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

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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 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 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

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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	10.07	20,996	12.24

(1) During 2002, we assumed 3.4 million options in connection with our acquisition of OTG Software.

As of June 30, 2003, the options outstanding and exercisable by exercise price are as follows (in thousands, except per share amounts):

Options Outstanding Options Exercisable

Range of Exercise Prices		Shares	Weighted Average Remaining Contractual Life (Years)	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price
$ 0.00	$ 2.79	3,646	8.68	$ 2.64	336	$ 1.47
2.79	3.75	624	7.93	3.31	231	3.36
3.94	4.76	3,492	8.17	4.74	1,581	4.73
4.77	5.67	4,374	8.97	5.45	741	5.22
5.70	8.00	3,360	8.18	7.06	1,703	7.19
8.05	9.44	1,191	7.95	8.97	829	8.94
9.47	9.75	3,588	7.41	9.74	2,532	9.74
9.98	13.19	3,018	7.02	11.16	2,314	11.10
13.23	20.75	3,421	7.05	15.86	2,561	16.24
21.09	77.00	2,133	6.37	31.76	1,958	31.58
		28,847	7.86	9.59	14,786	12.58

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Distribution and Dilutive Effect of Options. We have a goal to keep the dilution related to our option program to an average of less than three percent annually. Accordingly, the shares reserved under this program automatically increase on the first trading day in each calendar year by the lesser of (i) the number of shares equal to 3% of the total number of shares of our common stock outstanding on December 31 of the immediately preceding calendar year or (ii) 3.0 million shares. As of January 1, 2003, 3.0 million shares were added to the shares available to grant, bringing the aggregate number of shares available for grant to 10.6 million. Because we had 10.6 million shares available at the beginning of the year, we could potentially grant more that 3% of the total number of shares of our common stock this year. The dilution percentage is calculated as the new option grants for the year, net of options forfeited by employees leaving the Company, divided by the total outstanding shares at the beginning of the year.

Employee and executive option grants are as follows:

	Six Months Ended June 30,	Year Ended December 31,	
	2003	2002	2001
Net grants as a % of outstanding shares at beginning of period	2.2%	4.2%	8.4%
Grants to listed officers(2) as a percentage of total options granted		11.8	18.3
Grants to listed officers(2) as a percentage of outstanding shares		0.9	2.1
Cumulative options held by listed officers(2) as a percentage of total options outstanding at end of period	18.1	21.6	24.1

(2) See below for the Named Executive Officers; they represent the CEO and each of the four other most highly compensated executive officers whose salary and bonus are in excess of $100,000.

During the first six months of 2003, we granted options to purchase 3.7 million shares of our stock to our employees, which was a net grant of options for 2.5 million shares after deducting 1.2 million shares for options forfeited. The net options granted after forfeitures represented 2.2% of our total outstanding shares of 116.1 million as of the beginning of the year. Options granted to the five most highly compensated officers as a percentage of the total options granted to all employees vary from year to year. During the first six months of 2003, no options were granted to executive officers, which is down compared to 2002 and 2001. The decrease in 2002 when compared to 2001 is a result of the fact that one executive officer was hired in 2001. In order to attract this executive officer, a significant initial stock grant was made. Subsequent grants are substantially less than the initial grant.

As of June 30, 2003, the In-the-Money and Out-of-the Money (3) option information is as follows (in thousands, except per share amounts):

	Exercisable		Unexercisable		Total	
	Shares	Weighted Average Price	Shares	Weighted Average Price	Shares	Weighted Average Price
In-the-money	4,739	$ 5.50	10,948	$ 4.69	15,687	$ 4.93
Out-of-the-money	10,047	15.92	3,113	12.78	13,160	15.18

	14,786	12.58	14,061	6.48	28,847	9.59

(3) Out-of-the-money options are those options with an exercise price equal to or above the closing price of $8.42 at the end of the quarter. Our stock price is volatile. The high, average and low closing stock price for the six months ended June 30, 2003 was $8.71, $6.21 and $5.01, respectively.

Executive Officer Options. A Named Executive Officer is defined as the CEO and each of the four other most highly compensated executive officers whose salary and bonus are in excess of $100,000. With the closing stock price of $8.42 on June 30, 2003, the majority of the Listed Officers options were under water or out-of-the-money.

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As of and for the six months ended June 30, 2003, options exercised and remaining holdings of the Listed Officers were as follows (in thousands):

	Shares Acquired on Exercise	Value Realized	Number of Securities Underlying Unexercised Options as of June 30, 2003		Values of Unexercised In-the-Money Options at June 30, 2003	
			Exercisable	Unexercisable	Exercisable	Unexercisable
David B. Wright		$	1,844	1,256	$ 961	$ 2,643
David L. Beamer			296	414	530	1,187
Andrew J. Brown			522	438	216	982
Noah D. Mesel			87	175	96	601
Cory J. Sindelar			72	108	121	445

6. Subsequent Event Acquisition of Legato by EMC

On July 7, 2003, EMC Corporation (EMC) and Legato announced a definitive agreement for EMC to acquire Legato. Under terms of the agreement, Legato stockholders will receive 0.9 of a share of EMC common stock for each share of Legato common stock. Based upon the EMC closing stock price of $11.74 on July 7, 2003, the transaction is valued at approximately $1.3 billion. The acquisition is subject to customary closing conditions, including Legato s stockholder and regulatory approvals, and is expected to be completed in the fourth quarter of calendar year 2003. Upon completion of the acquisition, EMC intends to operate Legato as a software division of EMC headquartered in Mountain View, California, led by David B. Wright, Legato s current Chairman and CEO. Legato s sales, marketing and service will remain focused on selling and servicing Legato s full line of products and solutions. EMC and Legato will integrate engineering and development functions to accelerate the development and delivery of comprehensive storage management solutions for growth markets such as email management and HSM/archiving.

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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, including without limitation, our financial outlook, successful introduction of new products and expansion of operation. All forward-looking statements included in this document are based on information available to us on the date hereof. We assume no obligation to update any such forward-looking statements. Our actual results could differ materially from those indicated in such forward-looking statements. Factors that could cause or contribute to such differences include, but are not limited to, fluctuations in quarterly operating results, uncertainty in future operating results, 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, 2002.

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,	
	2003	2002	2003	2002
Revenue:				
License	45%	50%	46%	51%
Service and support	55	50	54	49
Total revenue	100	100	100	100.0
Cost of revenue:				
License	3	4	3	3
Service and support	15	18	15	19
Total cost of revenue	18	22	18	22

Gross profit	82	78	82	78
Operating expenses:				
Sales and marketing	44	55	44	57
Research and development	24	30	25	28
General and administrative	10	16	11	14
Amortization of acquired intangibles	3	3	4	3
Write-off of in-process research and development		54		28
Restructuring charges	5		2	
Litigation settlement charge				57
Total operating expenses	86	158	86	187
Loss from operations	(4)	(80)	(4)	(109)
Interest and other income, net	(1)	2	(1)	2
Loss before benefit from income taxes	(5)	(78)	(5)	(107)
Provision for/(benefit from) income taxes	1	(4)		(28)
Net loss	(6)%	(74)%	(5)%	(79)%

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Overview

We develop, market and support storage software products and services worldwide. Our solutions protect and manage information, assure the availability of applications and provide immediate access to business-critical information in distributed open systems environments. Our solutions provide enterprise level customers the business continuity and operational efficiency to maintain a constant state of access to, and availability of, business-critical information. Our solutions recognize the interdependence between data and applications. Information management within an enterprise includes the protection, recovery and archiving of data, the management of performance and operation of applications, the optimization of storage devices and media including disk and tape, and the capture, organization and immediate access to content and messages. Our heterogeneous software products are mostly found in distributed, open systems which are generally understood to include UNIX, Windows NT, Windows 2000 and Linux server and storage computer systems.

OTG Software, Inc. On May 14, 2002, we completed our acquisition of OTG Software, Inc. (OTG) for cash and stock at a value of $382.5 million. OTG, based in Rockville, Maryland, provides data management and collaboration solutions that virtualize storage for any type of data, including files, messages and databases, while providing easy and transparent access. Today, we market the OTG Software products under the XtenderSolutions® brand. The results of the operations of OTG have been included in our Consolidated Statement of Operations since May 15, 2002. At the time of the acquisition, OTG had approximately 400 employees.

Results of Operations

Revenue

Total revenue increased $15.0 million, or 24%, to $76.6 million in the second quarter of 2003 from $61.6 million for the second quarter of 2002. Revenue attributable to the former OTG business accounted for $4.4 million of the increase. The remainder of the increase is due to an increase of our update renewal rate as discussed below. For the six months ended June 30, 2003, total revenue increased $33.4 million, or 29%, to $150.6 million from $117.2 million during the same period a year ago. The former OTG products accounted for $14.5 million of the increase; and the remainder of the increase is due to an increase of our update renewal rate as discussed below.

License revenue. License revenue increased $4.2 million, or 14%, to $34.8 million in the second quarter of 2003 from $30.6 million in the second quarter of 2002. The revenue contribution from the OTG acquisition accounted for $2.5 million of increased license revenue in the second quarter of 2003. For the first six months of 2003, license revenue increased $9.8 million, or 17%, to $69.2 million from $59.4 million in 2002. OTG-related products accounted for $7.4 million of the increase. We also experienced an increase in license revenue of $3.6 million from our transactions greater than $250,000 even though the number of transactions greater than $250,000 was relatively constant. We expect license revenue to increase in absolute dollars, but may decrease as a percentage of total revenue, for the remainder of 2003.

We typically sell our products with the first year of update service included, creating a multiple element arrangement. As discussed in Note 1 to the accompanying condensed consolidated financial statements, we account for these arrangements using the Residual Method, which means a portion, or potentially all, of the product sale is allocated to our update service with license fee being the remainder, or residual. Our vendor specific objective evidence for the value of the update service is the fees our customers are willing to pay for the update subscription when it sold separately in the second year. Therefore, as our update renewal fees increase as a percentage of product list price, the greater proportion of initial product sale is allocated to our update subscription, thereby reducing the residual amount of license fee. Compared to the second quarter of 2002, we have experienced nominal change to our average selling price for update service renewals and, hence, no material impact to license revenue.

International license revenue increased in absolute dollars to $16.7 million in the second quarter of 2003 from $15.9 million in the second quarter of 2002. However, as a percentage of total license revenue, international license revenue decreased to 48% in the second quarter of 2003 from 52% in the same period a year ago. The decrease as a

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percentage is primarily due to a significant contract signed in the second quarter of 2002. For the six months ended June 30, 2003, international license revenue increased $3.0 million to $31.9 million from $28.9 million in 2002, but decreased as a percentage of total license revenue to 46% from 49% in 2002. The decrease as a percentage of total license revenue relates primarily to the revenue contribution of OTG products which are sold primarily in the United States.

Service and Support Revenue. Service and support revenue increased $10.9 million, or 35%, to $41.8 million in the second quarter of 2003 from $30.9 million in the second quarter of 2002. Throughout 2002, a greater percentage of our initial product sales were allocated to update revenue as discussed above. Because update revenue is recognized over time, we continue to realize the cumulative effect of this increased allocation in the second quarter of 2003 when compared to the second quarter of 2002. The service and support revenue related to OTG products accounted for $1.9 million of the increase. For the first six months of 2003, service and support revenue increased $23.6 million, or 41% to $81.4 million from $57.8 million for the same period a year ago. The majority of the increase relates to the cumulative effect of our increasing selling price for update renewals as discussed above. In addition, the service and support revenue associated with OTG products accounted for $7.1 million of this increase. We expect service and support revenue to increase in absolute dollars and as a percentage of total revenue through the remainder of 2003.

Gross Profit

Gross profit increased $14.7 million, or 31%, to $62.7 million, representing 82% of total revenue, in the second quarter of 2003 as compared to $48.0 million, representing 78% of total revenue, in the second quarter of 2002. For the remainder of 2003, we expect gross profit to be relatively unchanged at 80-82% of revenue.

Gross profit from license revenue increased $4.4 million, or 16%, to $32.8 million, representing 94% of license revenue, in the second quarter of 2003 from $28.4 million, representing 93% of license revenue, in the second quarter of 2002. For the first six months of 2003, gross profit from license revenue increased $9.8 million, or 18% to $65.3, representing 94% of license revenue, from $55.5 million, representing 93% of license revenue, in 2002. The increase in absolute dollars, and as a percentage, relates to the overall increase of license revenue. 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 service and support revenue increased $10.3 million, or 53%, to $29.9 million, representing 72% of service and support revenue, in the second quarter of 2003 from $19.6 million, representing 63% of service and support revenue, in the second quarter of 2002. The increase in absolute dollars, and as a percentage, is primarily a result of the increase in support and update revenue partially offset by increase in subcontracting of external consultants of $0.5 million. For the first six months of 2003, gross profit from service and support revenue increased $22.0 million, or 62% to $57.9 million, representing 71% of service and support revenue, from $35.9 million, representing 62% of service and support revenue, in 2002. The increase in absolute dollars, and as a percentage, is primarily a result of the increase in support and update revenue. Service and support personnel decreased to 320 in 2003 from 353 in 2002. Costs of service and support revenue consist primarily of personnel-related costs incurred in providing telephone support, consulting services, and training to customers, costs of providing software updates and costs of education and consulting materials. For the remainder of 2003, we expect gross profit from service and support revenue to be relatively unchanged.

Operating Expenses

Sales and marketing. Sales and marketing expenses consist primarily of salaries and commissions for sales and marketing personnel and promotional and advertising expenses. Sales and marketing expenses decreased $0.9 million, or 3%, to $33.3 million in the second quarter of

2003 from $34.2 million in the second quarter of 2002**.** The decrease in sales and marketing expenses was attributable primarily to decreases in travel and entertainment of $0.5 million. For the first six months of 2003, sales and marketing expenses increased $0.7 million, or 1% to $66.6 million from $65.9 million for the same period in 2002. The increase in sales and marketing expenses was attributable primarily to increases in salaries and benefits of $2.0

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million, information technology costs of $0.7 million and marketing costs of $0.2 million partially offset by decreases in commission expense of $1.7 million and travel and entertainment of $0.4 million. Sales and marketing personnel decreased to 566 in 2003 from 631 in 2002. We believe that sales and marketing expenses will decrease as a percentage of revenue.

Research and development. Research and development expenses consist primarily of personnel-related costs. Research and development expenses increased $0.3 million, or 2%, to $18.6 million in the second quarter of 2003 from $18.3 million in the second quarter of 2002. The increase in research and development expenses was primarily attributable to increase in salaries and benefits of $0.8 million partially offset by decreases in depreciation expense of $0.4 million. For the first six months of 2003, research and development expenses increased $4.3 million, or 13%, to $37.1 million from $32.8 million for the same period in 2002. The increase in research and development expenses was primarily attributable to increase in salaries and benefits of $4.0 million. The number of research and development personnel decreased to 416 in 2003 from 473 in 2002. We expect research and development expenses to decrease as a percentage of revenue and 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 decreased $1.6 million, or 17%, to $8.0 million in the second quarter of 2003 from $9.6 million in the second quarter of 2002. The decrease in general and administrative expenses was primarily attributable to decreases in salaries and benefits of $0.8 and facilities of $0.6 million. For the first six months of 2003, general and administrative expenses decreased $0.5 million, or 3%, to $16.2 million from $16.7 million for the same period in 2002. The decrease in general and administrative expenses was primarily attributable to decreases in information technology costs of $0.7 million, bad debt expense of $0.6 and facilities of $0.5 million partially offset by legal costs of $0.9 million and depreciation expense of $0.4 million. General and administrative personnel decreased to 203 in 2003 from 245 in 2002. We believe that general and administrative expenses will decrease in absolute dollars.

Amortization of intangibles. Amortization of intangibles increased $0.5 million to $2.7 million in the second quarter of 2003 from $2.2 million in the second quarter of 2002. The amortization is a result of our purchase of certain identifiable tangible assets via the OTG Software acquisition in May 2002, which we are amortizing over five years. We expect to amortize the identifiable intangibles of $25.2 million by $5.4 million for the remainder of 2003, $7.9 million in 2004, $5.0 million in 2005 and 2006 and $1.9 million in 2007.

Restructuring Charges. During the fourth quarter of 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.

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 includes plaintiffs 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.

Interest and other income (expense), net. Interest and other income (expense), net, primarily represents interest income from funds available for investment. Interest and other income (expense), net decreased $1.8 million to a loss of $0.5 million in the second quarter of 2003 from income of $1.3 million in the second quarter of 2002 and decreased $2.9 million to a loss of $0.9 million in the first six months in 2003 from income of $2.0 million for the same period in 2002. The decrease represents an overall decrease in investment balances and a reduction of interest income due to lower cash investment yields. Interest income was further offset by foreign currency losses primarily recognized in the second quarter of 2003, and a realized loss of $0.4 million from the sale of an investment in the first quarter of 2003.

Provision for (benefit from) income taxes. During the third quarter of 2002, we established a full valuation allowance against our deferred tax assets, because we determined that it is more likely than not that all deferred tax assets will not be realized in the foreseeable future. The net operating loss and R&D credit carryovers that make up the vast majority of our deferred tax assets do not begin to expire until 2019, possibly allowing sufficient time to be utilized. Going forward, we will assess the continued need for the valuation allowance. After we have demonstrated profitability for a period of time and begin utilizing a portion of the deferred tax assets, we may reverse the valuation allowance, likely resulting in a benefit to the Consolidated Statement of Operations in some future period. At this time, we cannot reasonably estimate when this reversal might occur, if at all.

As we continue to provide a full valuation allowance, we have not received any benefit from our continued operating losses. However, we have incurred $0.4 million of income tax expense in the second quarter of 2003 related to income generated by our foreign subsidiaries.

LIQUIDITY AND CAPITAL RESOURCES

Our cash, cash equivalents and investments totaled $72.0 million as of June 30, 2003 as compared to $70.0 million as of December 31, 2002; and our short-term liquidity (cash plus investments plus accounts receivable less line of credit less accounts payable less accrued liabilities) improved in the first six months in 2003 to $47.2 million from $40.4 million at December 31, 2002. We also increased our borrowings under our line of credit by $2.9 million during the six months ended June 30, 2003. Cash equivalents are highly liquid investments with original maturities of ninety days or less as of the date of purchase. Investments are debt instruments with original maturities greater than three months.

Net cash used in operating activities was $1.9 million for the six months ended June 30, 2003 and consisted primarily of the net loss of $7.0 million and a net change in assets and liabilities of $10.3 million, partially offset by depreciation and amortization of $14.6 million. The decreases in accounts receivable of $8.3 million and accrued liabilities of $15.1 million relate primarily to the higher than usual year-end balances and the subsequent collections and payments, respectively. For the six months ended June 30, 2002, 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.

Net cash provided by investing activities was $1.8 million for the six months ended June 30, 2003, which resulted primarily from the net maturities of marketable securities and sales of investment of $6.4 million, partially offset by the purchases of property and equipment of $4.6 million. For the six months ended June 30, 2002, net cash provided by investing activities was $40.2 million, which resulted primarily from the net maturities of marketable securities of $55.5 million, partially offset by the purchases of property and equipment of $10.5 million and technology of $3.2 million.

Net cash provided by financing activities was $7.5 million for the six months ended June 30, 2003, which resulted from the net increase in line of credit of $2.9 million and the proceeds from the issuance of our common stock of $4.6 million. Net cash provided by financing activities was $9.4 million for the six months ended June 30, 2002, 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, 2003, the only significant contractual obligations or commercial commitments consisted of our facility lease commitments and line of credit. (See Note 4 to the Notes to the Condensed Consolidated Financial Statements included herein for further details.) We do not have any other off-balance sheet arrangement that could significantly reduce our liquidity.

Based on our current operating plan and limited capital spending, we believe our current cash and investment balances and cash flow from the sale of stock will be sufficient to meet our working capital and capital expenditure requirements for at least the next twelve months.

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 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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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 business and results of operations may be affected by our announced merger with EMC Corporation.

On July 7, 2003, we entered into an agreement to merge with EMC Corporation. The announcement of the merger could have an adverse effect on our revenue in the near-term if customers delay, defer, or cancel purchases pending consummation of the planned merger. While we are attempting to mitigate this risk through communications with our customers, current and prospective customers could be reluctant to purchase our software or services due to potential uncertainty about the direction of the combined company s product offerings and its support and service of existing products. If our announcement of the merger causes our customers to delay purchase decisions pending consummation of the planned merger, our results of operations could be negatively affected. In addition, any such delays of orders or related disruptions could cause our quarterly operating results to fall below the expectations of market analysts, which could cause a decline in our stock price.

If the planned merger is not completed, our business and stock price may be adversely affected.

If the planned merger with EMC Corporation is not completed, we could suffer a number of consequences that may adversely affect our business, results of operations and stock price, including the following:

- we would not realize the benefits we expect from becoming a part of a combined company with EMC Corporation, including the potentially enhanced financial and competitive position;
- activities relating to the merger and related uncertainties may divert our management s attention from our day-to-day business and cause disruptions among our employees and to our relationships with customers and business partners, thus detracting from our ability to grow revenue and minimize costs and possibly leading to a loss of revenue and market position that we may not be able to regain if the transaction does not occur;
- the market price of our common stock could decline following an announcement that the merger has been abandoned, to the extent that the current market price reflects a market assumption that the merger will be completed;
- we could be required to pay EMC a termination fee of $45,000,000 and provide reimbursement for certain costs incurred;
- we would remain liable for our costs related to the transaction, such as legal, accounting and investment banking fees;
- we may not be able to take advantage of alternative business opportunities or effectively respond to competitive pressures.

In connection with the proposed transaction, we expect that EMC Corporation will file a registration statement on Form S-4, including a proxy statement/prospectus with the SEC, and we expect to file the proxy statement/prospectus with the SEC as a proxy statement. The proxy statement/prospectus will be mailed to all holders of our common stock and will contain important information about us, EMC, the transaction and related matters, including additional risk factors. Investors will be able to obtain free copies of these and other documents filed by Legato and EMC with the SEC through the web site maintained by the SEC at www.sec.gov. In addition, investors will be able to obtain free copies of the proxy statement/prospectus from us. We urge all of our stockholders to read the proxy statement/prospectus when it becomes available.

Our quarterly operating results are volatile and are subject to macro- and microeconomic factors beyond our control.

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;
- Market acceptance of our new products, applications and product enhancements of our competitors;
- Price changes by us or our competitors;
- The on-going just-in-time spending practices by our customers information technology departments;
- Our ability to develop, introduce and market new products, applications and product enhancements;
- Our ability to control, and where appropriate reduce, 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 or intangibles;

The mix of sales among our channels;

Deferrals of customer orders in anticipation of new products, applications or product enhancements;

Market readiness of 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;

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 due to changing customer demand, the unpredictability of future orders and weakness in the market for storage software.

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. Larger sales transactions may include extended

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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;

The on-going sluggish economy affects our end-user customers businesses; accordingly, those customers tend to purchase information technology on a just-in-time basis;

OEM license and royalty revenue are difficult to forecast. Our royalty revenue is dependent upon product license sales by OEMs of their products that incorporate our software. Accordingly, this royalty revenue is subject to OEMs product cycles and the general health of their businesses; these trends are also difficult for us to predict. Fluctuations in licensing activity from quarter to quarter further impact royalty revenue, because initial license fees generally are non-recurring and generally are recognized upon the signing of a license agreement;

The timing of recognition of revenue for each of the different elements of enterprise license and other large transactions (which principally consist of license, maintenance and professional services elements) 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, we continue to record losses, and we may incur additional losses in the future. We lost $7.0 million for the six months ended June 30, 2003 and $228.8 million for the year ended December 31, 2002. Our accumulated deficit was $306.4 million as of June 30, 2003. 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 are currently subject to litigation.

On or about July 26, 2001, a class action lawsuit was filed in the Southern District of New York naming OTG 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

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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, financial position or cash flows.

Our competitors include several very large technology companies that have greater cash resources and larger sales and marketing than ours.

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 competitors include, but are not limited to, Commvault, Computer Associates, EMC, Fujitsu-Siemens, Hewlett Packard, Hitachi, IBM, Sun Microsystems 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.

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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, which comprises a large majority of our sales and is subject to significant competition.

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.

Although we continue to introduce new products, we must respond to technological changes and competition 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. In particular, our content management and messaging management offerings compete in markets where new standards continue to be introduced and to evolve. To be successful, we need to develop and

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introduce new software products on a timely basis that keep pace with technological developments and emerging industry standards and address the increasingly sophisticated needs of our customers. In addition, we need to continue to integrate into our product lines the technologies of products we acquired through the acquisition of OTG Software completed in May 2002. 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 2002, including OpenVMS, zSeries for NetWorker and NetWorker Operations, and currently plan to introduce and market several more potential new products and major revisions to existing products in the next twelve months. Some of our competitors currently offer products analogous to certain of these products. Such potential new releases are subject to significant technical risks. We may fail to introduce such releases on a timely basis or at all. In the past, we have experienced delays in the commencement of commercial shipments of some 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 are inherently complex; they may contain undetected errors, as has occurred in the past.

Software products as complex as those we offer are likely to contain errors or failures that are initially undetected when the product is 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 are used to manage data critical to organizations. As a result, the licensing and support of products we offer entail the risk of product liability claims. Although we generally include provisions in our license agreements that are intended to limit our liability, and routinely purchase errors and omissions insurance to mitigate our risk exposure, a successful product liability claim brought against us could seriously harm our business, operating results and financial condition.

We rely on enterprise license transactions, which vary greatly in number of licenses, types of services, total price and other material terms; thus revenue from such transactions is difficult to predict.

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;

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These transactions typically involve significant technical evaluation and commitment of capital and other resources;

A large 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 such as distributors, systems integrators and value-added resellers; it is very difficult for us to predict their quarterly or annual sales of Legato products.

We rely, and will continue to 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, if not successful, 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, and in some cases already do, 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.

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We depend on revenue from outside the United States, where sales cycles are longer, there are currency risks and there exist a number of local factors that could negatively affect sales.

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;
- A shift in the strength of foreign currencies, principally the Euro, relative to the U.S. Dollar
- 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, and currently we cannot accurately predict sales trends in that market.

The overwhelming majority of our business is in the enterprise data storage market. The enterprise data storage management market remains maturing and dynamic. 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 experience from time to time significant economic downturns characterized by decreased product demand, product overcapacity, price erosion, work slowdowns and layoffs. 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, and potentially improper, 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. We have implemented policies to prevent and discourage such conduct, but there can be no assurance that such policies will be followed. For instance, in the event that our sales personnel have negotiated terms that do not appear in the contract and of which we are unaware, whether the additional terms are written or verbal, we could be prevented from recognizing revenue in accordance with our plans. Furthermore, depending on when we learn of unauthorized actions and the size of transactions involved, we may have to restate revenue for a previously reported period, which would seriously harm our business, operating results and financial condition.

We rely on our sales personnel, who may be difficult to retain, thereby disrupting our business.

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 for the successful execution of our business strategy.

Our future performance depends on the continued service of our key technical, sales and senior management personnel. Most of our technical and sales personnel are not bound by employment agreements. The loss of the services of one or more of our 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, in May 2002. Our ability to achieve favorable results in 2003 and beyond will be dependent in part upon our ability to continue 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 expand relationships based upon the broader range of products and services available from us. In some instances, we may need to discontinue relationships with business partners whose interests are no longer aligned with ours. We must accomplish the synergies we 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.

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As of June 30, 2003, we had goodwill of $270.7 million and acquired intangibles of $25.2 million on our Consolidated Balance Sheet. To the extent we do not generate sufficient cash flows to recover the net amount of the goodwill and intangibles recorded, the goodwill and 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. We expect to amortize identifiable intangibles of $5.4 million in the remainder of 2003, $7.9 million in 2004, $5.0 million in 2005 and 2006 and $1.9 million in 2007.

Protection of our intellectual property is limited by the nature of the applicable law, and any misuse of our intellectual property by third parties could negatively affect our revenue and potentially result in litigation.

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, use our software without proper licenses, 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 generally due to fluctuations in our business, in our industry and the stock market.

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;

Unsubstantiated rumors in the marketplace regarding products and business plans;

Conditions in the financial markets in general;

Litigation; and

General business conditions and trends in the distributed computing environment and software industry.

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

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Interest Rate Risk. Our exposure to market risk for changes in interest rates relates primarily to our investment portfolio. While we are exposed with respect to interest rate fluctuations in many countries, our interest income is most sensitive to fluctuations in the general level of U.S. interest rates. In this regard, changes in the U.S. interest rates affect the interest earned on our cash, cash equivalents 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, 2003 (dollars in millions).

	Carrying Value	Interest Rate
Investments fixed rate	$ 9.3	4.6%
Cash equivalents:		
Variable rate	14.6	0.9
	$ 23.9	2.3

Foreign Currency Risk. As a global concern, we face exposure to adverse movements in foreign currency exchange rates. This exposure may change over time as business practices evolve and could seriously harm our financial results. Substantially all of our international sales are currently denominated in U.S. dollars and Euros. 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.

ITEM 4. CONTROLS AND PROCEDURES

(a) Evaluation of Disclosure Controls and Procedures

The Company s management, with the participation of the Company s Chief Executive Officer and Chief Financial Officer, evaluated the effectiveness of the Company s disclosure controls and procedures as of the end of the period covered by this report. Based on that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that the Company s disclosure controls and procedures as of the end of the period covered by this report have been designed and are functioning effectively to provide reasonable assurance that the information required to be disclosed by the Company in reports filed under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in the SEC s rules and forms. The Company believes that a controls system, no matter how well designed and operated, cannot provide absolute assurance that the objectives of the controls system are met, and no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within a company have been detected.

(b) Change in Internal Control over Financial Reporting

No change in the Company s internal control over financial reporting occurred during the Company s most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the Company s internal control over financial reporting.

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PART II OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

Information concerning legal proceedings is incorporated herein by reference to Note 5 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 10, 2003. 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	104,635,247	1,421,948
Brendan J. Dawson	104,278,480	1,778,715
Kenneth A. Goldman	104,634,797	1,422,398
Richard A. Kay	104,278,770	1,778,425
Christopher B. Paisley	104,495,416	1,561,779
David N. Strohm	104,503,038	1,554,157
David B. Wright	104,275,955	1,781,240

To approve an amendment to the Company s 1995 Stock Option/Stock Issuance Plan that will increase the number of shares of common stock subject to the stock option grants made to non-employee directors pursuant to the automatic option grant provisions of the plan:

Votes for:	56,396,738
Votes against:	48,973,552
Votes abstaining:	686,905

To ratify the appointment of PricewaterhouseCoopers LLP as the Company s independent public accountants for the year ending December 31, 2003:

Votes for:	103,409,678
Votes against:	2,609,698
Votes abstaining:	37,819

ITEM 5. OTHER INFORMATION

Not applicable.

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

(a) Exhibits:

10.1	Separation Agreement, dated May 21, 2003, between Registrant and James P. Chappell.
10.2	Amendment to Separation Agreement, dated June 27, 2003, between Registrant and James P. Chappell.
10.3	Consulting Agreement, dated June 1, 2003, between Registrant and James P. Chappell.
31.1	Certification of Chief Executive Officer Pursuant to Rule 13a-14(a) or 15d-14(a).
31.2	Certification of Chief Financial Officer Pursuant to Rule 13a-14(a) or 15d-14(a).
32.1	Certification Pursuant to 18 U.S.C. Section 1350.

(b) Reports on Form 8-K:

On April 22, 2003, the Registrant furnished a Current Report on Form 8-K under Item 9, as amended on April 22, 2003, containing a copy of its earnings release for the first quarter ended March 31, 2003, pursuant to Item 12 (Results of Operations and Financial Condition).

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

Chief Financial Officer

By: /s/ CORY J. SINDELAR

Cory J. Sindelar

Vice President, Corporate Controller

and Principal Accounting Officer

Date: July 30, 2003

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