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LEGATO SYSTEMS INC
Form 10-Q
November 14, 2001

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

FORM 10-Q

(Mark One)

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d)
OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended September 30, 2001

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
(State of Incorporation)

94-3077394
(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 No

The number of shares outstanding of the Registrant's Common Stock as of November 2, 2001 was 89,449,838.

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LEGATO SYSTEMS, INC

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PART I -- FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

LEGATO SYSTEMS, INC.
Condensed Consolidated Balance Sheets
(in thousands)

	September 30, 2001	Decem 20
	-----	-----
	(unaudited)	
ASSETS		
Current assets:		
Cash and cash equivalents.....	\$ 79,983	\$110

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Short-term investments.....	73,352	40
Accounts receivable, net.....	37,004	47
Deferred tax assets.....	63,623	35
Other current assets.....	13,053	20
	-----	-----
Total current assets.....	267,015	254
Long-term investments.....	-	14
Property and equipment, net.....	40,282	37
Intangible assets, net.....	89,705	103
Other assets.....	4,078	5
	-----	-----
	\$401,080	\$414
	=====	=====
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable.....	\$ 10,137	\$ 5
Accrued liabilities.....	38,991	33
Deferred revenue.....	43,915	53
	-----	-----
Total current liabilities.....	93,043	92
Stockholders' equity.....	308,037	322
	-----	-----
	\$401,080	\$414
	=====	=====

See accompanying notes to condensed consolidated financial statements.

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

	Three Months Ended September 30,		Nine Months September	
	2001	2000	2001	
	-----	-----	-----	
	(unaudited)			
Revenue:				
License.....	\$ 32,681	\$ 32,936	\$ 111,267	\$
Service and support.....	24,332	21,234	69,304	
	-----	-----	-----	
Total revenue.....	57,013	54,170	180,571	
	-----	-----	-----	
Cost of revenue:				
License.....	2,055	1,387	3,986	
Service and support.....	11,297	10,158	37,015	
	-----	-----	-----	
Cost of revenue.....	13,352	11,545	41,001	
	-----	-----	-----	
Gross profit.....	43,661	42,625	139,570	
	-----	-----	-----	

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Operating expenses:			
Sales and marketing.....	32,302	25,904	93,330
Research and development.....	17,055	14,229	48,285
General and administrative.....	8,092	6,112	22,767
Amortization of acquired intangibles.....	7,516	9,522	24,270
Restructuring charges.....	(1,329)	-	4,758
	-----	-----	-----
Total operating expenses.....	63,636	55,767	193,410
	-----	-----	-----
Loss from operations.....	(19,975)	(13,142)	(53,840)
Interest and other income, net.....	1,281	1,923	6,124
	-----	-----	-----
Loss before benefit from income taxes.....	(18,694)	(11,219)	(47,716)
	-----	-----	-----
Benefit from income taxes.....	(5,710)	(7,475)	(14,155)
	-----	-----	-----
Net loss.....	\$ (12,984)	\$ (3,744)	\$ (33,561)
	=====	=====	=====
Net loss per share:			
Basic and diluted.....	\$ (0.15)	\$ (0.04)	\$ (0.38)
	=====	=====	=====
Weighted average common shares outstanding.....	89,288	86,956	88,624
	=====	=====	=====

See accompanying notes to condensed consolidated financial statements.

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

	Ni

	2001

Cash flows from operating activities:	
Net loss.....	\$ (33,561)
Adjustments to reconcile net loss to net cash provided by operating activities:	
Deferred taxes.....	(27,990)
Depreciation and amortization.....	39,100
Provision for doubtful accounts and product returns.....	1,560
Tax benefit from stock option exercises.....	5,430
Changes in assets and liabilities:	
Accounts receivable.....	10,640
Other assets.....	8,740
Accounts payable.....	3,280
Accrued liabilities.....	3,490

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Deferred revenue.....	(10,16)

Net cash provided by operating activities.....	55

Cash flows from investing activities:	
Purchases of available-for-sale securities.....	(391,61)
Maturities and sales of available-for-sale securities.....	373,76
Acquisition of Software Clearing House, Inc.....	(8,69)
Purchase of property and equipment.....	(17,49)

Net cash used in investing activities.....	(44,04)

Cash flows from financing activities-	
Proceeds from issuance of common stock.....	13,20
Payment of short-term loan payable.....	-----
Net cash provided by financing activities.....	13,20

Net change in cash and cash equivalents.....	(30,29)
Cash and cash equivalents at beginning of period.....	110,27

Cash and cash equivalents at end of period.....	\$ 79,98
	=====

See accompanying notes to condensed consolidated financial statements.

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LEGATO SYSTEMS, INC.

Notes to Condensed Consolidated Financial Statements (unaudited)

1. Basis of Presentation

The accompanying unaudited condensed 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 condensed 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, 2001, 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, 2000, included in the Company's Form

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10-K dated March 28, 2001.

Certain prior year consolidated financial statement balances have been reclassified to conform to the 2001 presentation.

2. Balance Sheet Components

	September 30, 2001	December 31, 2000
	-----	-----
Accounts receivable:		
Trade accounts receivable.....	\$ 44,371	\$ 55,386
Allowances for doubtful accounts and product returns....	(7,367)	(7,731)
	-----	-----
	\$ 37,004	\$ 47,655
	=====	=====
Property and equipment:		
Computer equipment and software.....	\$ 58,585	\$ 46,114
Furniture and fixtures.....	10,848	10,138
Office equipment.....	5,689	4,474
Leasehold improvements.....	11,404	11,676
	-----	-----
	86,526	72,402
Accumulated depreciation and amortization.....	(46,244)	(35,074)
	-----	-----
	\$ 40,282	\$ 37,328
	=====	=====
Accrued liabilities:		
Accrued compensation and benefits.....	\$ 13,949	\$ 14,806
Income taxes payable.....	12,847	9,240
Other accrued liabilities.....	12,195	9,505
	-----	-----
	\$ 38,991	\$ 33,551
	=====	=====

3. Revenue Recognition

Revenue is derived from primarily two sources: (i) license revenue, derived from the sale of product licenses to resellers and end users, including large-scale enterprises and royalty revenue, derived from initial license fees and ongoing royalties from the licensing of source code to original equipment manufacturers ("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. For sales to domestic distributors, license revenue is recognized upon sale by the distributor to the end user, since these distributors generally have unlimited rights of return, and we historically have not been able to make reasonable estimates of product returns for these distributors. For sales to customers having rights of return,

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including exchange rights for unsold products and product upgrades, estimated product returns are recorded upon recognition of revenue. Provisions for estimated warranty costs and anticipated retroactive price adjustments are recorded at the time products are shipped. 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. The Company also incurs additional internal costs to assist certain of its resellers and distributors in selling its products to end-users.

Service and support revenue consists primarily of revenue received for providing software updates, technical support for software products, on-site support, and consulting and education services. Revenue from updates and support is recognized ratably over the term of the agreements. Revenue allocated to consulting and education 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, the Company accounts for the delivered elements in accordance with the "Residual Method" prescribed by Statement of Position 98-9.

4. Comprehensive Income (Loss)

Comprehensive income (loss) includes unrealized gains (losses) on investments. The impact of which is excluded from net income (loss) and is included in stockholders' equity. A summary of comprehensive income (loss) is as follows (in thousands):

	Three Months Ended September 30,		Nine Sep
	2001	2000	2001
Net loss.....	\$ (12,984)	\$ (3,744)	\$ (33,561)
Unrealized gain (loss) on investments (net of taxes)	606	33	627
	\$ (12,378)	\$ (3,711)	\$ (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 we incur a loss, potential common shares outstanding are excluded from the computation of diluted net loss per share as their effect is anti-dilutive. Options to purchase approximately 21,650,000 shares and 12,251,000 shares of common stock at the weighted average price of \$12.51 per share and \$17.56 per share were outstanding as of September 30, 2001 and 2000, respectively, but were not included in the computation of diluted net loss per share because their effect would be

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anti-dilutive.

6. Legal Proceedings

Beginning on January 20, 2000, a number of shareholder securities class action complaints were filed in the U.S. District Court, Northern District of California, against us and certain of our directors and officers. On May 1, 2000, the court consolidated the pending cases and, on May 10, 2000, appointed a lead plaintiff, who filed a consolidated

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amended complaint on August 7, 2000. Defendants moved to dismiss. On January 17, 2001, the court granted the motions to dismiss with leave to amend. On February 13, 2001, plaintiffs filed a second amended complaint, which generally alleges that, between April 22, 1999 and May 17, 2000, defendants made false or misleading statements of material fact about our prospects and failed to follow generally accepted accounting principles in violation of the federal securities laws. The complaint seeks an unspecified amount in damages. Defendants answered the complaint in April 2001 denying all allegations that they violated the federal securities laws.

On February 1, 2000, a shareholder derivative action was filed in the U.S. District Court, Northern District of California, against certain of our officers and directors. We are named as a nominal defendant. The derivative case has been related to the securities class action. Plaintiffs filed an amended complaint on February 9, 2001, which generally alleges the same conduct as the shareholder class action, and claims that defendants breached their fiduciary duties and engaged in improper insider trading. The derivative complaint sought unspecified damages and injunctive relief. Defendants moved to dismiss the derivative complaint. On July 10, 2001, the court granted defendants' motion to dismiss with leave to amend. Plaintiffs filed an amended complaint on August 23, 2001; plaintiffs then moved to voluntarily dismiss the amended complaint with the right to refile the complaint at a later date if they choose to do so. Defendants have moved to permanently dismiss the amended complaint.

On April 13, 2000, a shareholder derivative action was filed in the Superior Court of California, County of Santa Clara, against certain of our officers and directors. We are named as a nominal defendant. On May 23, 2000, a shareholder derivative action was filed in the Superior Court of California, County of San Mateo, against certain of our officers and directors. We are named as a nominal defendant. Both state derivative complaints generally allege the same conduct as the derivative action filed in federal court, claiming that our officers and directors breached their fiduciary duties for the same period, and seek unspecified damages and injunctive relief. The state derivative cases have been consolidated in San Mateo County. Plaintiffs filed a consolidated amended complaint. Defendants filed a demurrer, which was denied on July 20, 2001. Defendants have filed a writ petition with the California Court of Appeal and California Supreme Court.

The Securities and Exchange Commission has entered a formal order of investigation concerning our restatement of financial results for the first, second and third quarters of 1999, and our revision of financial results for the fourth quarter of 1999. We have been voluntarily cooperating with the Staff of the Commission in its investigation.

The Company and the individual defendants intend to defend all of these actions vigorously. However, there can be no assurance that any of the complaints discussed above will be resolved without costly litigation, or in a

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manner that is not materially adverse to our financial position, results of operations or cash flows. No estimate can be made of the possible loss or possible range of losses associated with the resolution of these contingencies.

7. 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 third 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 the Statement of Operations. During the quarter, we also paid approximately \$1.0 million in lease commitments and real estate broker's fees. As of September 30, 2001, accrued restructuring charges totaled \$0.9 million and related primarily to future lease commitments related to the facilities in Eden Prairie and Paris, France.

8. Recent Accounting Pronouncements

In June 2001, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards ("SFAS") No. 141, "Business Combinations." SFAS No. 141 requires the use of the purchase method of accounting for business combinations initiated after June 30, 2001, and eliminates the pooling-of-interests method. We are currently assessing, but have not yet determined, the impact of SFAS No. 141 on our financial position and results of operations.

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In June 2001, the FASB also issued SFAS No. 142, "Goodwill and Other Intangible Assets," which is effective for fiscal years beginning after December 15, 2001. SFAS No. 142 requires the discontinuance of goodwill amortization. In addition, the standard includes provisions upon adoption for the reclassification of certain existing recognized intangibles as goodwill, reassessment of the useful lives of existing recognized intangibles, reclassification of certain intangibles out of previously reported goodwill and the testing for impairment of existing goodwill and other intangibles. We are currently assessing, but have not yet determined, the impact of SFAS No. 142 on our financial position and results of operations.

In August 2001, the FASB issued SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets," which is effective for fiscal years beginning after December 15, 2001. SFAS No. 144 supersedes SFAS No. 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed." We are currently assessing, but have not yet determined, the impact of SFAS No. 144 on our financial position and results of operations.

9. Acquisition of Software Clearing House, Inc.

On July 17, 2001, the Company acquired Software Clearing House, Inc. ("SCH"), which develops and distributes advanced storage solutions for the open systems market. Under the terms of the acquisition agreement, all issued and outstanding shares of SCH were purchased for \$10.3 million. The Company also paid \$1.9 million to current and former employees as a transactional bonus, assumed net liabilities of \$0.3 million and anticipates incurring approximately \$1.6 million in acquisition related expenses, which consist primarily of professional fees, severance expense and facility abandonment costs.

The total aggregate purchase price was \$10.1 million (excluding SCH's opening cash balance of \$4.0 million) and was allocated to the assets acquired,

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including tangible and intangible assets, and liabilities assumed based upon the fair value of such assets and liabilities on the date of acquisition. The allocation of purchase price to assets and liabilities was based on management's estimates of their fair value with the excess cost over the net assets acquired allocated to goodwill. The purchase price was allocated as follows (in thousands):

Tangible assets received	\$ 2,522
Developed technology	989
Goodwill	9,377
Liabilities assumed	(2,792)

	\$ 10,096
	=====

The tangible assets consist primarily of accounts receivable, deferred tax assets and property and equipment. The liabilities assumed consist primarily of accounts payable. Developed technology was identified and valued through analysis of data provided by SCH concerning development projects, their stage of development, the time and resources needed to complete them, if applicable, their expected income generating ability and the associated risks. 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 the developed technology. Since SCH had recently completed its latest product, AlphaStor, there were no research and development projects that were in-process as of the date of acquisition.

The following unaudited pro forma information combines the results of operations as if the acquisition of SCH had been consummated as of the beginning of the periods presented (in thousands, except for per share data):

	Nine months ended September 30, 2001 -----
Revenue	\$189,244
Net loss.....	(34,981)
Basic and diluted net loss per share.....	\$ (0.39)

The pro forma net loss includes the impact of adjustments related to a conforming accounting change (the write-off of capitalized software development costs) and the reduction of interest income. The pro forma information does not purport to be indicative of the results that would have occurred had the acquisition actually been in effect for these periods, or the results that may occur in the future.

10. Subsequent Events

In October 2001, we initiated plans to reduce our operating costs across the Company. These plans include, but are not limited to, facilities closures and headcount reductions. On October 22, 2001, we closed our development

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laboratories in Orem, Utah and New Delhi, India, in order to improvement management effectiveness and to reduce our cost structure. Certain of the engineers and developers from these locations will be transferred to other research and development laboratories in the United States. We expect these plans to be substantially complete by the end of the year and to result in a restructuring charge not to exceed \$6 million in the fourth quarter of 2001.

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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 reflecting our expectations, beliefs, intentions or strategies regarding the future, including without limitation, our financial outlook, successful introduction of new products and expansion of operation. 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, the current challenging information technology spending environment, continued weakness in the economy, litigation, competition, product concentration, technological changes, reliance on enterprise license transactions, modifications in the application of accounting policies, reliance on indirect sales channels, changes in sales and marketing strategies, dependence on international revenue, management of our growth and expansion, the ability to attract and retain qualified personnel, the ability to integrate recently-acquired business lines and other risks discussed in this item under the heading "Risk Factors" and the risks discussed in our other Securities and Exchange Commission filings.

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 Mont Ended Septem
	2001	2000	2001
Revenue:			
License	57%	61%	62%
Service and support	43	39	38
	---	---	---
Total revenue	100	100	100
	---	---	---
Cost of revenue:			
License	3	2	2
Service and support	20	19	21

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	---	---	---
Total cost of revenue	23	21	23
	---	---	---
Gross profit	77	79	77
	---	---	---
Operating expenses:			
Sales and marketing	57	48	52
Research and development	30	26	27
General and administrative	14	11	12
Amortization of acquired intangibles	13	18	13
Restructuring charges	(2)	-	3
	---	---	---
Total operating expenses	112	103	107
	---	---	---
Loss from operations	(35)	(24)	(30)
Interest and other income, net	2	3	3
	---	---	---
Loss before benefit from income taxes	(33)	(21)	(27)
Benefit from income taxes	(10)	(14)	(8)
	---	---	---
Net loss	(23)%	(7)%	(19)%
	===	===	===

Overview

We develop, market and support software products and services for heterogeneous client/server computing environments in mid- to large-scale enterprises. We are a technology leader in the network storage management software market through our commitment to open, standards-based software development. Our software delivers to

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customers a solution that is scalable, high-performance and manageable and ensures high data and application availability on a wide range of servers, clients, applications, databases and storage devices. Our data protection products, primarily the NetWorker family of products, and our data availability products, primarily our Legato Automated Availability Manager, support many server platforms and accommodate a variety of clients, applications, databases and storage devices. Our long-term strategy is to create an integrated set of solutions centered on information protection, availability and storage management that provide back-up, availability and management of mission-critical business information in the enterprise network environment. With the addition of AlphaStor, a media management product we acquired through our acquisition of SCH, we have strengthened our management product offerings.

Revenue

Total revenue increased \$2.8 million, or 5%, to \$57.0 million in the third quarter of 2001 from \$54.2 million for the third quarter of 2000. For the first nine months of 2001, total revenue increased \$7.6 million, or 4%, to \$180.6 million from \$173.0 million for the same period in 2000.

License revenue. License revenue decreased \$0.3 million, or 1%, to \$32.7 million in the third quarter of 2001 from \$32.9 million in the third quarter of 2000. The decrease was primarily due to smaller size of license transactions and a slow down in shrink-wrap sales immediately following the terrorist events that occurred in the United States on September 11, 2001. For the first nine months

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of 2001, license revenue increased \$1.0 million, or 1%, to \$111.3 million from \$110.3 million for the same period in 2000.

International license revenue for the third quarter of 2001 increased slightly over the same period in 2000, and the percentage of total license revenue by geographic region for the third quarter of 2001 was 50% in North America, 34% in Europe and 16% in Asia, which compares to 52% in North America, 34% in Europe and 14% in Asia for the third quarter of 2000.

For the third quarter of 2001, license revenue by channel consisted of 41% from direct customers, 15% from OEMs and 44% from resellers, which compares to 30% from direct customers, 20% from OEMs and 50% from resellers for the third quarter of 2000. The increase in the percentage of license revenue from direct customers reflects a decrease in the number of multi-year arrangements in 2001 whereby a significant portion of the license revenue is being recognized over the deployment term. The decrease in the percentage of license revenue from OEMs and resellers reflects the decrease in economy and reduced growth rates experienced in the storage industry.

Service and Support Revenue. Service and support revenue increased \$3.1 million, or 15%, to \$24.3 million in the third quarter of 2001 from \$21.2 million in the third quarter of 2000. The increase was primarily a result of the growth in the number of registered customers electing to subscribe to support contracts and the renewals of software support contracts after the initial one-year term concluded. This increase was partially offset by a decrease in revenue from education and consulting services. During the second quarter of 2001, we transitioned our education services to Global Knowledge Networks, Inc., an international information technology education integrator. For the first nine months of 2001, service and support revenue increased \$6.6 million, or 11%, to \$69.3 million from \$62.7 million for the same period a year ago. Our increase in internal staffing for software support helped to increase new sales and renewals of our software support contracts.

Gross Profit

Gross profit increased \$1.1 million, or 2%, to \$43.7 million, representing 77% of total revenue, in the third quarter of 2001 from \$42.6 million, representing 79% of total revenue, in the third quarter of 2000. For the first nine months of 2001, gross profit increased \$0.6 million, or less than 1%, to \$139.6 million, representing 77% of total revenue, from \$139.0 million, representing 80% of total revenue, for the same period in 2000.

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 \$0.9 million, or 3%, to \$30.6 million, representing 94% of license revenue, in the third quarter of 2001 from \$31.5 million, representing 96% of license revenue, in the third quarter of 2000. For the first nine months of 2001, gross profit

from license revenue increased \$1.5 million, or 1%, to \$107.3 million, representing 96% of license revenue, from \$105.8 million, representing 96% of license revenue, for the same period in 2000.

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, education and consulting materials. Gross profit from service and support revenue increased \$1.9 million,

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or 18%, to \$13.0 million, representing 54% of service and support revenue, in the third quarter of 2001 from \$11.1 million, representing 52% of service and support revenue, in the third quarter of 2000. For the first nine months of 2001, gross profit from service and support revenue decreased \$0.9 million, or 3%, to \$32.3 million, representing 47% of service and support revenue, from \$33.2 million, representing 53% of service and support revenue, for the same period in 2000. The decrease relates primarily to a smaller number of consulting services billings during 2001. The reduction in gross margin of service and support revenue relates primarily to the under utilization of our consulting organization and the increase in support personnel to enhance customers satisfaction. Service and support personnel have increased to 332 during 2001 from 286 in 2000.

Operating Expenses

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 \$6.4 million, or 25%, to \$32.3 million in the third quarter of 2001 from \$25.9 million in the third quarter of 2000. For the first nine months of 2001, sales and marketing expenses increased \$14.8 million, or 19%, to \$93.3 million from \$78.5 million for the same period in 2000. The increase in sales and marketing expenses was primarily attributable to the replacement of headcount after sales headcount was reduced by 12% in the second quarter of 2000. Sales and marketing personnel have increased to 515 during 2001 from 422 in 2000. We believe that sales and marketing expenses, excluding commissions, will decrease in absolute dollars as the sales force becomes more productive and as we reduce certain marketing programs.

Research and development. Research and development expenses consist primarily of personnel-related costs. Research and development expenses increased \$2.9 million, or 20%, to \$17.1 million in the third quarter of 2001 from \$14.2 million in the third quarter of 2000. For the first nine months of 2001, research and development expenses increased \$2.9 million, or 6%, to \$48.3 million from \$45.4 million for the same period in 2000. The increase in research and development expenses was primarily attributable to an increase in headcount and a bonus of \$0.6 million related to a retention plan established over a year ago. Research and development personnel have increased to 416 during 2001 from 379 in 2000. 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 \$2.0 million, or 32%, to \$8.1 million in the third quarter of 2001 from \$6.1 million in the third quarter of 2000. For the first nine months of 2001, general and administrative expenses increased \$2.6 million, or 13%, to \$22.8 million from \$20.2 million for the same period in 2000. Excluding non-recurring professional fees of \$1.3 million in 2000, general and administrative expenses increased \$3.9 million, or 21% during the first nine months of 2001. The increase in general and administrative expenses was primarily attributable to increased staffing and professional fees. General and administrative personnel have increased to 204 during 2001 from 162 in 2000. We believe that general and administrative expenses will decrease in absolute dollars and as a percentage of revenue.

Amortization of intangibles. Amortization of intangibles decreased \$2.0 million to \$7.5 million in the third quarter of 2001 from \$9.5 million in the third quarter of 2000. For the first nine months of 2001, amortization of intangibles decreased \$4.3 million to \$24.3 million from \$28.6 million in 2000. We are amortizing these intangibles on a straight-line basis over periods ranging from seventeen months to five years from the respective dates of acquisition.

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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 third

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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 Condensed Consolidated Statements of Operations.

Interest and other income, net. Interest and other income primarily represents interest income from funds available for investment. Interest and other income, net decreased \$0.6 million to \$1.3 million in the third quarter of 2001 from \$1.9 million in the third quarter of 2000 due to a decline in interest rates throughout 2001. Interest and other income, net increased \$1.4 million to \$6.1 million in the first nine months in 2001 from \$4.7 million for the same period in 2000 due to a gain of \$2.0 million on the sale of our equity investment in HighGround Systems, Inc. after HighGround was acquired by Sun Microsystems in April 2001.

Benefit from income taxes. The benefit from income taxes for the third quarter of 2001 was \$5.7 million compared to \$7.5 million for the third quarter of 2000. For the first nine months of 2001, the benefit from income taxes was \$14.2 million compared to \$7.7 million for the same period in 2000. The effective tax rate was 30% for the first nine months of 2001 and 26% for the same period in 2000. The increase in the benefit for income taxes primarily relates to a decrease in the amount of non-deductible goodwill amortization.

LIQUIDITY AND CAPITAL RESOURCES

Our cash, cash equivalents and investments totaled \$153.3 million as of September 30, 2001, and represented 38% of total assets as compared to \$165.1 million as of December 31, 2000. As of September 30, 2001, we had no long-term debt and stockholders' equity was \$308.0 million.

We have financed our operations to date primarily by generating cash from operations and selling our common stock. Net cash provided by operating activities was \$0.6 million for the nine months ended September 30, 2001 and consisted primarily of a net change in assets and liabilities of \$13.2 million and depreciation and amortization of \$39.1 million, partially offset by the net loss of \$33.6 million and deferred taxes of \$25.2 million. For the nine months ended September 30, 2000, net cash provided by operating activities was \$12.3 million and consisted primarily of a net change in assets and liabilities of \$3.8 million and depreciation and amortization of \$39.4 million partially offset by the net loss of \$21.3 million and deferred taxes of \$13.6 million.

Net cash used in investing activities was \$44.0 million for the nine months ended September 30, 2001, which resulted from the net purchases of marketable securities of \$17.8 million, the acquisition of property and equipment of \$17.5 million and the purchase of SCH for \$8.7 million. For the nine months ended September 30, 2000, net cash used in investing activities was \$20.9 million, which primarily resulted from the acquisition of property and equipment of \$21.1 million.

Net cash provided by financing activities was \$13.2 million for the nine months ended September 30, 2001, which resulted from the proceeds received from the issuance of our common stock from stock option exercises and our employee stock purchase plan. For the nine months ended September 30, 2000, net cash

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provided by financing activities was \$7.6 million, which resulted from the proceeds received from the issuance of our common stock of \$14.5 million partially offset by the repayment of a note payable of \$6.8 million.

We believe our current cash balances and cash flow from operations, if any, will be sufficient to meet the Company's working capital and capital expenditure requirements for at least the next twelve months.

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.

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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:

- . 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 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;
- . Lengthy sales cycles, particularly with enterprise license transactions;
- . 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 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 business lines;
- . Acquisition costs or other non-recurring charges in connection with the acquisition of companies, products or technologies;
- . Personnel changes; and
- . General economic factors.

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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:

- . 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 business; 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 recognized upon the signing of a license agreement;
- . 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;
- . Macroeconomic factors may affect our customers' decision to license our products or procure services;
- . The storage management market is rapidly evolving;

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- . Our sales cycles vary substantially from customer to customer, in large part because we are becoming increasingly dependent upon larger company-wide enterprise license transactions to corporate customers. Such transactions include product license, service and support components and may take a long time to complete;
- . 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;
- . 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;
- . Modification in reseller relationships resulting in a different application of our revenue recognition policies; 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.

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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 are currently subject to litigation.

Beginning on January 20, 2000, a number of shareholder securities class action complaints were filed in the U.S. District Court, Northern District of California, against us and certain of our directors and officers. On May 1, 2000, the court consolidated the pending cases and, on May 10, 2000, appointed a lead plaintiff, who filed a consolidated amended complaint on August 7, 2000. Defendants moved to dismiss. On January 17, 2001, the court granted the motions to dismiss with leave to amend. On February 13, 2001, plaintiffs filed a second amended complaint, which generally alleges that, between April 22, 1999 and May 17, 2000, defendants made false or misleading statements of material fact about our prospects and failed to follow generally accepted accounting principles in violation of the federal securities laws. The complaint seeks an unspecified amount in damages. Defendants answered the complaint in April 2001 denying all allegations that they violated the federal securities laws.

On February 1, 2000, a shareholder derivative action was filed in the U.S. District Court, Northern District of California, against certain of our officers and directors. We are named as a nominal defendant. The derivative case has been related to the securities class action. Plaintiffs filed an amended complaint on February 9, 2001, which generally alleges the same conduct as the shareholder class action, and claims that defendants breached their fiduciary duties and engaged in improper insider trading. The derivative complaint sought unspecified damages and injunctive relief. Defendants moved to dismiss the derivative complaint. On July 10, 2001, the court granted defendants' motion to dismiss with leave to amend. Plaintiffs filed an amended complaint on August 23, 2001; plaintiffs then moved to voluntarily dismiss the amended complaint with the right to refile the complaint at a later date if they choose to do so. Defendants have moved to permanently dismiss the amended complaint.

On April 13, 2000, a shareholder derivative action was filed in the Superior Court of California, County of Santa Clara, against certain of our officers and directors. We are named as a nominal defendant. On May 23, 2000, a shareholder derivative action was filed in the Superior Court of California, County of San Mateo, against certain of our officers and directors. We are named as a nominal defendant. Both state derivative complaints generally allege the same conduct as the derivative action filed in federal court, claiming that our officers and directors breached their fiduciary duties for the same period, and seek unspecified damages and injunctive relief. The state derivative cases have been consolidated in San Mateo County. Plaintiffs filed a consolidated amended complaint. Defendants filed a demurrer, which was denied on July 20, 2001. Defendants have filed a writ petition with the California Court of Appeal and California Supreme Court.

The Securities and Exchange Commission has entered a formal order of investigation concerning our restatement of financial results for the first, second and third quarters of 1999, and our revision of financial results

for the fourth quarter of 1999. We have been voluntarily cooperating with the Staff of the Commission in its investigation.

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The Company and the individual defendants intend to defend all of these actions vigorously. However, there can be no assurance that any of the complaints discussed above will be resolved without costly litigation, or in a manner that is not materially adverse to our financial position, results of operations or cash flows. No estimate can be made of the possible loss or possible range of losses associated with the resolution of these contingencies.

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:

Windows NT and Windows 2000 platforms:

Computer Associates; and
Veritas.

Unix platforms:

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 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 upgrade existing 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

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harm our business, operating results and financial condition. We cannot reasonably predict NetWorker's remaining life for several reasons, including:

- . The recent emergence of our market;
- . The effect of new products, applications or product enhancements;

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- . Technological changes in the network storage management environment in which NetWorker operates; and
- . Future competition.

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 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 continue to integrate into our product lines the technologies of products we acquired through the acquisitions of Intelliguard Software, Inc., Qualix Group, Inc. (dba FullTime Software Inc.) and Vinca Corporation in 1999, and 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 already this year, and currently plan to introduce and market several more potential new products in the next twelve months. Some of our competitors currently offer 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

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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, which 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. In addition, many of the large organizations that we target as customers have lowered their rate of spending on enterprise software. Such failure would seriously harm our business, operating results and financial condition. 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;

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- . These transactions typically involve significant technical evaluation and commitment of capital and other resources;
- . 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 U.S.;
- . 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

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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.

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 working 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 successfully expand international operations, 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

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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;

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- . Unexpected changes in regulatory requirements; o 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 must manage our growth and expansion and hire and retain qualified personnel.

We have recently hired a number of new executives as well as other employees throughout the Company. Approximately 40% of our employees joined the Company since the beginning of the year. We also plan to expand the geographic scope of our customer base. This expansion has resulted, and will continue to result, in substantial demands on our management resources.

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

As a result of our acquisitions in 1999 and in 2001, we recorded goodwill and intangibles of \$177.0 million of which \$89.7 million was included on our Condense Consolidated Balance Sheet as of September 30, 2001. To the extent we do not generate sufficient cash flows to recover the net amount of the investment recorded, the investment could be considered impaired and could be subject to earlier write-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.

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.

As described above, we have hired a large number of new employees, including executives in our sales, marketing and finance organizations, in the past nine months. 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.

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

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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

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unaware, whether the additional terms are written or verbal, we could be prevented from recognizing revenue in accordance with our plans.

We rely on our sales personnel.

We experienced a number of voluntary resignations in our sales force during the past year, including some of our senior level sales employees. 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 depend on growth in the enterprise storage market.

All of our business is in the enterprise storage market. The enterprise storage management market is still an emerging 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 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.

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 July 2001, we acquired Software Clearing House, Inc. ("SCH"), a software developer, reseller and consulting organization based in Cincinnati, Ohio. Our ability to achieve results in the remainder of 2001 and beyond will be dependent in part upon our ability to successfully integrate the people, products and business lines of SCH. In addition, we will need to work with SCH's customers and business partners to establish new relationships based upon the broader range of products and services available from us. Further, 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,

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operating results or financial condition.

We cannot assure you 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 unconsummated acquisition, including the claims that we failed to negotiate in good faith, misappropriated confidential information or other claims.

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

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and copyright laws, which afford only limited protection. However, we may not develop proprietary products or technologies that are patentable, 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.

Despite our efforts to protect our proprietary rights, we are aware that unauthorized parties have attempted to transfer licenses to third parties, copy aspects of our products or to obtain and use information that we regard as proprietary. Policing unauthorized use and transfer of our products is difficult, and software piracy can be expected to be a persistent problem. In licensing our products, other than in enterprise license transactions, we rely on "shrink wrap" licenses that are not signed by licensees. Such licenses may be unenforceable under the laws of certain jurisdictions. In addition, the laws of some foreign countries do not protect our proprietary rights to as great an extent as do the laws of the United States. Our means of protecting our proprietary rights may not be adequate. Our competitors may independently develop similar technology, duplicate our products or design around patents issued to us or other intellectual property rights of ours.

From time to time, we have received claims that we are infringing third parties' intellectual property rights. In the future, we may be subject to claims of infringement by third parties with respect to current or future products, trademarks or other proprietary rights. We expect that software product developers will increasingly be subject to infringement claims as the number of products and competitors in our industry segment grows and the functionality of products in different industry segments overlaps. Any such claims, with or without merit, could be time-consuming, result in costly litigation, cause product shipment delays or require us to enter into royalty or licensing agreements with third parties. If such royalty or licensing agreements, if required, are not available on terms acceptable to us, our business, operating results and financial condition could be seriously harmed.

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

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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.

Our trading price is volatile.

The trading of our common stock historically has been highly volatile, and we expect that the price of our common stock will continue to fluctuate significantly in the future. An investment in our common stock is subject to a variety of significant risks, including, but not limited to the following:

- . Quarterly fluctuations in financial results or results of other software companies;
- . Changes in our revenue growth rates or our competitors' growth rates;
- . Announcements that our revenue or income are below analysts' expectations;
- . Changes in analysts' estimates of our performance or industry performance;
- . Announcements of new products by our competitors or by us;
- . Announcements of disappointing financial results from our competitors, strategic allies or major end users;
- . Developments with respect to our patents, copyrights or proprietary rights or those of our competitors;
- . Sales of large blocks of our common stock;
- . Conditions in the financial markets in general;
- . Litigation; and
- . General business conditions and trends in the distributed computing environment and software industry.

In addition, the stock market may experience extreme price and volume fluctuations, which may affect the market price for the securities of technology companies without regard to their operating performance or any of the factors listed above. These broad market fluctuations may seriously harm the market price of our common stock.

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ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Interest Rate Risk. Our exposure to market risk for changes in interest rates relates primarily to our investment portfolio. While we are exposed with respect to interest rate fluctuations in many countries, our interest income is most sensitive to fluctuations in the general level of U.S. interest rates. In this regard, changes in the U.S. interest rates affect the interest earned on our cash, cash equivalents, short-term and long-term investments. We invest in high quality credit issuers and, by policy, limit the amount of our credit exposure to any one issuer. As stated in our policy, our first priority is to reduce the risk of principal loss. Consequently, we seek to preserve our invested funds by limiting default risk, market risk and reinvestment risk. We

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mitigate default risk by investing in only high quality credit securities that we believe to be low risk and by positioning our portfolio to respond appropriately to a significant reduction in a credit rating of any investment issuer or guarantor. The portfolio includes only marketable securities with active secondary or resale markets to ensure portfolio liquidity.

The table below presents the carrying value and related weighted average interest rates for our interest bearing instruments as of September 30, 2001 (dollars in millions).

	Carrying Value	Interest Rate
	-----	-----
Interest bearing instruments:		
Cash equivalents--fixed rate	\$ 45.3	3.1%
Investments--fixed rate	73.4	5.3

	\$ 118.7	
	=====	

Foreign Currency Risk. As a global concern, we face exposure to adverse movements in foreign currency exchange rates. This exposure may change over time as business practices evolve and could seriously harm our financial results. Substantially all 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, reduce the demand for our products. Reduced demand for our products could seriously harm our financial results. Currently, we do not hedge against any foreign currencies and as a result, could incur unanticipated gains or losses.

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PART II -- OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

Information concerning legal proceedings is incorporated herein by reference to Note 6 of the condensed consolidated financial statements in Part I of this Form 10-Q.

ITEM 2. CHANGES IN SECURITIES AND USE OF PROCEEDS
Not applicable.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES
Not applicable.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS
Not applicable.

ITEM 5. OTHER INFORMATION
Not applicable.

ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K.

(a) Exhibits: None.

(b) Reports on Form 8-K: The Company did not file any Reports on Form 8-K during the quarter ended September 30, 2001.

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SIGNATURES

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

LEGATO SYSTEMS, INC.

By: /s/ Andrew J. Brown

Andrew J. Brown
Executive Vice President, Finance and
Chief Financial Officer

By: /s/ Cory J. Sindelar

Cory J. Sindelar
Vice President, Corporate Controller and
Principal Accounting Officer

Date: November 13, 2001