LEGATO SYSTEMS INC
Form 10-Q
August 14, 2002
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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, 2002

OR

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

For the transition period from ___________ to ___________

Commission File Number: 000-26130

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

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

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

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No ¨

The number of shares outstanding of the Registrant s Common Stock as of July 31, 2002 was 114,878,469.

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PART I FINANCIAL INFORMATION

Item 1. ***Financial Statements***

LEGATO SYSTEMS, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS
(in thousands)

	June 30, 2002	December 31, 2001
	(unaudited)	
ASSETS		
Current assets:		
Cash and cash equivalents	$ 29,213	$ 63,281
Short-term investments	26,235	82,414
Accounts receivable, net	53,475	39,581
Deferred tax assets	57,835	61,136
Other current assets	10,574	12,373
Total current assets	177,332	258,785
Property and equipment, net	54,111	42,884
Intangible assets, net	35,976	15,616
Goodwill, net	269,569	16,026
Long-term deferred tax assets	57,559	19,754
Other assets	5,784	2,196
	$ 600,331	$ 355,261
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 21,295	$ 8,316
Accrued liabilities	61,297	41,440
Deferred revenue	53,719	41,748
Total current liabilities	136,311	91,504
Deferred revenue net of current portion	2,983	3,798
Total liabilities	139,294	95,302
Stockholders equity	461,037	259,959
	$ 600,331	$ 355,261

See accompanying notes to condensed consolidated financial statements.

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LEGATO SYSTEMS, INC.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(in thousands, except per share data)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2002	2001	2002	2001
	(unaudited)			
Revenue:				
License	$ 30,629	$ 40,103	$ 59,379	$ 78,586
Service and support	30,928	22,408	57,809	44,972
Total revenue	61,557	62,511	117,188	123,558
Cost of revenue:				
License	2,215	1,205	3,926	1,931
Service and support	11,325	12,744	21,920	25,718
Cost of revenue	13,540	13,949	25,846	27,649
Gross profit	48,017	48,562	91,342	95,909
Operating expenses:				
Sales and marketing	34,219	30,577	65,938	61,028
Research and development	18,252	15,982	32,772	31,230
General and administrative	9,606	7,279	16,675	14,675
Amortization of acquired intangibles	2,166	7,700	3,598	16,754
Write-off of in-process research and development	33,200		33,200	
Restructuring charges		6,087		6,087
Litigation settlement charge			67,000	
Total operating expenses	97,443	67,625	219,183	129,774
Loss from operations	(49,426)	(19,063)	(127,841)	(33,865)
Interest and other income, net	1,348	3,715	1,862	4,843
Loss before benefit from income taxes	(48,078)	(15,348)	(125,979)	(29,022)
Benefit from income taxes	(2,224)	(5,372)	(33,384)	(8,445)
Net loss	$ (45,854)	$ (9,976)	$ (92,595)	$ (20,577)
Net loss per share:				
Basic and diluted	$ (0.45)	$ (0.11)	$ (0.96)	$ (0.23)
Weighted average common shares outstanding	102,643	88,719	96,540	88,287

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, 2002	2001
	(unaudited)	
Cash flows from operating activities:		
Net loss	$ (92,595)	$ (20,577)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:		
Deferred taxes (net of effect of acquisitions)	(37,422)	(18,868)
Depreciation and amortization	12,193	27,118
Write-off of in-process research and development	33,200	
Amortization of deferred stock compensation	289	
Provision for doubtful accounts and sales returns	183	1,465
Tax benefit from stock option exercises		2,277
Changes in assets and liabilities:		
Accounts receivable	(161)	8,974
Other assets	1,100	8,069
Accounts payable	8,893	(1,410)
Accrued liabilities	(12,295)	7,384
Deferred revenue	2,346	(8,592)
Net cash provided by (used in) operating activities	(84,269)	5,840
Cash flows from investing activities:		
Purchases of available-for-sale securities	(16,053)	(194,522)
Maturities and sales of available-for-sale securities	72,775	184,700
Purchase of technology	(3,250)	
Acquisition of OTG Software, net of cash acquired	(1,609)	
Acquisition of property and equipment	(10,503)	(10,464)
Net cash provided by (used in) investing activities	41,360	(20,286)
Cash flows from financing activities		
Proceeds from issuance of common stock	9,434	9,667
Effect of changes in foreign exchange rates	(593)	
Net change in cash and cash equivalents	(34,068)	(4,779)
Cash and cash equivalents at beginning of period	63,281	110,274
Cash and cash equivalents at end of period	$ 29,213	$ 105,495

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, 2002, and the Company makes no representations related thereto. These financial statements should be read in conjunction with the annual audited consolidated financial statements and notes as of and for the year ended December 31, 2001, included in the Company s Form 10-K dated March 14, 2002.

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

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

2. Balance Sheet Components

	June 30, 2002	December 31, 2001
Accounts receivable:		
Trade accounts receivable	$ 60,514	$ 47,449
Allowances for doubtful accounts and sales returns	(7,039)	(7,868)
	$ 53,475	$ 39,581
Property and equipment:		
Computer hardware	$ 50,516	$ 43,801
Computer software	26,013	18,978
Office equipment, furniture and fixtures	18,177	16,193
Leasehold improvements	17,432	13,344
	112,138	92,316
Accumulated depreciation and amortization	(58,027)	(49,432)
	$ 54,111	$ 42,884
Accrued liabilities:		
Accrued compensation and benefits	$ 16,911	$ 19,202
Income taxes payable	10,900	7,354
Other accrued liabilities	33,486	14,884
	$ 61,297	$ 41,440

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LEGATO SYSTEMS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

3. Revenue Recognition

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

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

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

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

4. Comprehensive Loss

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2002	**2001**	**2002**	**2001**
Net loss	$ (45,854)	$ (9,976)	$ (92,595)	$ (20,577)
Unrealized gain (loss) on investments	(68)	(272)	(643)	21
Foreign currency translation adjustments	593		593	
	$ (45,329)	$ (10,248)	$ (92,645)	$ (20,556)

5. Computation of Net Income (Loss) Per Share

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

LEGATO SYSTEMS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Options to purchase 24.8 million shares and 17.3 million shares of common stock at a weighted average price of $11.31 per share and $14.64 per share were outstanding as of June 30, 2002 and 2001, respectively, but were not included in the computation of diluted net loss per share because their effect would be anti-dilutive.

6. 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 million of the settlement amount was reimbursed by our corporate insurance. The settlement was recorded as a $67 million charge to the results of operations for the quarter ended March 31, 2002 and was paid during the quarter ended June 30, 2002.

Both the securities class action and the derivative action arose from events that caused Legato to restate its results for the first three quarters of 1999. The settlements do not constitute any admission of wrongdoing on the part of Legato or the individual defendants. On May 3, 2002, the Superior Court of California for San Mateo County approved the settlement in the derivative litigation. On May 6, 2002, the U.S. District Court for the Northern District of California granted preliminary approval to the class action settlement. On July 31, 2002, the U.S. District Court for the Northern District of California approved the settlement in the class action lawsuit.

7. Restructuring Charges

During 2001, we incurred $9.4 million in charges as we restructured our development operations to reduce our cost structure and to integrate and reduce selling and marketing activities. In connection with these activities, we reduced our workforce by approximately 215 employees and closed our development facilities in Sunnyvale, California, Eden Prairie, Minnesota, Orem, Utah and New Delhi, India. As of June 30, 2002, accrued restructuring charges related primarily to future lease commitments, which will be paid through 2004, and some severance and benefits, which will be paid in 2002. The following table summarizes the restructuring activity during 2002 (in thousands):

	Severance and Benefits	Excess Facilities	Total
Balance, December 31, 2001	$ 636	$ 1,221	$ 1,857
Cash payments	(385)	(209)	(594)
Balance, June 30, 2002	$ 251	$ 1,012	$ 1,263

8. Acquisition of OTG Software, Inc.

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

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

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LEGATO SYSTEMS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

The OTG acquisition was accounted for under Statements of Financial Accounting Standards (SFAS) No. 141, Business Combinations, and certain specified provisions of SFAS No. 142, Goodwill and Other Intangible Assets. The results of the operations of OTG were included in our Condensed Consolidated Statement of Operations since May 15, 2002. The following table summarizes the estimated fair value of the assets acquired and liabilities assumed at the date of the acquisition of OTG (in thousands).

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

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

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

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

Purchased technology, customer relationships and in-process research and development (IPR&D) were identified and valued through interviews and analysis of data provided by management. For development projects that had reached technological feasibility, they were classified as purchased technology, and the value assigned to the

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LEGATO SYSTEMS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

purchased technology was capitalized. The income approach, which includes an analysis of the cash flows and risks associated with achieving such cash flows, was the primary technique utilized in valuing acquired intangible assets. Key assumptions included estimates of revenue growth, cost of sales, operating expenses and taxes. Discount rates used in the valuation of purchased technology, customer relationships and IPR&D were 20%, 15% and 35%, respectively.

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2002	2001	2002	2001
Revenue	$ 62,309	$ 78,803	$ 131,409	$ 154,951
Net loss	$ (35,822)	$ (5,245)	$ (87,755)	$ (16,617)
EPS basic and diluted	$ (0.28)	$ (0.05)	$ (0.73)	$ (0.15)

9. Intangible Assets and Goodwill

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

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2002	2001	2002	2001
	(in thousands, except for per share amounts)			
Net loss as reported	$ (45,854)	$ (9,976)	$ (92,595)	$ (20,577)
Adjustment:				
Amortization of goodwill		4,363		8,726
Net loss as adjusted	$ (45,854)	$ (5,613)	$ (92,595)	$ (11,851)

Net loss per share, basic and diluted as reported	$	(0.45)	$	(0.11)	$	(0.96)	$	(0.23)
Net loss per share, basic and diluted as adjusted	$	(0.45)	$	(0.06)	$	(0.96)	$	(0.13)

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LEGATO SYSTEMS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

	June 30, 2002	December 31, 2001
Goodwill	$ 305,749	$ 48,998
Patents and purchased technology	41,539	24,589
Customer relationships	30,800	22,500
Assembled workforce		4,500
Less: accumulated amortization	(72,543)	(68,945)
	$ 305,545	$ 31,642

The following is the gross carrying amount and accumulated amortization for the acquired intangible assets at June 30, 2002 (in thousands):

	June 30, 2002		
	Gross Carrying Amount	Accumulated Amortization	Net Book Value
Patents and purchased technology	$ 41,539	$ (14,946)	$ 26,593
Customer relationships	30,800	(21,417)	9,383
Total	$ 72,339	$ (36,363)	$ 35,976

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

	June 30, 2002
Balance as of December 31, 2001	16,026
Reclass of assembled workforce	1,292
Acquisition of OTG	252,251
Balance as of June 30, 2002	$ 269,569

The aggregate amortization expenses for the intangible assets listed above totaled $2.2 million and $3.1 million for the three months ended June 30, 2002 and 2001, respectively, and $3.6 million and $7.6 million for the six months ended June 30, 2002 and 2001, respectively. The weighted-average amortization period for the intangible assets as of June 30, 2002 is as follows (in years):

Patents and purchased technology	3.0
Customer relationships	4.0
Total weighted-average amortization period	3.2

Expected future intangible amortization expense is as follows (in thousands):

Fiscal Years:

Remainder of 2002	$	6,058
2003		11,213
2004		8,348
2005		4,490
2006		4,400
Thereafter		1,467
	$	35,976

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LEGATO SYSTEMS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

10. Recent Accounting Pronouncements

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

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

In April 2002, the Emerging Issues Task Force (EITF) issued EITF Issue No. 01-14, Income Statement Characterization of Reimbursements Received for Out-of-Pocket Expenses Incurred, which requires that all out-of-pocket expenses billed to a customer be classified as revenue. EITF Issue No. 01-14 is effective for our fiscal quarter beginning on January 1, 2002, with comparative financial statements for prior periods reclassified to conform to this presentation. We had previously treated reimbursement for out-of-pocket expenses as a reduction to cost of revenue. Our adoption of EITF Issue No. 01-14 did not have a material impact on our revenue or any effect on our gross margins, operating margins, net loss and net loss per share.

11. Subsequent Event

In July 2002, we initiated plans to further reduce our operating costs across the Company. Our restrictions on travel and capital spending will remain, at least, through the remainder of 2002. The reductions in headcount will be substantially complete by the end of the third quarter and will result in severance charges not to exceed $4.0 million in the third quarter of 2002.

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

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

CRITICAL ACCOUNTING POLICIES

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

RESULTS OF OPERATIONS

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2002	2001	2002	2001
Revenue:				
License	49.8%	64.2%	50.7%	63.6%
Service and support	50.2	35.8	49.3	36.4
Total revenue	100.0	100.0	100.0	100.0
Cost of revenue:				
License	3.6	1.9	3.3	1.6
Service and support	18.4	20.4	18.7	20.8
Total cost of revenue	22.0	22.3	22.0	22.4
Gross profit	78.0	77.7	78.0	77.6
Operating expenses:				
Sales and marketing	55.6	48.9	56.3	49.4
Research and development	29.7	25.6	28.0	25.3
General and administrative	15.6	11.6	14.2	11.9
Amortization of acquired intangibles	3.5	12.3	3.1	13.6
Write-off of in-process research and development	53.9		28.3	
Restructuring charges		9.7		4.9
Litigation settlement charge			57.2	
Total operating expenses	158.3	108.1	187.1	105.1
Loss from operations	(80.3)	(30.4)	(109.1)	(27.5)
Interest and other income, net	2.2	5.9	1.6	3.9

Loss before benefit from income taxes	(78.1)	(24.5)	(107.5)	(23.6)
Benefit from income taxes	(3.6)	(8.6)	(28.5)	(6.8)
Net loss	(74.5)%	(15.9)%	(79.0)%	(16.8)%

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Overview

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

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

Revenue

Total revenue decreased $0.9 million, or 2%, to $61.6 million in the second quarter of 2002 from $62.5 million for the second quarter of 2001. For the first six months of 2002, total revenue decreased $6.4 million, or 5%, to $117.2 million from $123.6 million for the same period in 2001.

License revenue. License revenue decreased $9.5 million, or 24%, to $30.6 million in the second quarter of 2002 from $40.1 million in the second quarter of 2001. The decrease was primarily due to the general economic environment and, specifically, the reduced spending by information technology organizations. With reduced IT spending, we experienced a reduction in the number of transactions, elongated sales cycles and just-in-time buying. For the first six months of 2002, license revenue decreased $19.2 million, or 24%, to $59.4 million from $78.6 million for the same period in 2001. OTG accounted for $2.2 million of license revenue in the quarter ended June 30, 2002. Without OTG, our license revenue would have decreased by 29% for the three months ended June 30, 2002 and by 27% for the six months ended June 30, 2002.

Service and Support Revenue. Service and support revenue increased $8.5 million, or 38%, to $30.9 million in the second quarter of 2002 from $22.4 million in the second quarter of 2001. 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 and a decrease in the overall level of discounting of our update and support services. For the first six months of 2002, service and support revenue increased $12.8 million, or 29%, to $57.8 million from $45.0 million for the same period a year ago. OTG accounted for $3.3 million of service and support revenue in the quarter ended June 30, 2002. Without OTG, our service and support revenue would have increased 23% for the three months ended June 30, 2002 and by 21% for the six months ended June 30, 2002.

International license revenue decreased $5.6 million, or 26%, to $15.9 million in the second quarter of 2002 from $21.5 million in the second quarter of 2001. International license revenue decreased primarily as a result of the general weakness of the economy in Asia and, to a lesser extent, Europe. The majority of international license revenue came from Europe during these periods.

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Gross Profit

Gross profit decreased $0.6 million, or 1%, to $48.0 million, representing 78% of total revenue, in the second quarter of 2002 from $48.6 million, representing 78% of total revenue, in the second quarter of 2001. For the first six months of 2002, gross profit decreased $4.6 million, or 5%, to $91.3 million, representing 78% of total revenue, from $95.9 million, representing 78% of total revenue, in 2001.

Gross profit from license revenue consists of license revenue less the related costs of product media, documentation, third-party royalties and packaging. Gross profit from license revenue decreased $10.5 million, or 27%, to $28.4 million, representing 93% of license revenue, in the second quarter of 2002 from $38.9 million, representing 97% of license revenue, in the second quarter of 2001. For the first six months of 2002, gross profit from license revenue decreased $21.2 million, or 28%, to $55.5 million, representing 93% of license revenue, from $76.7 million, representing 98% of license revenue, in 2001. The decrease in absolute dollars, and as a percentage, relates to the overall decrease of license revenue.

Costs of service and support revenue consist primarily of personnel-related costs incurred in providing telephone support, consulting services, training to customers and costs of providing software updates and education. Gross profit from service and support revenue increased $9.9 million, or 103%, to $19.6 million, representing 63% of service and support revenue, in the second quarter of 2002 from $9.7 million, representing 43% of service and support revenue, in the second quarter of 2001. For the first six months of 2002, gross profit from service and support revenue increased $16.6 million, or 86%, to $35.9 million, representing 62% of service and support revenue, from $19.3 million, representing 43% of service and support revenue, in 2001. The increase in absolute dollars is primarily a result of the increase in support and update renewals as well as a reduction in the operating costs of our consulting group. OTG accounted for $1.1 million of the increase in the second quarter of 2002. Service support personnel increased to 381 in 2002 from 309 in 2001. The increase in headcount of 72 resulted from 106 individuals from OTG partially offset by reductions in consulting and support organizations of the legacy Legato.

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 $3.6 million, or 12%, to $34.2 million in the second quarter of 2002 from $30.6 million in the second quarter of 2001. For the first six months of 2002, sales and marketing expenses increased $4.9 million, or 8%, to $65.9 million from $61.0 million for the same period in 2001. The increase in sales and marketing expenses was primarily attributable to growth of our sales force and associated support personnel. OTG accounted for $2.4 million of the increase in the second quarter of 2002. Sales and marketing personnel increased to 588 in 2002 from 483 in 2001. Of this increase of 105, 73 relate to individuals from OTG. Going forward, we believe that sales and marketing expenses will increase slightly in absolute dollars.

Research and development. Research and development expenses consist primarily of personnel-related costs. Research and development expenses increased $2.3 million, or 14%, to $18.3 million in the second quarter of 2002 from $16.0 million in the second quarter of 2001. For the first six months of 2002, research and development expenses increased $1.6 million, or 5%, to $32.8 million from $31.2 million for the same period in 2001. We incurred $2.7 million of OTG research and development costs during the second quarter of 2002. The number of research and development personnel increased to 474 in 2002 from 377 in 2001. OTG added 138 individuals during the second quarter of 2002. We expect research and development expenses to increase in absolute dollars.

General and administrative. General and administrative expenses include personnel and other costs of our finance, human resources, facilities, information systems and other administrative departments. General and administrative expenses increased $2.3 million, or 32%, to $9.6 million in the second quarter of 2002 from $7.3 million in the second quarter of 2001. For the first six months of 2002, general and administrative expenses increased $2.0 million, or 14%, to $16.7 million from $14.7 million for the same period in 2001. The increase in general and administrative expenses was primarily attributable to OTG, which added $1.8 million of expenses in the second quarter of 2002. General and administrative personnel increased to 259 in 2002 from 179 in 2001. Of the increase of 80, 43 individuals came from OTG. We expect that general and administrative headcount will decrease next quarter.

Amortization of intangibles. Amortization of intangibles decreased $5.5 million to $2.2 million in the second quarter of 2002 from $7.7 million in the second quarter of 2001. For the first six months of 2002, amortization of intangibles decreased $13.2 million to $3.6 million from $16.8 million in 2001. The decrease is the result of a smaller remaining balance after recording the impairment of certain intangibles in the fourth quarter of 2001 and after adopting SFAS No. 142, whereby we stopped amortizing our goodwill balance of $17.3 in the first quarter of 2002. We are amortizing the remaining identifiable intangibles on a straight-line basis over periods ranging from three to five years from the respective dates of acquisition.

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

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

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

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

Expected future amortization of intangibles is as follows (in thousands):

Fiscal Years:		
Remainder of 2002	$	6,058
2003		11,213
2004		8,348
2005		4,490
2006		4,400
Thereafter		1,467
	$	35,976

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

Restructuring Charges. During the second quarter of 2001, we incurred $6.1 million of charges related primarily to the closure of our facilities in Sunnyvale, California and Eden Prairie, Minnesota. As of June 30, 2002, accrued restructuring charges totaled $1.3 million and related primarily to future lease commitments, which will be paid through 2004, and some severance and benefits, which will be paid in 2002.

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

Interest and other income, net. Interest and other income, net, primarily represents interest income from funds available for investment. Interest and other income, net decreased $2.4 million to $1.3 million in the second quarter of 2002 from $3.7 million in the second quarter of 2001 and decreased $2.9 million to $1.9 million in the first six months in 2002 from $4.8 million for the same period in 2001. The decrease represents a reduction in our yield on our cash investments and some foreign currency losses recognized in 2002. With the payment of the litigation settlement and purchase of OTG, our cash balance has been reduced significantly. As such, we expect that interest income will decrease significantly in future periods.

Income taxes. The benefit from income taxes for the second quarter of 2002 was $2.2 million compared to $5.4 million for the second quarter of 2001. The effective tax rate was 4.6% for the second quarter of 2002 and 35% for the second quarter of 2001. For the first six months of 2002, the benefit from income taxes was $33.4 million compared to $8.4 million for the same period in 2001. The increase in the year to date benefit for income taxes primarily relates to the substantial increase in the net operating loss as a result of the litigation settlement charges incurred in the first quarter of 2002, which is tax deductible.

LIQUIDITY AND CAPITAL RESOURCES

Our cash, cash equivalents and investments totaled $55.4 million as of June 30, 2002, and represented 9% of total assets as compared to $145.7 million as of December 31, 2001. Cash and cash equivalents are highly liquid investments with original maturities of ninety days or less. Investments consist mainly of short-term corporate securities and auction rate receipts. The decrease primarily reflects the payment of $66.7 million (net of $21 million from our insurers) in May 2002 for the settlement of the class action and derivative lawsuits filed in 2000. As of June 30, 2002, we had no long-term debt.

We have financed our operations to date primarily by cash from operations and the sale of common stock. Net cash used in operating activities was $84.3 million for the six months ended June 30, 2002 and consisted primarily of the net loss of $92.6 million and deferred taxes of $37.4 million, partially offset by the write-off of in-process research and development of $33.2 million and depreciation and amortization of $12.2 million. For the six months ended June 30, 2001, net cash provided by operating activities was $5.8 million 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.

Net cash provided by investing activities was $41.4 million for the six months ended June 30, 2002, which resulted primarily from the net maturities of marketable securities of $56.7 million, partially offset by the purchases of property and equipment of $10.5 million and technology of $4.9 million. For the six months ended June 30, 2001, net cash used in investing activities was $20.3 million, which resulted from the net purchases of marketable securities of $9.8 million and the acquisition of property and equipment of $10.5 million.

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Net cash provided by financing activities was $9.4 million and $9.7 million for the six months ended June 30, 2002 and 2001, respectively, which resulted from the proceeds received from the issuance of our common stock from stock option exercises and our employee stock purchase plan.

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

Our current operating plan anticipates a pro forma net loss for the third quarter of 2002, which we expect will reduce our cash and investments by $12 million to $17 million. However, we are currently forecasting a small pro forma net income for the fourth quarter of 2002 and continued pro forma profitability in 2003. Our profitability and limited capital spending should result in positive cash flow. We believe this model will provide us the liquidity and capital resources required to sustain our operations through 2003. Should our forecasts not meet our expectations, we would be required to take further actions to assure sufficient liquidity through 2003, including, but not limited to:

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

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

RISK FACTORS

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

Our quarterly operating results are volatile.

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

- Lengthy sales cycles, particularly with enterprise license transactions;
- The dollar value of orders and the timing of when orders are received;
- Intense competition;
- Macroeconomic uncertainty and weakness;
- Market acceptance of our new products, applications and product enhancements of our competitors;
- Changes in our pricing policies or those of our competitors;
- The current challenging spending environment in our customers   IT departments;
- Our ability to develop, introduce and market new products, applications and product enhancements;
- Our ability to control costs;

Quality control of products sold;

Delay in the recognition of revenue from enterprise license and application service provider transactions;

Success in expanding sales and marketing programs;

Technological changes in our customers environments;

The impairment of goodwill, intangibles or deferred tax assets;

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- The mix of sales among our channels;
- Deferrals of customer orders in anticipation of new products, applications or product enhancements;
- Market readiness to deploy our products for distributed computing environments;
- Changes in our strategy or that of our competitors;
- Customer budget cycles and changes in these budget cycles;
- Foreign currency and exchange rates;
- Our ability to effectively manage and reduce our tax liabilities;
- Our ability to integrate recently acquired businesses;
- Acquisition costs or other non-recurring charges in connection with the acquisition of companies, products or technologies;
- Loss of our information technology infrastructure for a significant period of time;
- Personnel changes; and
- General economic factors.

Our future operating results are uncertain.

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

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

- Our sales cycles vary substantially from customer to customer, in large part because we depend upon large enterprise license transactions with corporate customers. Furthermore, such transactions may include extended payment terms, escalating discounts, acceptance provisions or other terms that would preclude immediate revenue recognition of some or all of the license component;
- Revenue in any quarter is substantially dependent on orders booked and shipped in that quarter since we operate with virtually no order backlog;
- We do not recognize revenue on sales to domestic distributors until the products are sold through to end-users;
- The storage management market is rapidly evolving;
- Due to general economic factors that currently affect our end-user customers businesses, those customers are being more deliberate in the manner in which they make information technology spending decisions;
- OEM license and royalty revenue are difficult to forecast. Our royalty revenue is dependent upon product license sales by OEMs of their products that incorporate our software. Accordingly, this royalty revenue is subject to OEMs product cycles and the general health of their businesses; these trends are also difficult for us to predict. Fluctuations in licensing activity from quarter to quarter further impact royalty revenue, because initial license fees generally are non-recurring and generally recognized upon the signing of a license agreement;
- The timing of large orders can significantly affect revenue within a quarter;

The timing of recognition of revenue from enterprise license and application service provider transactions can significantly affect revenue within a quarter; and

Our expense levels are relatively fixed and are based, in part, on our expectations of our future revenue. Consequently, if revenue levels fall below our expectations, our net losses will increase because only a small portion of our expenses varies with our revenue.

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

We have recorded losses and may continue to record losses.

We have cumulative losses and expect to incur additional losses. For the six months ended June 30, 2002, we incurred a net loss of $92.6 million and had an accumulated deficit of $163.3 million, including $67.0 million related to the settlement of securities class action and derivative lawsuits and $33.2 million related to the write-off of in-process research and development. We anticipate that our costs will increase for the immediate future as we integrate OTG and Legato. If we cannot achieve and sustain operating profitability or positive cash flow from operations, we may not be able to meet our working capital requirements. This would have a material adverse effect on our business financial condition and results of operations.

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

We have incurred significant operating losses, have had negative operating cash flows since the second quarter of 2001 and are not currently profitable. Our current operating plan anticipates a pro forma net loss for the third quarter of 2002, which we expect will reduce our cash and investments by $12 million to $17 million. However, we are currently forecasting a small pro forma net income for the fourth quarter of 2002 and continued pro forma profitability in 2003. Our profitability and limited capital spending should result in positive cash flow. We believe this model will provide us the liquidity and capital resources required to sustain our operations through 2003. Should our forecasts not meet our expectations, we would be required to take further actions to assure sufficient liquidity through 2003, including, but not limited to:

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

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

Our market is highly competitive.

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

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

We depend on our NetWorker product line.

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

The effect of new products, applications or product enhancements;

Technological changes in the network storage management environment in which NetWorker operates; and

Future competition.

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

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

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

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

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

The markets for our products are characterized by rapid technological change, changing customer needs, frequent new software product introductions and evolving industry standards. The introduction of products embodying new technologies and the emergence of new industry standards could render our existing products obsolete and unmarketable. To be successful, we need to develop and introduce new software products on a timely basis that keep pace with technological developments and emerging industry standards and address the increasingly sophisticated needs of our customers. In addition, we need to integrate into our product lines the technologies of products we acquired through the acquisition of OTG Software completed in May 2002, and to develop the technologies we acquired from Software Clearing House, Inc. in July 2001. We may fail to develop and market new products that respond to technological changes or evolving industry standards, experience difficulties that could delay or prevent the successful development, introduction and marketing of these new products or fail to develop new products that adequately meet the requirements of the marketplace or achieve market acceptance. If so, our business, operating results and financial condition would be seriously harmed.

We have introduced several new products during 2001, and currently plan to introduce and market several more potential new products in the next twelve months. Some of our competitors currently offer products analogous to

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

Our products may contain undetected errors.

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

Defects in our products would harm our business.

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

We rely on enterprise license transactions.

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

- The sales cycle is typically lengthy, generally lasting three to nine months, and varies substantially from transaction to transaction;
- Enterprise license transactions often include multiple elements such as product licenses and service and support;
- Recognition of revenue from enterprise license transactions may vary from transaction to transaction;
- These transactions typically involve significant technical evaluation and commitment of capital and other resources;
- A growing number of our direct-license customers are located outside the United States, where the sales cycle can be lengthier than transactions negotiated within the United States;
- Our customers are being more deliberate about information technology spending decisions due to the current state of the overall economy; and
- Customers internal procedures frequently cause delays in orders. Such internal procedures include approval of large capital expenditures, implementation of new technologies within their networks and testing new technologies that affect key operations.

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

We rely on indirect sales channels.

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

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

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

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

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

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

We are modifying some of our marketing strategies.

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

We depend on international revenue.

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

Additional risks inherent in our international business activities generally include:

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

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

We depend on growth in the enterprise data storage market.

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

We are affected by general economic and market conditions.

Segments of the computer industry have recently experienced significant economic downturns characterized by decreased product demand, product overcapacity, price erosion, work slowdowns and layoffs. These downturns appear to coincide with the widely-reported weakness in the overall economy. Our operations may experience substantial fluctuations from period-to-period as a consequence of such industry trends, general economic conditions affecting the timing of orders from major customers and other factors affecting capital spending. The occurrence of such factors could seriously harm our business, operating results or financial condition.

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

The recognition of our revenue depends on, among other things, the terms negotiated in our contracts with our customers. Our personnel may act outside of their authority and negotiate additional terms without our knowledge. In the event that our sales personnel have negotiated terms that do not appear in the contract and of which we are unaware, whether the additional terms are written or verbal, we could be prevented from recognizing revenue in accordance with our plans. Furthermore, depending on when we learn of unauthorized actions and the size of

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transactions involved, we may have to restate revenue for a previously reported period, which would seriously harm our business, operating results and financial condition.

We rely on our sales personnel.

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

We rely on our key personnel.

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

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

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

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

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

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

As of June 30, 2002, goodwill was $269.5 million and acquired intangibles of $36.0 million on our Consolidated Balance Sheet. With our adoption of Statement of Financial Accounting Standard No. 142, Goodwill and Other Intangible Assets in the first quarter of 2002, goodwill was no longer be amortized. We expect to amortize identifiable intangibles of $6.1 million in the second half of 2002, $11.2 million in 2003 and $8.3 million in 2004. To the extent we do not generate sufficient cash flows to recover the net amount of the intangibles recorded, the intangibles could be subsequently written-off. In such event, our results of operations in any given period could be negatively impacted, and the market price of our stock could decline.

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Protection of our intellectual property is limited.

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

Despite our efforts to protect our proprietary rights, we are aware that unauthorized parties have attempted to transfer licenses to third parties, 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, in whole or in part, 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 on 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 are not available on terms acceptable to us, our business, operating results and financial condition could be seriously harmed.

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;
- Acquisitions or dispositions of our common stock by corporate officers or members of the Board of Directors;
- Conditions in the financial markets in general;
- Litigation; and
- General business conditions and trends in the distributed computing environment and software industry.

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

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Item 3. ***Quantitative and Qualitative Disclosures About Market Risk***

Interest Rate Risk. Our exposure to market risk for changes in interest rates relates primarily to our investment portfolio. While we are exposed with respect to interest rate fluctuations in many countries, our interest income is most sensitive to fluctuations in the general level of U.S. interest rates. In this regard, changes in the U.S. interest rates affect the interest earned on our cash, cash equivalents and 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 investments in marketable securities as of June 30, 2002 (dollars in millions).

	Carrying Value	Interest Rate
Investments fixed rate	$ 26.2	4.4%
Cash equivalents:		
Fixed rate	9.1	2.2%
Variable rate	7.9	1.4%
	$ 43.2	3.4%

Foreign Currency Risk. As a global concern, we face exposure to adverse movements in foreign currency exchange rates. These exposures may change over time as business practices evolve and could seriously harm our financial results. Substantially all of our international sales are currently denominated in U.S. dollars. An increase in the value of the U.S. dollar relative to foreign currencies could make our products more expensive and therefore, reduce the demand for our products. Reduced demand for our products could seriously harm our financial results. Currently, we do not hedge against any foreign currencies and as a result, could incur unanticipated gains or losses.

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PART II OTHER INFORMATION

Item 1. ***Legal Proceedings***

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

Item 2. ***Changes in Securities and Use of Proceeds***

Not applicable.

Item 3. ***Defaults Upon Senior Securities***

Not applicable.

Item 4. ***Submission of Matters to a Vote of Security Holders***

The Company s annual meeting of stockholders was held on June 14, 2002. The following matters were submitted to a vote of security holders:

To elect the following to serve as Directors of the Company:

Nominees	Votes For	Votes Abstaining
Eric A. Benhamou	83,592,223	509,355
H. Raymond Bingham	83,040,502	1,061,076
Brendan J. Dawson	82,312,303	1,789,275
Kenneth A. Goldman	83,047,525	1,054,053
Christopher B. Paisley	83,591,003	510,545
David N. Strohm	83,591,933	509,645
David B. Wright	69,616,089	14,485,489

To ratify the Company s appointment of PricewaterhouseCoopers LLP as independent public accountants for the year ending December 31, 2002:

Votes for:	81,614,468
Votes against:	2,421,197
Votes abstaining:	47,735

The Company held a special meeting of stockholders on May 14, 2002 to vote on a proposal to approve the adoption of a merger agreement under which the Company would acquire all of the outstanding shares of OTG Software, Inc. The proposal was approved as follows:

Votes for:	63,651,727
Votes against:	4,267,974
Votes abstaining:	243,534

Item 5. ***Other Information***

Not applicable.

Item 6. Exhibits and Reports on Form 8-K.

(a) Exhibits: 99.1 Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

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(b) Reports on Form 8-K: On April 17, 2002, the Registrant filed a Current Report on Form 8-K to report under Item 5 (Other Events) and Item 7 (Financial Statements and Exhibits) to announce agreements to settle class action and derivative lawsuits filed in 2000.

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, 2002

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