believe this model will provide us the liquidity and capital resources required to sustain our operations through 2003. Should our forecasts not meet our expectations or should we determine it is desirable to increase our liquidity, we would be required to take further actions in 2003, including, but not limited to:

- Reductions in personnel;
- Divestitures of technologies or business groups; and
- Issuance of debt or equity securities.

We may not be able to obtain future equity or debt financing on favorable terms, if at all. If we seek to raise additional capital through the issuance of equity or equity-related securities, the percentage of ownership of existing stockholders will be diluted. Future borrowing instruments such as credit facilities or lease agreements are likely to contain restrictive covenants and may require us to pledge assets as security for borrowings there under. Our inability to obtain additional capital on satisfactory terms may delay or prevent some of our development plans or otherwise forego market opportunities.

Table of Contents

RISK FACTORS

The following risk factors and other information included in this report on Form 10-Q should be carefully considered. The risks and uncertainties described below are not the only ones we face. Additional risks and uncertainties not presently known to us or that we currently deem less significant also may impair our business operations. If any of the following risks actually occur, our business, operating results and financial condition could be materially and negatively affected.

Our quarterly operating results are volatile.

Our quarterly operating results have varied in the past and may vary in the future. Our quarterly operating results may vary depending on a number of factors, many of which are outside of our control, including:

- Lengthy sales cycles, particularly with enterprise license transactions;
- The dollar value of orders and the timing of when orders are received;
- Intense competition;
- Macroeconomic uncertainty and weakness;
- Market acceptance of our new products, applications and product enhancements of our competitors;
- Changes in our pricing policies or those of our competitors;
- The current challenging spending environment in our customers IT departments;
- Our ability to develop, introduce and market new products, applications and product enhancements;
- Our ability to control costs;
- Quality control of products sold;
- Delay in the recognition of revenue from enterprise license and application service provider transactions;
- Success in expanding sales and marketing programs;
- Technological changes in our customers environments;
- The impairment of goodwill, intangibles or deferred tax assets;
- The mix of sales among our channels;
- Deferrals of customer orders in anticipation of new products, applications or product enhancements;
- Market readiness to deploy our products for distributed computing environments;
- Changes in our strategy or that of our competitors;
- Customer budget cycles and changes in these budget cycles;
- Foreign currency and exchange rates;
- Our ability to effectively manage and reduce our tax liabilities;
- Our ability to integrate recently acquired businesses;
- Acquisition costs or other non-recurring charges in connection with the acquisition of companies, products or technologies;
- Loss of our information technology infrastructure for a significant period of time;
- Personnel changes; and
- General economic factors.

Our future operating results are uncertain.

Our historical results of operations are not necessarily indicative of our results for any future period. Expectations, forecasts and projections by others or us are by nature forward-looking statements, and it is likely that future results will vary. Forward-looking statements that were reasonable at the time made may ultimately prove to be incorrect or false. It is our general policy and practice not to update our forward-looking statements. Some investors in our securities inevitably will experience gains while others will experience losses, depending on the prices at which they purchase and sell securities. Prospective and existing investors are strongly urged to carefully consider the various cautionary statements and risks set forth in this report.

We cannot predict our future revenue with any significant degree of certainty for several reasons including:

- Our sales cycles vary substantially from customer to customer, in large part because we depend upon large enterprise license transactions with corporate customers. Furthermore, such transactions may include

22

extended payment terms, escalating discounts, acceptance provisions or other terms that would preclude immediate revenue recognition of some or all of the license component;

- Revenue in any quarter is substantially dependent on orders booked and shipped in that quarter since we operate with virtually no order backlog;
- We do not recognize revenue on sales to domestic distributors until the products are sold through to end-users;
- The storage management market is rapidly evolving;
- Due to general economic factors that currently affect our end-user customers businesses, those customers are being more deliberate in the manner in which they make information technology spending decisions;
- OEM license and royalty revenue are difficult to forecast. Our royalty revenue is dependent upon product license sales by OEMs of their products that incorporate our software. Accordingly, this royalty revenue is subject to OEMs product cycles and the general health of their businesses; these trends are also difficult for us to predict. Fluctuations in licensing activity from quarter to quarter further impact royalty revenue, because initial license fees generally are non-recurring and generally are recognized upon the signing of a license agreement;
- The timing of large orders can significantly affect revenue within a quarter;
- The timing of recognition of revenue from enterprise license and application service provider transactions can significantly affect revenue within a quarter; and
- Our expense levels are relatively fixed and are based, in part, on our expectations of our future revenue. Consequently, if revenue levels fall below our expectations, our net losses will increase because only a small portion of our expenses varies with our revenue.

We believe that period-to-period comparisons of our results of operations may not be meaningful and should not be relied upon as indications of future performance. Our operating results could be below the expectations of public market analysts and investors in some future quarter or quarters. Our failure to meet such expectations would likely cause the market price of our common stock to decline.

We have recorded losses and may continue to record losses.

We have cumulative losses and may incur additional losses. For the nine months ended September 30, 2002, we incurred a net loss of $218.8 million and had an accumulated deficit of $289.4 million, including $81.5 million in a provision for income taxes, $67.0 million related to the settlement of securities class action and derivative lawsuits and $33.2 million related to the write-off of in-process research and development. We anticipate that our costs will decrease for the immediate future as we complete the integration of OTG and Legato. If we cannot achieve and sustain operating profitability or positive cash flow from operations, we may not be able to meet our working capital requirements. This would have a material adverse effect on our business financial condition and results of operations.

We may be unable to raise additional capital should it become necessary.

We have incurred significant operating losses, have had negative operating cash flows since the second quarter of 2001 and are not currently profitable. We are currently forecasting a small pro forma net income for the fourth quarter of 2002 and continued pro forma profitability in 2003. Our profitability and limited capital spending should result in positive cash flow. We believe this model will provide us the liquidity and capital resources required to sustain our operations through 2003. Should our forecasts not meet our expectations, we would be required to take further actions to assure sufficient liquidity through 2003, including, but not limited to:

- Reductions in personnel;
- Divestitures of technologies or business groups; and
- Issuance of debt or equity instruments.

We may not be able to obtain future equity or debt financing on favorable terms, if at all. If we seek to raise additional capital through the issuance of equity or equity-related securities, the percentage of ownership of existing stockholders will be diluted. Future borrowing instruments such as credit facilities or lease agreements are likely to contain restrictive covenants and may require us to pledge assets as security for borrowings there under. Our inability to obtain additional capital on satisfactory terms may delay or prevent some of our development plans or otherwise forego market opportunities.

We are currently subject to litigation.

On or about July 26, 2001, a class action lawsuit was filed in the Southern District of New York naming OTG, officers of OTG who signed the registration statement in connection with OTG s initial public offering, and the managing underwriters of the initial public offering as defendants. The complaint alleges that OTG s initial public offering registration statement and final prospectus contained material misrepresentations and/or omissions, related in part to additional, excessive and undisclosed commissions allegedly received by the underwriters from investors to whom the underwriters allegedly improperly allocated shares of the public offering. The complaint seeks relief in the form of damages and/or rescission of the plaintiff s purchase transaction. Since this initial complaint was filed, three other complaints making similar or identical allegations and seeking similar relief have been filed. All of the actions brought against OTG have been consolidated, and are being heard along with other similar actions brought against approximately 300 other issuers, issuers officers and underwriters in the Southern District of New York. On July 19, 2002, the defendants filed a motion to dismiss the complaint. We intend to defend the action vigorously and believe that it is not possible at the current time to estimate the amount of a probable loss, if any, that might result from this matter.

On July 1, 2002, we received notice that an action captioned *Nickel v. Kay, et al.* had been filed in the Circuit Court for Montgomery County, Maryland. The action, brought by a former OTG employee, asserts claims that Richard Kay, OTG and Legato are liable under various legal theories for the alleged breach of Mr. Nickel s employment contract and breach of fiduciary duties allegedly owed to Mr. Nickel. The complaint alleges compensatory and punitive damages, to be proven at trial. The case is in its preliminary stages, and an investigation of the facts is not complete. We intend to defend this action vigorously; however the outcome is uncertain at this time. Although insurance may be available to cover some portion of any potential liability, an adverse judgment could be materially adverse our operating results.

On September 30, 2002, we received written notice of a claim by one of OTG s resellers in Europe. The reseller alleges that OTG misrepresented information concerning the capabilities of certain OTG products during 2001, and OTG s intentions with respect to development plans for those products. On that basis, the reseller asserts that it is entitled to compensatory damages. Under the terms of the agreement with the reseller, if the parties are unable to resolve the dispute informally, the matter must be submitted to arbitration with the American Arbitration Association. The parties are currently working to resolve the matter amicably; however, the likelihood of such a resolution is uncertain at this time. Although insurance may be available to cover some portion of any potential liability, an adverse arbitral award could be materially adverse to our operating results.

In addition to the foregoing matters, we are parties to various other lawsuits and disputes regarding commercial and employment matters arising in the ordinary course of operations. We believe that the amounts in dispute in these other matters are insubstantial, and the effect of these matters, individually and in the aggregate, would not be material to our operating results.

Our market is highly competitive.

We operate in the enterprise storage management market, which is intensely competitive, highly fragmented and characterized by rapidly changing technology and evolving standards. Competitors vary in size and in the scope and breadth of the products and services offered. Our major competitors include: Computer Associates; EMC (Epoch); Hewlett Packard; IBM (Tivoli); and Veritas. We expect to encounter new competitors as we enter new markets. In addition, many of our existing competitors are broadening their platform coverage. We also expect increased competition from systems and network management companies, especially those that have historically focused on the mainframe market and are broadening their focus to include the client/server computer market. In addition, since there are relatively low barriers to entry in the software market, we expect additional competition from other established and emerging companies. We also expect that competition will increase as a result of future software

Table of Contents

industry consolidations. Increased competition could harm us by causing, among other things, price reductions, reduced gross margins and loss of market share.

Many of our current and potential competitors have longer operating histories and have substantially greater financial, technical, sales, marketing and other resources, as well as greater name recognition and a larger customer base than we have. As a result, certain current and potential competitors can respond more quickly to new or emerging technologies and changes in customer requirements. They can also devote greater resources to the development, promotion, sale and support of their products. In addition, current and potential competitors may establish cooperative relationships among themselves or with third parties. If so, new competitors or alliances among competitors may emerge and rapidly acquire significant market share. In addition, network operating system vendors could introduce new or upgraded operating systems or environments that include functionality offered by our products. If so, our products could be rendered obsolete and unmarketable. For all the foregoing reasons, we may not be able to compete successfully, which would seriously harm our business, operating results and financial condition.

We depend on our NetWorker product line.

We currently derive, and expect to continue to derive, a substantial majority of our revenue from our NetWorker software products and related services. A decline in the price of, or demand for, NetWorker, or failure to build and sustain broad market acceptance of NetWorker, would seriously harm our business, operating results and financial condition. We cannot reasonably predict NetWorker s remaining life for several reasons, including:

- The effect of new products, applications or product enhancements;
- Technological changes in the network storage management environment in which NetWorker operates; and
- Future competition.

Our business significantly depends on the acceptance of open system environments such as UNIX, Microsoft Windows and Linux operating systems to run computer networks, and a decrease in their rates of acceptance could cause our revenues to decline.

For the foreseeable future, we expect a substantial majority of our revenues to continue to come from sales of our Microsoft Windows-based data storage software products. As a result, we depend on the growing use of Windows-based operating systems for computer networks. If the deployment of Windows-based operating systems does not increase as we anticipate, or if it decreases, our revenues could decline. In addition, if users do not accept future Windows-based operating systems, or if there is a wide acceptance of other existing or new operating systems, including Microsoft products, our business would suffer.

Future Windows-based operating systems may not gain market acceptance. In addition, users of previous versions of Windows-based operating systems may decide to migrate to another operating system. We have expended significant resources on the development of Windows-compatible versions of our product suite and our future success depends upon sales of this product suite. If users of Windows-based networks do not widely adopt and purchase our products, our revenue and business would suffer.

We expect the percentage of our revenues attributable to UNIX- and Linux-based products to increase over time. We have expended significant resources developing and acquiring technology to make UNIX- and Linux-compatible versions of our products. If users of UNIX and Linux networks do not widely adopt and purchase our products our revenue and business would suffer.

We must respond to rapid technological changes with new product offerings.

The markets for our products are characterized by rapid technological change, changing customer needs, frequent new software product introductions and evolving industry standards. The introduction of products embodying new technologies and the emergence of new industry standards could render our existing products obsolete and unmarketable. To be successful, we need to develop and introduce new software products on a timely

Table of Contents

basis that keep pace with technological developments and emerging industry standards and address the increasingly sophisticated needs of our customers. In addition, we need to integrate into our product lines the technologies of products we acquired through the acquisition of OTG Software completed in May 2002, and to develop the technologies we acquired from Software Clearing House, Inc. in July 2001. We may fail to develop and market new products that respond to technological changes or evolving industry standards, experience difficulties that could delay or prevent the successful development, introduction and marketing of these new products or fail to develop new products that adequately meet the requirements of the marketplace or achieve market acceptance. If so, our business, operating results and financial condition would be seriously harmed.

We have introduced several new products during 2001, and currently plan to introduce and market several more potential new products in the next twelve months. Some of our competitors currently offer products analogous to certain of these potential new products. Such potential new products are subject to significant technical risks. We may fail to introduce such potential new products on a timely basis or at all. In the past, we have experienced delays in the commencement of commercial shipments of our new products. Such delays caused customer frustrations and delay of, or loss of, revenue. If potential new products are delayed or do not achieve market acceptance, our business, operating results and financial condition would be seriously harmed. In the past, we have also experienced delays in purchases of our products by customers anticipating our launch of new products. Our business, operating results and financial condition would be seriously harmed if customers defer material orders in anticipation of new product introductions.

Our products may contain undetected errors.

Software products as complex as those we offer may contain undetected errors or failures when first introduced or as new versions are released. We have in the past discovered software errors in certain of our new products after their introduction. As a result of those errors, we experienced delays or lost revenue during the period required to correct these shipments, despite testing by us and by our current and potential customers. In addition, customers have in the past brought to our attention bugs in our software created by the customers unique operating environments. Although we have been able to fix such software bugs in the past, we may not always be able to do so. These types of circumstances may result in the loss of, or delay in, market acceptance of our products or increase the need for additional customer support personnel, which could seriously harm our business, operating results and financial condition.

Defects in our products would harm our business.

Our products can be used to manage data critical to organizations. As a result, the licensing and support of products we offer may entail the risk of product liability claims. Although we generally include provisions in our license agreements that are intended to limit our liability, a successful product liability claim brought against us could seriously harm our business, operating results and financial condition.

We rely on enterprise license transactions.

We have developed strategies to pursue larger enterprise license transactions with corporate customers. However, we may not continue to successfully market our products through larger enterprise license transactions. Such failure would seriously harm our business, operating results and financial condition. In addition, many of the large organizations that we target as customers have lowered their rate of spending on enterprise software. Our operating results are sensitive to the timing of such orders. Such orders are difficult to manage and predict because:

- The sales cycle is typically lengthy, generally lasting three to nine months, and varies substantially from transaction to transaction;
- Enterprise license transactions often include multiple elements such as product licenses and service and support;
- Recognition of revenue from enterprise license transactions may vary from transaction to transaction;
- These transactions typically involve significant technical evaluation and commitment of capital and other resources;

Table of Contents

- A growing number of our direct-license customers are located outside the United States, where the sales cycle can be lengthier than transactions negotiated within the United States;
- Our customers are being more deliberate about information technology spending decisions due to the current state of the overall economy; and
- Customers internal procedures frequently cause delays in orders. Such internal procedures include approval of large capital expenditures, implementation of new technologies within their networks and testing new technologies that affect key operations.

Due to the large size of enterprise transactions, if orders forecasted for a specific transaction for a particular quarter are not realized in that quarter, our operating results for that quarter may be seriously harmed.

We rely on indirect sales channels.

We rely significantly on our distributors, systems integrators and value-added resellers, or collectively, resellers, for the marketing and distribution of our products. Our agreements with resellers are generally not exclusive and in many cases may be terminated by either party without cause. Many of our resellers carry product lines that are competitive with ours. These resellers may not give a high priority to the marketing of our products. Rather, they may give a higher priority to other products, including the products of competitors, or may not continue to carry our products. Events or occurrences of this nature could seriously harm our business, operating results and financial condition. In addition, we may not be able to retain any of our current resellers or successfully recruit new resellers. Any such changes in our distribution channels could seriously harm our business, operating results and financial condition.

Our strategy is also to increase the proportion of our customers licensed through OEMs. We may fail to achieve this strategy. We are currently investing, and will continue to invest, resources to develop this channel. Such investments could seriously harm our operating margins. We depend on our OEMs abilities to develop new products, applications and product enhancements on a timely and cost-effective basis that will meet changing customer needs and respond to emerging industry standards and other technological changes. Our OEMs may not effectively meet these technological challenges. These OEMs are not within our control, may incorporate the technologies of other companies in addition to, or to the exclusion of, our technologies, and are not obligated to purchase products from us. Our OEMs may not continue to carry our products. The inability to recruit, or the loss of, important OEMs could seriously harm our business, operating results and financial condition.

Our original equipment manufacturers could choose to compete with us or with each other, which could harm our business.

Our original equipment manufacturers, value-added resellers and distributors could choose to develop their own data storage management products and incorporate those products into their systems or product offerings in lieu of our products. In addition, the original equipment manufacturers that we do business with may compete with one another. To the extent that one of our original equipment manufacturer customers views the products we have developed for another original equipment manufacturer as competitive, it may decide to stop doing business with us, which could harm our business.

Overlapping sales efforts may lead to inefficiencies and may adversely affect our relationships with those who sell our products.

Our original equipment manufacturers, value-added resellers, distributors and direct sales force might target the same sales opportunities, which could lead to an inefficient allocation of sales resources. This would result in us marketing similar products to the same end-users. These overlapping sales efforts could also adversely affect our relationships with our original equipment manufacturers, value-added resellers, distributors and other sales channels and result in them being less willing to market our products aggressively, and could compromise margins on products we sell directly.

We are modifying some of our marketing strategies.

As noted above, we rely significantly upon resellers as part of our overall marketing strategy. We are currently realigning our approach to work with our strategic alliances and other resellers. The objective of our new approach is to form stronger ties with specific companies with whom we have global alliances. We are also restructuring our reseller networks in order to create greater rewards for distributors and resellers that demonstrate a greater commitment to us, as measured in net sales, technical certification and other factors. As a result of these changes, we may negatively affect the volume of sales through our strategic alliances or our resellers. If a significant number of resellers were to cease doing business with us as a result of these changes, and sales through the remaining resellers failed to compensate for the lost resellers, this strategic change could seriously harm our business, operating results and financial condition.

We depend on international revenue.

Our continued growth and profitability will require further expansion of our international operations. To expand international operations successfully, we must establish additional foreign operations, hire additional personnel and recruit additional international resellers. This will require significant management attention and financial resources and could seriously harm our operating margins. If we fail to further expand our international operations in a timely manner, our business, operating results and financial condition could be seriously harmed. In addition, we may fail to maintain or increase international market demand for our products. Most of our international sales are currently denominated in U.S. dollars. An increase in the value of the U.S. dollar relative to foreign currencies could make our products more expensive and, therefore, potentially less competitive in those markets. In some markets, localization of our products and license documents is essential to achieve or increase market penetration. We may incur substantial costs and experience delays in localizing our products and license language. We also may fail to generate significant revenue from localized products.

Additional risks inherent in our international business activities generally include:

- Significant reliance on our distributors and other resellers who do not offer our products exclusively;
- Unexpected changes in regulatory requirements;
- Tariffs and other trade barriers;
- Lack of acceptance of localized products, if any, in foreign countries;
- Longer negotiation and accounts receivable payment cycles;
- Difficulties in managing international operations;
- Potentially adverse tax consequences, including restrictions on the repatriation of earnings;
- The burdens of complying with a wide variety of multiple local, country and regional laws; and
- The risks related to the current weakness in some regions, including, without limitation, Europe and Asia. .

The occurrence of such factors could seriously harm our international sales and, consequently, our business, operating results and financial condition.

We depend on growth in the enterprise data storage market.

The overwhelming majority of our business is in the enterprise data storage market. The enterprise data storage management market is still a maturing and dynamic market. Our future financial performance will depend in large part on continued growth in the number of organizations adopting company-wide storage and management solutions for their client/server computing environments. The market for enterprise storage management may not continue to grow at historic rates, or at all. If this market fails to grow, or grows more slowly than we currently anticipate, and we are unable to capture market share from our competitors, our business, operating results and financial condition would be seriously harmed.

We are affected by general economic and market conditions.

Segments of the computer industry have recently experienced significant economic downturns characterized by decreased product demand, product overcapacity, price erosion, work slowdowns and layoffs. These downturns

Table of Contents

appear to coincide with the widely-reported weakness in the overall economy. Our operations may experience substantial fluctuations from period-to-period as a consequence of such industry trends, general economic conditions affecting the timing of orders from major customers and other factors affecting capital spending. The occurrence of such factors could seriously harm our business, operating results or financial condition.

Our revenue recognition could be impacted by the unauthorized actions of our personnel.

The recognition of our revenue depends on, among other things, the terms negotiated in our contracts with our customers. Our personnel may act outside of their authority and negotiate additional terms without our knowledge. In the event that our sales personnel have negotiated terms that do not appear in the contract and of which we are unaware, whether the additional terms are written or verbal, we could be prevented from recognizing revenue in accordance with our plans. Furthermore, depending on when we learn of unauthorized actions and the size of transactions involved, we may have to restate revenue for a previously reported period, which would seriously harm our business, operating results and financial condition.

We rely on our sales personnel.

In the past, we have experienced significant voluntary resignations in our sales force, including some of our senior level sales employees, and may experience such turnover again. Our future success depends on our continuing ability to attract and retain highly qualified sales personnel. Competition for such personnel remains intense, and we may fail to retain our sales personnel or attract, assimilate or retain other highly qualified sales personnel in the future. Any further disruption to our sales force could seriously harm our business, operating results and financial condition.

We rely on our key personnel.

Our future performance depends on the continued service of our key technical, sales and senior management personnel. Most of our technical, sales or senior management personnel are not bound by employment agreements. The loss of the services of one or more of our officers or other key employees could seriously harm our business, operating results and financial condition.

Our future success also depends on our continuing ability to attract and retain highly qualified technical, sales and managerial personnel. Despite recent weakness in the economy, competition for such highly qualified personnel remains intense, and we may fail to retain our key technical, sales and managerial employees or attract, assimilate or retain other highly qualified technical, sales and managerial personnel in the future.

If we make unprofitable acquisitions or are unable to successfully integrate any acquisition, our business would suffer.

We have in the past, and may in the future, acquire businesses, products or technologies that we believe compliment or expand our existing business. In furtherance of this strategy, we acquired OTG Software, Inc, a data storage software company based in Rockville, Maryland, on May 14, 2002. Also, in July 2001, we acquired Software Clearing House, Inc., a software developer, reseller and consulting organization based in Cincinnati, Ohio. Our ability to achieve favorable results in 2002 and beyond will be dependent in part upon our ability to successfully integrate the people, products and business lines of our acquisitions. In addition, we will need to work with our acquired companies customers and business partners to establish new relationships based upon the broader range of products and services available from us. We must accomplish the synergies identified during the acquisition process. Failure to execute on any of these elements of the integration process could seriously harm our business, operating results or financial condition.

We cannot ensure that any acquisitions or acquired businesses, products or technologies associated therewith will generate sufficient revenue to offset the associated costs of the acquisitions or will not result in other adverse effects. Moreover, from time to time, we may enter into negotiations for the acquisition of businesses, products or technologies but be unable or unwilling to consummate the acquisitions under consideration. This could cause significant diversion of managerial attention and out of pocket expenses to us. We could also be exposed to litigation as a result of an acquisition, including claims that we failed to negotiate in good faith, misappropriated confidential information or other claims.

Our investment in goodwill and intangibles resulting from our acquisitions could become impaired.

As of September 30, 2002, goodwill was $270.7 million and acquired intangibles of $33.3 million on our Consolidated Balance Sheet. With our adoption of Statement of Financial Accounting Standard No. 142, Goodwill and Other Intangible Assets in the first quarter of 2002, goodwill was no longer be amortized. We expect to amortize identifiable intangibles of $2.7 million in the remainder of 2002, $10.8 million in 2003 and $7.9 million in 2004. To the extent we do not generate sufficient cash flows to recover the net amount of the intangibles recorded, the intangibles could be subsequently written-off. In such event, our results of operations in any given period could be negatively impacted, and the market price of our stock could decline.

Protection of our intellectual property is limited.

Our success depends significantly upon proprietary technology. To protect our proprietary rights, we rely on a combination of patents, copyright and trademark laws, trade secrets, confidentiality procedures and contractual provisions. We seek to protect our software, documentation and other written materials under patent, trade secret and copyright laws, which afford only limited protection. Despite this limited protection, any issued patent may not provide us with any competitive advantages or may be challenged by third parties or the patents of others may seriously impede our ability to do business. We may also develop proprietary products or technologies that cannot be protected by patent law.

Despite our efforts to protect our proprietary rights, we are aware that unauthorized parties have attempted to transfer licenses to third parties, c