LEGATO SYSTEMS INC
Form 10-Q
July 30, 2003
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended June 30, 2003

OR

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

For the transition period from____________ to ______________

Commission File Number: 000-26130

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 ¨

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule12b-2 of the Exchange Act). Yes x No ¨

The number of shares outstanding of the Registrant s Common Stock as of July 21, 2003 was 117,786,729.

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PART I FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

LEGATO SYSTEMS, INC.

Condensed Consolidated Balance Sheets

(in thousands)

	June 30, 2003	December 31, 2002
	(unaudited)	
ASSETS		
Current assets:		
Cash and cash equivalents	$ 62,659	$ 54,726
Investments	9,315	15,318
Accounts receivable, net	42,752	51,501
Other current assets	9,707	7,487
Total current assets	124,433	129,032
Property and equipment, net	39,297	43,906
Intangible assets, net	25,196	30,586
Goodwill	270,709	270,709
Other assets	4,603	5,483
	$ 464,238	$ 479,716
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Line of credit	$ 13,495	$ 10,550
Accounts payable	11,224	12,294
Accrued liabilities	43,176	58,314
Deferred revenue	66,302	67,956
Total current liabilities	134,197	149,114
Deferred revenue net of current portion	3,389	2,808
	137,586	151,922
Stockholders equity:		
Common stock and capital in excess of par, $0.0001 par value;		
117,525 and 116,136 issued and outstanding, respectively	631,882	627,067
Deferred stock compensation	(260)	(416)
Accumulated other comprehensive income	1,471	582

Accumulated deficit	(306,441)	(299,439)
Total stockholders equity	326,652	327,794
	$ 464,238	$ 479,716

See accompanying notes to these 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 June 30,		Six Months Ended June 30,	
	2003	2002	2003	2002
	(unaudited)			
Revenue:				
License	$ 34,845	$ 30,629	$ 69,233	$ 59,379
Service and support	41,783	30,928	81,406	57,809
Total revenue	76,628	61,557	150,639	117,188
Cost of revenue:				
License	1,983	2,215	3,978	3,926
Service and support	11,941	11,325	23,528	21,920
Cost of revenue	13,924	13,540	27,506	25,846
Gross profit	62,704	48,017	123,133	91,342
Operating expenses:				
Sales and marketing	33,286	34,219	66,600	65,938
Research and development	18,616	18,252	37,126	32,772
General and administrative	8,014	9,606	16,168	16,675
Amortization of acquired intangibles	2,695	2,166	5,390	3,598
Write-off of in-process research and development		33,200		33,200
Restructuring charges	3,543		3,543	
Litigation settlement charge				67,000
Total operating expenses	66,154	97,443	128,827	219,183
Loss from operations	(3,450)	(49,426)	(5,694)	(127,841)
Interest and other income, net	(536)	1,348	(897)	1,862
Loss before provision for/(benefit from) income taxes	(3,986)	(48,078)	(6,591)	(125,979)
Provision for/(benefit from) income taxes	411	(2,224)	411	(33,384)
Net loss	$ (4,397)	$ (45,854)	$ (7,002)	$ (92,595)
Net loss per share:				
Basic and diluted	$ (0.04)	$ (0.45)	$ (0.06)	$ (0.96)
Weighted average common shares outstanding	117,011	102,643	116,595	96,540

See accompanying notes to condensed consolidated financial statements.

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LEGATO SYSTEMS, INC.

Condensed Consolidated Statements of Cash Flows

(in thousands)

	Six Months Ended June 30,	
	2003	2002
	(unaudited)	
Cash flows from operating activities:		
Net loss	$ (7,002)	$ (92,595)
Adjustments to reconcile net loss to net cash used in operating activities:		
Deferred taxes		(37,422)
Depreciation and amortization	14,572	12,193
Write-off of in-process research and development		33,200
Stock compensation expense	424	289
Provision for doubtful accounts and sales returns	404	183
Changes in assets and liabilities:		
Accounts receivable	8,345	(161)
Other assets	(1,340)	1,100
Accounts payable	(1,070)	8,893
Accrued liabilities	(15,138)	(12,295)
Deferred revenue	(1,073)	2,346
Net cash used in operating activities	(1,878)	(84,269)
Cash flows from investing activities:		
Purchases of available-for-sale securities	(57)	(17,239)
Maturities and sales of available-for-sale securities	6,436	72,775
Purchase of technology		(3,250)
Acquisition of OTG Software, net of cash acquired		(1,609)
Acquisition of property and equipment	(4,573)	(10,503)
Net cash provided by investing activities	1,806	40,174
Cash flows from financing activities:		
Proceeds from issuance of common stock	4,547	9,434
Borrowings against line of credit	28,115	
Payments against line of credit	(25,170)	
Net cash provided by financing activities	7,492	9,434
Effect of changes in foreign exchange rates	513	593
Net change in cash and cash equivalents	7,933	(34,068)
Cash and cash equivalents at beginning of period	54,726	63,281
Cash and cash equivalents at end of period	$ 62,659	$ 29,213

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 and Significant Accounting Policies

Basis of Presentation. The accompanying unaudited consolidated financial statements have been prepared by Legato Systems, Inc. (the Company or Legato) in accordance with the rules and regulations of the Securities and Exchange Commission. Certain information and footnote disclosures normally included in consolidated financial statements prepared in accordance with accounting principles generally accepted in the United States have been condensed or omitted in accordance with such rules and regulations. In the opinion of management, the accompanying unaudited 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, 2003, 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, 2002, included in the Company s Form 10-K dated February 28, 2003.

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

The financial statements for the three and six months ended June 30, 2002 include the results of OTG Software, Inc. since May 15, 2002, the date of acquisition.

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

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 reasonably assured. Estimated product returns are recorded upon recognition of revenue from customers having rights of return, including exchange rights for unsold products and product upgrades. For sales to international distributors, license revenue is generally recognized upon meeting the criteria above and identifying their customers. For sales to domestic distributors, license revenue is recognized upon sale by the distributor to its customer. License revenue from royalty payments is recognized upon receipt of royalty reports from OEMs related to their product sales. Revenue from subscription license agreements, which include software, rights to future products and maintenance, is recognized ratably over the term of the subscription period.

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

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

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2003	2002	2003	2002
Net loss	$ (4,397)	$ (45,854)	$ (7,002)	$ (92,595)
Unrealized gain (loss) on investments	(144)	(68)	(53)	(643)
Reclassification adjustment due to realized loss			429	
Foreign currency translation adjustments	362	593	513	593
	$ (4,179)	$ (45,329)	$ (6,113)	$ (92,645)

Computation of Net Income (Loss) Per Share. Basic net income (loss) per share is computed by dividing net income (loss) by the weighted average shares of common stock outstanding during the period. Diluted net income per share is computed by dividing net income by the weighted average shares of common stock and potential common shares outstanding during the period. Potential common shares outstanding consist of dilutive shares issuable upon the exercise of outstanding options to purchase common stock as computed using the treasury stock method. For periods in which Legato incurs a loss, potential common shares outstanding are excluded from the computation of diluted net loss per share as their effect is anti-dilutive. Options to purchase 28.8 million shares and 24.8 million shares of common stock at a weighted average price of $9.59 per share and $11.31 per share were outstanding as of June 30, 2003 and 2002, respectively, but were not included in the computation of diluted net loss per share because their effect would be anti-dilutive.

Stock-Based Compensation. We account for stock-based employee compensation plans under the recognition and measurement principles of APB Opinion No. 25, Accounting for Stock Issued to Employees, and related interpretations. No significant stock-based employee compensation cost is reflected in net income, as all options granted under those plans had an exercise price equal to the market value of the underlying common stock on the date of grant.

The following table illustrates the effect on net loss and net loss per share if we had applied the fair value recognition provisions of Statement of Financial Account Standard (SFAS) No. 123, Accounting for Stock-Based Compensation, to stock-based employee compensation (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2003	2002	2003	2002
Net loss as reported	$ (4,397)	$ (45,854)	$ (7,002)	$ (92,595)
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects	(9,787)	(13,464)	(19,930)	(23,704)

Net loss pro forma	$ (14,184)	$ (59,318)	$ (26,932)	$ (116,299)
Basic and diluted net loss per share as reported	$ (0.04)	$ (0.45)	$ (0.06)	$ (0.96)
Basic and diluted net loss per share pro forma	$ (0.12)	$ (0.58)	$ (0.23)	$ (1.20)
Weighted average fair value of options granted for the period	$ 5.09	$ 4.91	$ 4.11	$ 6.41

3. Recent Accounting Pronouncements

In December 2002, the Financial Accounting Standards Board (FASB) issued SFAS No. 148, Accounting for Stock Based Compensation Transition and Disclosure as Amendment to FAS 123. SFAS No. 148 provides two additional transition methods for entities that adopt the preferable method of accounting for stock based compensation. Further, the statement requires disclosure of comparable information for all companies regardless of whether, when or how an entity adopts the preferable, fair value based method of accounting. As we continue to

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disclose the fair value of stock option compensation only, SFAS No. 148 did not have any impact on our financial position or results of operations. The interim disclosures of SFAS No. 148 have been disclosed above.

In the first quarter of fiscal 2003, the Company adopted Financial Accounting Standards Board Interpretation No. 45 (FIN 45), Guarantor s Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others. FIN 45 requires that a liability be recorded in the guarantor s balance sheet upon issuance of a guarantee. In addition, FIN 45 requires disclosure about guarantees that an entity has issued, including a reconciliation of changes in the entity s product warranty liabilities. The initial recognition and measurement provisions of FIN 45 are applicable on a prospective basis to guarantees issued or modified after December 31, 2002. The adoption of this standard did not have a material impact on our consolidated results of operations or financial position.

In January 2003, the FASB issued Interpretation No. 46 (FIN 46), Consolidation of Variable Interest Entities, an Interpretation of ARB No. 51. FIN 46 requires certain variable interest entities to be consolidated by the primary beneficiary of the entity even if the equity investors in the entity do not have the characteristics of a controlling financial interest or do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support from other parties. FIN 46 is effective immediately for all new variable interest entities created or acquired after January 31, 2003. For variable interest entities created or acquired prior to February 1, 2003, the provisions of FIN 46 must be applied for the first interim or annual period beginning after June 15, 2003. The adoption of this standard will not have a material impact on our consolidated results of operations or financial position.

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

In April 2003, the FASB issued SFAS No. 149, Amendment of Statement 133 on Derivative Instruments and Hedging Activities. SFAS No. 149 amends and clarifies accounting for derivative instruments, including certain derivative instruments embedded in other contracts and for hedging activities under SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities. SFAS No. 149 is generally effective for derivative instruments, including derivative instruments embedded in certain contracts, entered into or modified after June 30, 2003 and for hedging relationships designated after June 30, 2003. We do not expect the adoption of SFAS No. 149 to have a material impact on our results of operations or financial position.

In May 2003, the FASB issued SFAS No. 150 Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity. SFAS No. 150 establishes standards for how an issuer classifies and measures certain financial instruments with characteristics of both liabilities and equity and is effective for financial instruments entered into or modified after May 31, 2003. We do not expect the adoption of this standard to have a material impact on our results of operations or financial position.

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3. Balance Sheet Components

	June 30, 2003	December 31, 2002
Accounts receivable:		
Trade accounts receivable	$ 48,792	$ 59,226
Allowances for doubtful accounts and sales returns	(6,040)	(7,725)
	$ 42,752	$ 51,501
Property and equipment:		
Computer hardware	$ 55,587	$ 52,705
Computer software	28,048	27,212
Office equipment, furniture and fixtures	19,021	18,490
Leasehold improvements	15,081	14,757
	117,737	113,164
Accumulated depreciation and amortization	(78,440)	(69,258)
	$ 39,297	$ 43,906
Accrued liabilities:		
Accrued compensation and benefits	$ 12,835	$ 18,369
Taxes payable	7,056	9,487
Restructuring	10,532	11,658
Other accrued liabilities	12,753	18,800
	$ 43,176	$ 58,314

4. Commitments and Contingencies

Operating Leases. We lease our operating facilities under non-cancelable operating leases that expire at various dates through 2011. Certain of these leases contain renewal options. We also entered into non-cancelable sub-leases that expire at various dates through 2011, which was offset against rent expense. As of June 30, 2003, future minimum lease commitments and sub-lease income were as follows (in thousands):

Year ending December 31,	Operating Leases	Sub-lease Income
Remainder of 2003	$ 9,304	$ 1,176
2004	17,042	2,329
2005	15,379	2,301
2006	13,860	2,346
2007	10,123	1,003
2008	9,588	806

Thereafter	14,961	1,948
	$ 90,257	$ 11,909

Indemnifications and Warranties. We sell software licenses and services to its customers under contracts which we refer to as Software License Agreements (SLA). Each SLA contains the relevant terms of the contractual agreement with the customer, and generally includes certain provisions for indemnifying the customer against losses, expenses, and liabilities from damages that may be awarded against the customer in the event our software is found to infringe upon a patent, copyright, trademark, or other proprietary right of a third party. The SLA generally limits the scope of and remedies for such indemnification obligations in a variety of industry-standard respects, including but not limited to certain time- and geography-based scope limitations and a right to replace an infringing product.

We believe our internal development processes and other policies and practices limit our exposure related to the indemnification provisions of the SLA. In addition, we require our employees to sign a proprietary information and inventions agreement, which assigns the rights to our employees development work to the Company. To date, we have not had to reimburse any of our customers for any losses related to these indemnification provisions, and no

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material claims are outstanding as of June 30, 2003. For several reasons, including the lack of prior indemnification claims and the lack of a monetary liability limit for certain infringement cases under the SLA, we cannot determine the maximum amount of potential future payments, if any, related to such indemnification provisions.

We also warrant to customers that software products operate substantially in accordance with specifications. Historically, minimal costs have been incurred related to product warranties, and as such, no accruals for warranty costs have been made.

Restructuring Charges. During 2002, we incurred a charge to our results of operations of $11.7 million, related primarily to excess facilities located in Burlington, Ontario; Mountain View, California and Rockville, Maryland and to the closure of several smaller sales offices. In the second quarter of 2003, we signed a sub-lease for a portion of our Rockville facility. The sublease has a term that ends with our lease termination date and represents $3.1 million of future sublease income. Because we were able to locate a sub-tenant earlier than expected, we recognized a benefit to the restructuring charge equal to $0.8 million. In May of 2003, we took certain actions to reduce our headcount by approximately 90 and to reallocate resources in order to improve efficiencies. As a result, we incurred $4.3 million of severance and related benefit expenses and expect to save $9.5 to $10.0 million annually. To date, we generally have realized the costs savings anticipated by our previous actions.

As of June 30, 2003, accrued restructuring charges related primarily to future lease commitments and to severance and related benefits. The following table summarizes the restructuring activity for the first six months of 2003 (in thousands):

	Severance & Benefits	Excess Facilities	Total
Balance, December 31, 2002	$ 878	$ 10,780	$ 11,658
Restructuring charges	4,329	(786)	3,543
Non-cash modification to option agreements	(245)		(245)
Cash payments	(3,194)	(1,230)	(4,424)
Balance, June 30, 2003	$ 1,768	$ 8,764	$ 10,532

Legal Proceedings. In April 2002, we settled the class action and derivative lawsuits filed in 2000 in the United States District Court for the Northern District of California and in San Mateo County Superior Court, respectively. The settlements in the federal and state litigation called for Legato to pay a total of $87.7 million, which included attorneys fees, in May 2002. Approximately $21.0 million of the settlement amount was reimbursed by our corporate insurance. The settlement was recorded as a $67.0 million charge to the results of operations for the quarter ended March 31, 2002 and was paid during the quarter ended June 30, 2002.

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

issuers officers and underwriters in the Southern District of New York. On July 19, 2002, the defendants filed a motion to dismiss the complaint. On February 19, 2003, the Court denied defendants motion with respect to the claims asserted against OTG. We intend to defend the action vigorously and believe that it is not possible at the current time to estimate the amount of a probable loss, if any, that might result from this matter. On June 26, 2003, the plaintiffs announced the terms of a settlement in principle with the issuer defendants. Under the terms of the settlement, Legato would not have to pay any of its own funds to plaintiffs, and all of its attorneys fees and costs beginning on June 1, 2003, would be paid by OTG s directors and officers liability insurance carriers. A committee of our Board of Directors has approved the settlement proposal, but before the settlement is final, it is subject to a

number of conditions, including approval by a sufficient number of other issuers, agreement on a formal stipulation of settlement, and approval by the U.S. District Court for the Southern District of New York.

On July 1, 2002, we received notice that an action captioned *Nickel v. Kay, et al.* had been filed in the Circuit Court for Montgomery County, Maryland. The action, brought by a former OTG employee, asserts claims that Richard Kay, OTG and Legato are liable under various legal theories for the alleged breach of Mr. Nickel s employment contract and breach of fiduciary duties allegedly owed to Mr. Nickel. The complaint alleges compensatory and punitive damages, to be proven at trial. In January 2003, the Court dismissed all claims against Legato. In March 2003, OTG settled with the plaintiff; the terms of the settlement are confidential, but the amount of the settlement did not materially affect the Company s operating results. The only remaining claims are asserted against Mr. Kay. The Company intends to work with Mr. Kay to vigorously oppose the remaining claims.

On or about November 20, 2002, we received an arbitration demand filed with the American Arbitration Association by Buro- und Datentechnik, an OTG European reseller, and BDT Products, one of its subsidiaries. The reseller alleges that OTG misrepresented information concerning the capabilities of certain OTG products, and OTG s intentions with respect to development plans for those products. On that basis, the reseller asserts that it is entitled to damages of $44 million, which consist primarily of alleged consequential damages in the form of lost profits. In response, on December 23, 2002, we filed a Statement of Defense and Counterclaim. We assert that the OTG products functioned as warranted, that consequential damages, including lost profits, are prohibited under the terms of the contract. Our counterclaim asserts that the reseller failed to perform its obligations to market and sell our products. We assert that if consequential damages are permitted, we seek such damages against the reseller in an unspecified amount. No estimate can be made of the possible loss or possible range of loss associated with the resolution of this contingency. Although insurance may be available to cover some portion of any potential liability, an adverse arbitration award could be materially adverse to our operating results, financial position or cash flows.

On July 9, 2003, the Company was served with a Complaint, captioned *Fan v. Legato Systems, Inc., et al.,* filed in the Superior Court for Santa Clara County, California. A similar complaint, captioned *Batchelor v. Wright, et al.*, was served on the Company on July 11. A third, similar complaint, captioned *Moskowitz v. Legato Systems, Inc.*, et al., was served on the Company on July 15, 2003. The complaints, each of which names as defendants the Company and each of the members of board of directors individually, allege that the board breached its fiduciary duties to the shareholders and engaged in self dealing in connection with the recently-announced acquisition agreement with EMC Corporation. The complaint seeks to enjoin the acquisition and to force the board to obtain a transaction in the interests of the shareholders. We believe the allegations in the complaints are meritless, and intend to defend the Company and the individual defendants vigorously.

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

5. Stock Option Program

Option Program Description. Our stock option program is a broad-based, long-term retention program that is intended to attract and retain talented employees and align stockholder and employee interests. We consider our option program critical to our operation and productivity; essentially all of our employees participate. Of the options granted in 2003, one-hundred percent went to employees other than the five most highly compensated officers. The program consists of one plan, which was approved by our shareholders, and is divided into three separate components:

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

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

Automatic Option Grant Program, under which option grants will automatically be made at periodic intervals to eligible non-employee Board members.

The Compensation Committee of our Board has primary responsibility for administering the option program. All members of the Compensation Committee are independent directors, as defined in the applicable rules for issuers traded on The Nasdaq Stock Market. The Board has also appointed a Stock Option Committee, currently comprised of one employee-Board member, to have separate but concurrent authority under the program to make stock option grants to individuals who are not officers, vice presidents or Board members at the time of grant, up to a maximum of 30, 000 shares per person. See the Report of the Compensation Committee on Executive Compensation appearing in the our proxy statement dated April 30, 2003 for further information concerning the policies and procedures of the Company and the Compensation Committee regarding the use of stock options.

As of June 30, 2003, 41.0 million shares of common stock have been authorized for issuance under the Company s 1995 Stock Option/Stock Issuance Plan (the 1995 Plan), of which 7.7 million were available for future grant. Options to purchase shares may be granted and shares may be issued directly under the 1995 Plan. Options must have an exercise price not less than 100% and 85% of fair market value of the common stock on the date of grant for incentive stock options and non-statutory stock options, respectively. The purchase price for shares issued directly may not be less than 85% of fair market value on the date of grant. Options generally vest over four years, whereby 25% of the shares become exercisable one year after the grant date and monthly thereafter over 36 months, and terminate ten years after their original grant date. A summary of option activity is as follows (in thousands, except per share amounts):

	Six Months Ended June 30, 2003		Year Ended December 31, 2002		Year Ended December 31, 2001	
	Shares	Weighted Average Price	Shares	Weighted Average Price	Shares	Weighted Average Price
Outstanding at beginning of period	26,388	$ 10.07	20,996	$ 12.24	14,892	$ 15.43
Options granted and assumed (1)	4,068	5.81	9,954	6.19	10,509	8.76
Options exercised	(409)	3.56	(1,087)	4.87	(1,421)	5.60
Options forfeited	(1,200)	9.28	(3,475)	13.67	(2,984)	19.26
Outstanding at the end of period	28,847	9.59	26,388			