LEGATO SYSTEMS INC
Form 10-Q
August 14, 2001

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 June 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	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 August 6, 2001 was 89,409,474.

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LEGATO SYSTEMS, INC

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PART I - FINANCIAL INFORMATION

PART I -- FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

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

	June 30, 2001	December 31, 2000
	(unaudited)	
ASSETS		
Current assets:		
Cash and cash equivalents	$105,495	$110,274
Short-term investments	64,714	40,626

Accounts receivable, net	37,216	47,655
Deferred tax assets	56,928	35,272
Other current assets	12,578	20,465
Total current assets	276,931	254,292
Long-term investments	--	14,245
Property and equipment, net	37,436	37,328
Intangible assets, net	87,138	103,900
Long-term deferred tax assets	--	2,788
Other assets	2,129	2,311
	$403,634	$414,864
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$ 3,716	$ 5,126
Accrued liabilities	40,935	33,551
Deferred revenue	45,261	53,853
Total current liabilities	89,912	92,530
Stockholders' equity	313,722	322,334
	$403,634	$414,864

See accompanying notes to condensed consolidated financial statements.

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

	Three Months Ended June 30,		Six Months Ende
	2001	2000	2001
		(unaudited)	
Revenue:			
License	$ 40,103	$ 37,365	$ 78,586
Service and support	22,408	20,916	44,972
Total revenue	62,511	58,281	123,558
Cost of revenue:			
License	1,205	1,582	1,931
Service and support	12,744	10,244	25,718
Cost of revenue	13,949	11,826	27,649
Gross profit	48,562	46,455	95,909

Operating expenses:			
Sales and marketing	30,577	25,042	61,028
Research and development	15,982	15,138	31,230
General and administrative	7,279	6,201	14,675
Amortization of acquired intangibles	7,700	9,522	16,754
Restructuring charges	6,087	--	6,087
Total operating expenses	67,625	55,903	129,774
Loss from operations	(19,063)	(9,448)	(33,865)
Interest and other income, net	3,715	1,790	4,843
Loss before benefit from income taxes	(15,348)	(7,658)	(29,022)
Benefit from income taxes	(5,372)	(77)	(8,445)
Net loss	$ (9,976)	$ (7,581)	$ (20,577)
Net loss per share:			
Basic and diluted	$ (0.11)	$ (0.09)	$ (0.23)
Weighted average common shares outstanding	88,719	86,561	88,287

See accompanying notes to condensed consolidated financial statements.

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

	Six Months Ended June 3	
	2001	2000
	(unaudited)	
Cash flows from operating activities:		
Net loss	$ (20,577)	$ (17,5
Adjustments to reconcile net loss to net cash provided by operating activities:		
Deferred taxes (net of effect of acquisitions)	(18,868)	(3,2
Depreciation and amortization	27,118	25,8
Provision for doubtful accounts and product returns	1,465	1,5
Tax benefit from stock option exercises	2,277	--
Changes in assets and liabilities:		
Accounts receivable	8,974	12,1
Other assets	8,069	5
Accounts payable	(1,410)	(2,0
Accrued liabilities	7,384	(4,8
Deferred revenue	(8,592)	(5,8
Net cash provided by operating activities	5,840	6,5
Cash flows from investing activities:		

Purchases of available-for-sale securities	(194,522)	(31,9
Maturities and sales of available-for-sale securities	184,700	30,9
Acquisition of property and equipment	(10,464)	(18,1
Net cash used in investing activities	(20,286)	(19,1
Cash flows from financing activities-		
Proceeds from issuance of common stock	9,667	9,5
Payment of short-term loan payable	--	(6,8
Net cash provided by financing activities	9,667	2,7
Net change in cash and cash equivalents	(4,779)	(9,8
Cash and cash equivalents at beginning of period	110,274	115,2
Cash and cash equivalents at end of period	$ 105,495	$ 105,3

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 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

	June 30, 2001	December 31, 2000
Accounts receivable:		
Trade accounts receivable	$ 44,461	$ 55,386
Allowances for doubtful accounts and product returns	(7,245)	(7,731)
	$ 37,216	$ 47,655
Property and equipment:		
Computer equipment and software	$ 52,317	$ 46,114
Furniture and fixtures	10,772	10,138
Office equipment	5,369	4,474
Leasehold improvements	11,071	11,676
	79,529	72,402
Accumulated depreciation and amortization	(42,093)	(35,074)
	$ 37,436	$ 37,328
Accrued liabilities:		
Accrued compensation and benefits	$ 13,417	$ 14,806
Income taxes payable	14,645	9,240
Other accrued liabilities	12,873	9,505
	$ 40,935	$ 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, 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 June 30,		
	2001	2000	2
Net loss...	$ (9,976)	$ (7,581)	$ (2
Unrealized gain (loss) on investments..................	(272)	1	
	$ (10,248)	$ (7,580)	$ (2

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 17,231,000 shares and 12,808,000 shares of common stock at the weighted average price of $14.64 per share and $18.31 per share were outstanding as of June 30, 2001 and 2000, respectively, but were not included in the computation of diluted net loss per share because their effect would be 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 certain of our directors and officers and the Company. On May 1, 2000, the court consolidated all of the pending cases and on May 10, 2000, appointed a lead plaintiff, who filed a consolidated amended complaint on August 7, 2000. Defendants filed motions to dismiss. On January 17, 2001, the court entered an order granting 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 the Company's 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 filed an answer to 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 moved to stay the derivative case. On January 17, 2001, the court denied plaintiffs' motion to stay. 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, but granted plaintiffs leave to amend their 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 period October 21, 1999 through April 3, 2000, and seek unspecified damages and injunctive relief. The Santa Clara derivative case was transferred to San Mateo County and consolidated with the San Mateo derivative case. Subsequently, plaintiffs filed a consolidated amended complaint in San Mateo County. Defendants moved to dismiss the consolidated amended complaint, but the court denied defendants' motion on July 20, 2001.

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 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 loss 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. As of June 30, 2001, accrued restructuring charges totaled $3.2 million and related primarily to future lease commitments on these properties.

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.

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.

9. Subsequent Event

On July 17, 2001, the Company acquired Software Clearing House, Inc., based in Cincinnati, Ohio, for approximately $8 million in cash, which will be accounted for under the purchase method of accounting. Software Clearing House develops and distributes advanced storage solutions for the open systems market.

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 June 30,		Six Months Ended June 30,	
	2001	2000	2001	2000
Revenue:				
License	64 %	64 %	64 %	65 %
Service and support	36	36	36	35
Total revenue	100	100	100	100
Cost of revenue:				
License	2	3	2	3
Service and support	20	17	20	16
Total cost of revenue	22	20	22	19
Gross profit	78	80	78	81
Operating expenses:				
Sales and marketing	49	43	50	44
Research and development	26	26	25	26
General and administrative	11	11	12	12
Amortization of acquired intangibles	12	16	14	16
Restructuring charges	10	-	5	-
Total operating expenses	108	96	106	98
Loss from operations	(30)	(16)	(28)	(17)
Interest and other income, net	6	3	4	2
Loss before benefit from income taxes	(24)	(13)	(24)	(15)
Benefit from income taxes	(8)	-	(7)	-
Net loss	(16)%	(13)%	(17)%	(15)%

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

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 Cluster and wanCluster products, 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 enhance and simplify network computing as a whole.

Revenue

Total revenue increased $4.2 million, or 7%, to $62.5 million in the second quarter of 2001 from $58.3 million for the second quarter of 2000. For the first six months of 2001, total revenue increased $4.8 million, or 4%, to $123.6 million from $118.8 million for the same period in 2000.

License revenue. License revenue increased $2.7 million, or 7%, to $40.1 million in the second quarter of 2001 from $37.4 million in the second quarter of 2000. The increase was primarily due to more significant license transactions for greater values being signed during the second quarter of 2001 as compared to the second quarter of 2000. For the first six months of 2001, license revenue increased $1.2 million, or 2%, to $78.6 million from $77.4 million for the same period in 2000.

Service and Support Revenue. Service and support revenue increased $1.5 million, or 7%, to $22.4 million in the second quarter of 2001 from $20.9 million in the second quarter of 2000. The increase was primarily as 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 partially offset by a decrease in revenue from education and consulting services. During the second quarter, we transitioned our education services to Global Knowledge Networks, Inc., an international information technology education integrator. As a result, we expect education services to continue to decrease in the third quarter. However, we expect our consulting organization to return to more historical levels in the third quarter of 2001. For the first six months of 2001, service and support revenue increased $3.6 million, or 9%, to $45.0 million from $41.4 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.

International license revenue increased $6.5 million, or 43%, to $21.5 million in the second quarter of 2001 from $15.0 million in the second quarter of 2000. International license revenue increased primarily as a result of the continued market acceptance of our products overseas as we continue to increase the number of international sales offices, international distributors and resellers marketing our products. The majority of international license revenue came from Europe during these periods. We intend to continue to expand our international operations, which will require management's attention and financial resources. To the extent that we are unable to affect these additions in a timely manner, our growth, if any, in international revenue will be limited, and our business, operating results and financial condition could be seriously harmed. In addition, we cannot guarantee that we will be able to maintain or increase international market demand for our products.

Gross Profit

Gross profit increased $2.1 million, or 5%, to $48.6 million, representing 78% of total revenue, in the second quarter of 2001 from $46.5 million, representing 80% of total revenue, in the second quarter of 2000. For the first six months of 2001, gross profit decreased $0.5 million, or 1%, to $95.9 million, representing 78% of total revenue, from $96.4 million, representing 81% of total revenue, 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 increased $3.1 million, or 9%, to $38.9 million, representing 97% of license revenue, in the second quarter of 2001 from $35.8 million, representing 96% of license revenue, in the second quarter of 2000. For the first six months of 2001, gross profit from license revenue increased $2.4 million, or 3%, to $76.7 million, representing 98% of license revenue, from $74.2 million, representing 96% of license revenue, in 2000. The increase in absolute dollars relates to the overall increase of license revenue.

Gross profit from service and support revenue decreased $1.0 million, or 9%, to $9.7 million, representing 43% of service and support revenue, in the second quarter of 2001 from $10.7 million, representing 51% of service and support revenue, in the second quarter of 2000. For the first six months of 2001, gross profit from service and support revenue decreased $2.9 million, or 13%, to $19.3 million, representing 43% of service and support revenue, from $22.2 million, representing 54% of service and support revenue, in 2000. The decrease relates primarily to a smaller number of consulting services billings during the second quarter of 2001. The reduced billings resulted from an increase in the amount of pre-sale activities and the necessity of providing higher support levels to customers. Service and support personnel increased to 309 in 2001 from 287 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.

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 $5.6 million, or 22%, to $30.6 million in the second quarter of 2001 from $25.0 million in the second quarter of 2000. For the first six months of 2001, sales and marketing expenses increased $8.4 million, or 16%, to $61.0 million from $52.6 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 increased to 483 in 2001 from 409 in 2000. We believe that sales and marketing expenses will be relatively constant in absolute dollars, but will decrease as a percentage of revenue as the sales force becomes more productive.

Research and development. Research and development expenses consist primarily of personnel-related costs. Research and development expenses increased $0.9 million, or 6%, to $16.0 million in the second quarter of 2001 from $15.1 million in the second quarter of 2000. For the first six months of 2001, research and development expenses increased $0.1 million, or less than 1%, to $31.2 million from $31.1 million for the same period in 2000. The slight increase in research and development expenses was primarily attributable to travel and entertainment costs and incentive compensation offset by a decrease in salaries. The number of research and development personnel decreased to 377 in 2001 from 402 in 2000. We expect research and development expenses to increase 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 $1.1 million, or 17%, to $7.3 million in the second quarter of 2001 from $6.2 million in the second quarter of 2000. For the first six months of 2001, general and administrative expenses increased $0.6 million, or 4%, to $14.7 million from $14.1 million for the same period in 2000. Excluding non-recurring professional fees of $1.3 million in 2000, general and administrative expenses increased $1.9 million, or 15%. The increase in general and administrative expenses was primarily attributable to increased staffing. General and administrative personnel increased to 179 in 2001 from 154 in 2000. We believe that general and administrative expenses will increase slightly in absolute dollars, but remain constant or decrease as a percentage of revenue.

Amortization of intangibles. Amortization of intangibles decreased $1.8 million to $7.7 million in the second quarter of 2001 from $9.5 million in the second quarter of 2000. For the first six months of 2001, amortization of intangibles decreased $2.2 million to $16.8 million from $19.0 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.

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. As of June 30, 2001, accrued restructuring charges totaled $3.2 million and related primarily to future lease commitments on these properties.

Interest and other income, net. Interest and other income primarily represents interest income from funds available for investment. Interest and other income, net increased $1.9 million to $3.7 million in the second quarter

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of 2001 from $1.8 million in the second quarter of 2000 and increased $2.1 million to $4.8 million in the first six months in 2001 from $2.7 million for the same period in 2000. The increase year over year related primarily to a gain 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 second quarter of 2001 was $5.4 million compared to $0.1 million for the second quarter of 2000. The effective tax rate was 35% for the second quarter of 2001 and 1% for the second quarter of 2000. For the first six months of 2001, the benefit from income taxes was $8.4 million compared to $0.2 million for the same period in 2000. The increase in the benefit for income taxes primarily relates to a decrease in the amount of goodwill amortized that is non-deductible for tax purposes.

LIQUIDITY AND CAPITAL RESOURCES

Our cash, cash equivalents and investments totaled $170.2 million as of

June 30, 2001, and represented 42% of total assets as compared to $165.1 million as of December 31, 2000. Cash and cash equivalents are highly liquid investments with original maturities of ninety days or less. Investments consist mainly of short-term municipal securities and auction rate receipts. As of June 30, 2001, we had no long-term debt and stockholders' equity was $313.7 million.

We have financed our operations to date primarily by cash from operations and the sale of common stock. Net cash provided by operating activities was $5.8 million for the six months ended June 30, 2001 and consisted primarily of a net change in assets and liabilities of $14.4 million and depreciation and amortization of $27.1 million, partially offset by the net loss of $20.6 million and deferred taxes of $18.9 million. For the six months ended June 30, 2000, net cash provided by operating activities was $7.1 million and consisted primarily of depreciation and amortization of $25.9 million partially offset by the net loss of $17.6 million.

Net cash used in investing activities was $20.3 million for the six months ended June 30, 2001, which resulted from the net purchases of marketable securities of $9.8 million and the acquisition of property and equipment of $10.5 million. For the six months ended June 30, 2000, net cash used in investing activities was $19.7 million, which primarily resulted from the acquisition of property and equipment of $18.1 million.

Net cash provided by financing activities was $9.7 million for the six months ended June 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 six months ended June 30, 2000, net cash provided by financing activities was $2.7 million, which resulted from the proceeds received from the issuance of our common stock of $9.6 million partially offset by a payment 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.

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 size and timing of orders;
- Intense competition;

- Macroeconomic uncertainty and weakness in the markets in which we operate;
- 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;
- Modification in reseller relationships resulting in changes to the application of revenue recognition policies;
- Success in expanding sales and marketing programs;
- Technological changes in our markets;
- 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.

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, which 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;
- 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 take a long time to complete;
- Due to general economic factors that currently affect our 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 income will decrease 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 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 certain of our directors and officers and the Company. On May 1, 2000, the court consolidated all of the pending cases and, on May 10, 2000, appointed a lead plaintiff, who filed a consolidated amended complaint on August 7, 2000. Defendants filed motions to dismiss. On January 17, 2001, the court entered an order granting 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 the Company's 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 filed an answer to 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 moved to stay the derivative case. On January 17, 2001, the Court denied plaintiffs' motion to stay. 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, but granted plaintiffs leave to amend their 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 period October 21, 1999 through April 3, 2000, and seek unspecified damages and injunctive relief. The Santa Clara derivative case was transferred to San Mateo County and consolidated with the San Mateo derivative case. Subsequently, plaintiffs filed a consolidated amended complaint in San Mateo County. Defendants moved to dismiss the consolidated amended complaint, but the court denied defendants' motion on July 20, 2001.

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 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 loss 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 achieve 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 recent emergence of our market;
- The effect of new products, applications or product enhancements;
- 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 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. 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 environment. 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, 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 six 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;
- They 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 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 allies 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 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 global economic turbulence.

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 significant number of new senior executives as well as other employees throughout the Company. 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.

From time to time, we receive customer complaints about the timeliness and accuracy of customer support. We plan to add customer support personnel in order to address current customer support needs. If we are not successful in hiring and retaining such personnel, our business, operating results and financial condition could be seriously harmed. Our ability to compete effectively and to manage future expansion of our operations, if any, will require us to continue to improve our financial and management controls, reporting systems and procedures on a timely basis, and to expand, train and manage our employees in all areas of the business. Our failure to do so would seriously harm our business, operating results and financial condition.

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

As a result of our acquisitions in 1999, we recorded goodwill and intangibles of $167.2 million, which is being amortized over a period of two to five years. We will amortize $31.8 million in 2001, $29.5 million in 2002, $28.6 million in 2003 and $14.0 million in 2004. 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.

We recently experienced a period of high employee turnover and have hired a number of new executives at the levels of director, vice president and above. Our future success also depends on our continuing ability to attract and retain highly qualified technical, sales and managerial personnel. 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.

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, then 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 management market.

All of our business is in the enterprise storage management 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 second half 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, 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 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 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.

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 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 June 30, 2001 (dollars in millions).

	Carrying Value	Interest Rate
Interest bearing instruments:		
Cash equivalents--fixed rate	$ 82.1	4.9 %
Investments--fixed rate	52.8	5.9
	$ 134.9	

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.

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 June 30, 2001.

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: August 14, 2001