CYBERGUARD CORP
Form 10-Q/A
July 11, 2003
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, DC 20549

FORM 10-Q

AMENDMENT NO 1

(Mark One)

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

For the quarterly period ended MARCH 31, 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 0-24544

CYBERGUARD CORPORATION

(Exact name of Registrant as Specified in Its Charter)

Florida	**65-0510339**
(State or Other Jurisdiction of	**(I.R.S. Employer**
Incorporation or Organization)	**Identification No.)**
2000 West Commercial Blvd., Suite 200,	
Fort Lauderdale, Florida	**33309**
(Address of Principal Executive Offices)	**(Zip Code)**

Registrant s Telephone Number, Including Area Code 954-958-3900

Former Name, Former Address and Former Fiscal Year, if Changed Since Last Report

Indicate by check þ whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports),

Yes þ No ¨

and (2) has been subject to such filing requirements for the past 90 days.

Yes þ No ¨

As of May 9, 2003, 20,641,099 shares of the Registrant s $0.01 par value Common Stock were outstanding.

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PART I: FINANCIAL INFORMATION

Item 1. Financial Statements

CYBERGUARD CORPORATION AND SUBSIDIARIES

CONDENSED CONSOLIDATED BALANCE SHEETS

(Unaudited)

(Amounts in thousands)

	Mar. 31, 2003	June 30, 2002
ASSETS		
Cash and cash equivalents	$ 10,538	$ 6,166
Restricted cash	82	44
Accounts receivable, less allowance for uncollectible accounts of $327 at Mar. 31, 2003 and $109 at June 30, 2002	6,904	5,152
Inventories, net	451	442
Other current assets	1,302	801
Total current assets	19,277	12,605
Property and equipment at cost, less accumulated depreciation of $3,076 at Mar. 31, 2003 and $2,335 at June 30, 2002	1,720	1,212
Capitalized software, net	202	219
Intangibles, net	963	
Other assets	87	94
Deferred tax asset, net	4,249	
Total assets	$ 26,498	$ 14,130
LIABILITIES AND SHAREHOLDERS EQUITY		
Note payable	$ 29	$ 140
Accounts payable	844	778
Deferred revenue	5,181	3,951
Accrued expenses and other liabilities	3,388	2,305
Total liabilities	9,442	7,174
Commitments and Contingencies		
Shareholders equity		
Preferred Stock par value $0.01; authorized 5 shares; none issued		
Common stock par value $0.01; authorized 50,000 shares; issued and outstanding 20,423 at Mar. 31, 2003 and 19,100 at June 30, 2002	204	191
Additional paid-in capital	91,240	88,673
Accumulated deficit	(74,487)	(82,075)
Accumulated other comprehensive income	99	167
Total shareholders equity	17,056	6,956

Total liabilities and shareholders equity	$ 26,498	$ 14,130

See accompanying notes to condensed consolidated financial statements

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CYBERGUARD CORPORATION AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(Unaudited)

(Amounts in thousands, except per share data)

	Three Months Ended		Nine Months Ended	
	Mar. 31, 2003	Mar. 31, 2002	Mar. 31, 2003	Mar. 31, 2002
Revenues:				
Products	6,178	4,557	16,846	11,526
Services	2,465	1,734	7,130	5,093
Total revenues	8,643	6,291	23,976	16,619
Cost of revenues:				
Products	1,499	1,377	4,120	3,243
Services	568	511	1,841	1,455
Total cost of revenues	2,067	1,888	5,961	4,698
Gross profit	6,576	4,403	18,015	11,921
Operating expenses:				
Research and development	1,686	1,239	3,941	3,598
Selling, general and administrative	3,917	3,079	10,782	9,034
Total operating expenses	5,603	4,318	14,723	12,632
Operating income (loss)	973	85	3,292	(711)
Other income/(expense):				
Interest income, net	31	13	85	40
Loss on sale of assets			(33)	(17)
Other income/(expense):	(25)	(17)	75	(29)
Total other income/(expense)	6	(4)	127	(6)
Net income (loss) before income tax benefit	979	81	3,419	(717)
Income tax benefit	4,169		4,169	
Net income (loss)	5,148	81	7,588	(717)
Basic earnings (loss) per common share	$ 0.26	$ 0.00	$ 0.39	$ (0.04)
Weighted average number of common shares outstanding	20,078	18,883	19,574	18,700

Diluted earnings (loss) per common share	$ 0.20	$ 0.00	$ 0.31	$ (0.04)
Diluted common shares outstanding	25,567	22,369	24,376	18,700

See accompanying notes to condensed consolidated financial statements

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CYBERGUARD CORPORATION AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

(Amounts in thousands)

	Nine Months Ended	
	Mar. 31, 2003	Mar. 31, 2002
Cash flows from operating activities:		
Net income/(loss)	$ 7,588	$ (717)
Adjustments to reconcile net income/(loss) to net cash provided by operating activities:		
Depreciation	750	504
Amortization	316	554
Loss on disposal of property & equipment	33	17
Provision for uncollectible accounts receivable	218	30
Deferred tax benefit	(4,249)	
Compensation expense related to stock options	75	106
Non cash expense for company 401(k) match	192	193
Translation adjustment	(68)	14
Changes in assets and liabilities (excluding the effect of acquisition)		
(Increase)/Decrease in restricted cash	(38)	760
(Increase) in accounts receivable	(1,970)	(1,039)
(Increase)/Decrease in other current assets	(458)	93
(Increase) in inventories	(543)	(140)
Increase/(Decrease) in accounts payable	66	(22)
Increase/(Decrease) in accrued expenses and other liabilities	565	(111)
Increase in deferred revenue	1,230	1,051
Decrease/(Increase) in other, net	7	(1)
Net cash provided by operating activities	3,714	1,291
Cash flows used in investing activities:		
Capitalized software costs	(179)	(172)
Acquisition of certain assets of Netoctave	(300)	
Proceeds from the sale of property & equipment		11
Purchase of property & equipment	(315)	(338)
Net cash (used in) investing activities	(794)	(499)
Cash flows provided by/(used in) financing activities:		
Repayment on notes payable	(111)	(830)
Borrowing on notes payable		257
Net repayments on line of credit		(113)
Proceeds from stock options exercised	1,473	403
Proceeds from issuance of common stock in stock purchase plan	90	160
Net cash provided by/(used in) financing activities	1,452	(123)

Net increase in cash	4,372	670
Cash and cash equivalents at beginning of period	6,166	4,771
Cash and cash equivalents at end of period	$ 10,538	$ 5,441
Supplemental disclosure of cash flow information:		
Cash paid for interest	7	55
Cash paid for income taxes		
Supplemental disclosure of non-cash information:		

During January 2001, approximately 310 options to purchase shares of the Company s common stock were issued at a below market price, which required the Company to record approximately $16 and $59 in compensation expense for the period ended March 2003 and 2002 respectively. The Company s CEO, Scott Hammack, participated in a special option program where he received no salary for twelve months which required the Company to record compensation expense of $59 for the nine-months ended March 31, 2003 and $47 for the nine-months ended March 31, 2002.

In connection with the acquisition of certain assets of Netoctave, 107 shares valued at $750 were issued, a contingent purchase consideration of $450 and costs associated with the closing of $68 were accrued for during the quarter ended March 31, 2003.

For the period ended March 31, 2003, approximately $694 of inventory was reclassified to fixed assets.

See accompanying notes to condensed consolidated financial statements

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CYBERGUARD CORPORATION

Notes to Condensed Consolidated Financial Statements

March 31, 2003

Amounts in thousands, except per share data

(Unaudited)

1. Basis of Presentation

CyberGuard Corporation (the Company) has prepared the condensed consolidated financial statements included herein, without audit, pursuant to the rules and regulations of the Securities and Exchange Commission with respect to Form 10-Q. Certain information and footnote disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles have been condensed or omitted pursuant to such rules and regulations, although the Company believes that the disclosures made are adequate so as to make the information contained not misleading. These interim financial statements and the notes should be read in conjunction with the financial statements and the notes included in the Company s 10-K for the year ended June 30, 2002 and the risk factors set forth in the Company s annual report on Form 10-K, including, without limitation, risk related to the factors listed below. In the Company s opinion, all adjustments (consisting only of normal recurring adjustments) necessary for fair presentation of the information shown, have been included. The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the amounts reported in the consolidated financial statements and accompanying notes. On an on-going basis, we evaluate significant estimates used in preparing our financial statements, including revenue recognition, bad debt, software development cost, inventory valuation, and reserve for deferred taxes. We base our estimates on historical experience and various other assumptions that we believe to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying value of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions. The results of operations for the nine months ended March 31, 2003 are not necessarily indicative of the results of operations that may be expected for the year ending June 30, 2003.

2. Summary of Significant Accounting Policies

Software Development Costs The Company capitalizes costs related to the development of certain software products on a product by product basis in accordance with Statement of Financial Accounting Standards No. 86, Accounting For the Costs of Computer Software to be Sold, Leased, or Otherwise Marketed (SFAS No. 86) which requires capitalization to begin when technological feasibility has been established and ends when the product is available for general release to customers. Software development costs incurred prior to technological feasibility, defined by implementation of a beta project, are considered research and development costs and are expensed as incurred. Capitalized costs are amortized on a straight-line method over the remaining estimated economic life of the product, which we estimate to be two years, which reflects the rapid changes in security software and is the greater of the two amounts calculated using the methods noted in SFAS 86. Amortization starts when the product is available for general release to customers. Unamortized capitalized software cost is evaluated at each balance sheet date and compared to the net realizable value. Any excess capitalized cost above net realizable value will be written off. No such impairment existed at March 31, 2003. The Company capitalized $179 in software development costs for the nine months ended March 31, 2003.

Revenue Recognition Our revenue is derived from two primary sources:

(1) Product revenue which includes revenue from the sale of our firewall/VPN appliance, and

(2) Service revenue, which is primarily maintenance, provides for customer support.

Revenues from product sales are recognized only when a contract or agreement has been executed,

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CYBERGUARD CORPORATION

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Amounts in thousands, except per share data

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delivery of the product has occurred, the fee is fixed and determinable and we believe collection is probable. Product revenue is generally recognized on product shipment; this includes the transfer of both title and risk of loss, provided that no significant obligations remain. There is no product right of return available to the customer. We defer revenues on product sales for new value added resellers where we are unable to determine the ability of the reseller to honor a commitment to make fixed or determinable payment. Revenue will be deferred until the resellers demonstrate consistency of payment within terms and there are no instances where we have to take back of the product because of non-payment for a three-month period. For the quarter ended March 31, 2003, two resellers were reclassified from cash basis to accrual. During the nine months ended March 31, 2003, fifteen (15) resellers, net, were changed from cash basis to accrual, based on a reasonable assurance of collectibility from evaluating their payment histories and no product returns. The impact of the reclassification did not have a material effect on revenue.

Service revenues consist primarily of the annual fee for maintenance (post-contract customer support) and maintenance renewals from our existing customers and are recognized ratably on a monthly basis over the service contract term. The post contract customer support provides our customers access to our worldwide support organization for technical support, unspecified product updates/enhancements on a when and if available basis and general security information. The updates are considered minor enhancements to the software that are not separately marketable or considered a competitive feature or major upgrade. All products and services are separately contracted.

The Company also provides other professional support services, such as training and consulting, which are available under service agreements and charged for separately. These services are generally provided under time and materials contracts and revenue is recognized as the service is provided.

Net Income Per Share Basic income/(loss) per share is computed by dividing net income/(loss) available to common shareholders by the weighted-average number of common shares outstanding for the period. Diluted earnings/(loss) per share data is computed on the basis of the weighted average number of common shares outstanding plus the effect of outstanding stock options and warrants using the treasury method. When the effects of the outstanding stock options, warrants and/or convertible securities are anti-dilutive, they are not included in the calculation of diluted earnings/(loss) per share.

The table below illustrates the components of earnings per share:

	Three Months Ended March 31, 2003	Three Months Ended March 31, 2002	Nine Months Ended March 31, 2003	Nine Months Ended March 31, 2002
Net Income/(loss)	$ 5,148	$ 81	$ 7,588	$ (717)

Weighted average number of common shares outstanding	20,078	18,883	19,574	18,700
Dilutive effect of:				
Employee stock options	3,903	2,570	3,516	0
Warrants	1,586	916	1,286	0
Weighted average number of common shares outstanding	25,567	22,369	24,376	18,700
Earnings/(loss) per share				
Basic	0.26	0.00	0.39	(0.04)
Diluted	0.20	0.00	0.31	(0.04)

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(Unaudited)

The Company has adopted the disclosure provisions of SFAS No. 148, Accounting for Stock Based Compensation Transition and Disclosure, which amends SFAS No. 123, Accounting for Stock-Based Compensation. SFAS No. 148 allows for continued use of recognition and measurement principles of Accounting Principles Board (APB) Opinion No. 25 and related interpretations in accounting for those plans. The Company applies the recognition and measurement principles of APB Opinion No. 25, and related interpretations in accounting for those plans. **For the three and nine months ended March 31, 2003 there was approximately $5 and $16 of stock based compensation reflected in net income. For the three and nine months ended March 31, 2002 there was approximately $5 and $59 of stock based employee compensation included in net income. Stock based compensation was the result of stock issued at prices below market value at the date of the grant.**

The following table illustrates the effect on net income and earnings per share if the Company had applied the fair value recognition provisions to stock-based employee compensation. Such disclosure is not necessarily indicative of the fair value of stock options that could be granted by the Company in future periods or of the value of all options currently outstanding.

	Three months ended March 31,		**Nine months ended March 31,**	
	2003	**2002**	**2003**	**2002**
Net income (loss), as reported	$ 5,148	$ 81	$ 7,588	$ (717)
Add: Stock-based employee compensation expense included in reported net income, net of related tax effects	$ 5	$ 5	$ 16	$ 59
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards	$ (524)	$ (745)	$ (2,157)	$ (1,902)
Pro forma net income/ (loss)	$ 4,629	$ (659)	$ 5,447	$ (2,560)
Earnings / (loss) per share:				
Basic as reported	$ 0.26	$ 0.00	$ 0.39	$ (0.04)
Basic pro forma	$ 0.23	$ (0.03)	$ 0.28	$ (0.14)
Diluted as reported	$ 0.20	$ 0.00	$ 0.31	$ (0.04)
Diluted pro forma	$ 0.18	$ (0.03)	$ 0.22	$ (0.14)

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The fair value method for these options was estimated at the date of grant using the Black-Scholes option pricing model with the following weighted average assumptions for the three and nine-month periods ended March 31, 2003 and March 31, 2002: the risk-free interest rate was 3.06%; the expected dividend yield was 0.0%, the volatility factor of the expected market price of the Company s common stock was 94.0%, and a grant life of the option of 3 years.

The Company s operating results and financial condition may be impacted by a number of factors including, but not limited to, the following, any of which could cause actual results to vary materially from current and historical results or the Company s anticipated future results. A portion of the Company s revenue is derived from its international operations and sources. As a result, the Company s operations and financial results could be affected by international factors such as; changes in foreign currency exchange rates, weak economic conditions in the international markets in which the Company distributes its products, conflict in the Middle East, and recent health warnings in the Asia / Pacific region. The network security industry is highly competitive and competition is expected to intensify. There are numerous companies competing in segments of the market in which the Company does business. Competitors include organizations significantly larger and with more development, marketing and financial resources than the Company. In addition, the Company is subject to risks and uncertainties which include, but are not limited to, the timely development of and acceptance of new products, impact of competitive products, competition for and retention of key management and technology employees, possible attacks on our networks causing changes to the public s perception of the Company, the ability to secure additional financing, government regulation, inventory obsolescence, the ultimate outcome of certain litigation matters, and cash balances in excess of federally insured limits. For a more complete discussion of these factors affecting the Company s business and prospects and forward-looking statements, please refer to Part II, Item 7 of Form 10K for the fiscal year ended June 30, 2002.

3. Recent Accounting Pronouncements

In June 2002, the FASB issued SFAS No. 146, Accounting for Costs Associated with Exit or Disposal Activities (SFAS 146). SFAS 146 addresses financial accounting and reporting for costs associated with exit or disposal activities and nullifies Emerging Issues Task Force (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), as liabilities for these costs are now recognized when incurred rather than at the date an entity commits to an exit plan. The provisions of SFAS 146 are effective, on a prospective basis, for exit or disposal activities initiated by the Company after December 31, 2002. The Company believes SFAS 146 will not have any impact on the Company at this time.

In November 2002, the FASB issued FASB Interpretation (FIN) No. 45, Guarantor s Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others. FIN No. 45 requires that a liability be recorded on the guarantor s balance sheet upon issuance of a guarantee. In addition, FIN No. 45 requires disclosures about the guarantees that an entity has issued, including a rollforward of the entity s product warranty liabilities. FIN No. 45 is effective for financial statements for fiscal years ending after December 31, 2002. The Company believes FIN 45 will not have any future impact on the Company at this time.

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(Unaudited)

In December 2002, the FASB issued SFAS No. 148, Accounting for Stock-Based Compensation Transition and Disclosure. SFAS No. 148 provides alternative methods of transition for a voluntary change to the fair value based method of accounting for stock-based employee compensation. In addition, SFAS No. 148 requires prominent annual and interim disclosures of the pro forma effect of using the fair value method of accounting for stock-based employee compensation. The disclosure requirements of SFAS No. 148 are effective for fiscal years ended after December 15, 2002, and therefore, are included in the financial statements presented herein. While SFAS No. 148 allows for a voluntary change to the fair value based method of accounting for stock-based employee compensation, we continue to use the recognition and measurement principles of APB Opinion No. 25, Accounting for Stock Issued to Employees, and related interpretations for those plans; therefore, we do not expect SFAS No. 148 to have a material impact upon our consolidated financial position and results of operations

In January 2003, the FASB issued FIN No. 46, Consolidation of Variable Interest Entities, an Interpretation of ARB No. 51. FIN No. 46 provides guidance on the identification of, and financial reporting for, entities over which control is achieved through means other than voting rights; such entities are known as variable interest entities (VIEs). FIN No. 46 applies to new entities that are created after the effective date, as well as to existing entities. The Company believes FIN 46 will not have any future impact on the Company at this time.

In January 2003, the EITF reached a consensus on Issue No. 02-16, Accounting by a Customer (Including a Reseller) for Certain Consideration Received from a Vendor. EITF Issue No. 02-16 provides guidance regarding how a reseller of a vendor s products should account for cash consideration received from that vendor. We do not expect EITF No. 02-16 to have a material impact upon our consolidated financial position and results of operations

4. Acquisition of NetOctave

The acquisition of certain assets of NetOctave, Inc., closed on March 4, 2003, pursuant to an Asset Purchase Agreement dated January 22, 2003. On January 22, 2003 the company leased space in North Carolina and hired the NetOctave employees and those expenses have been included in the Company s consolidated financial statements. In addition, we recorded revenue for the sale of Net Octave product, purchased from Net Octave suppliers, and sold to third party customers. The net impact of the for the period January 23 through March 4, 2003 included in the Company s financial statements was a charge of approximately $89.

The purchase consideration was approximately $1,5 million. The consideration consisted of (a) cash of $300, (b) a payment of up to $450 based upon a percentage of certain revenues during the next twelve months. The payment is payable quarterly. and (c) 107,419 shares of the Company s Common Stock valued at $750, based upon the market value of the shares. NetOctave was granted certain registration rights for the Common Stock it received in the transaction. The purchase price was determined through arms-length negotiations between representatives of the Company and NetOctave.

NetOctave is a manufacturer of security processors and accelerator boards and cards for the secure sockets layer (SSL) and Internet protocol security (IPSec) markets. As a result of the acquisition, the

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Amounts in thousands, except per share data

(Unaudited)

Company will gain new technology, engineering talent and a customer base for the SSL and IPSec markets.

The following table summarizes the estimated fair values of the assets acquired. The acquisition was accounted for using the purchase method of accounting, as required by Statement of Financial Accounting Standard No. 141, Business Combinations. Under this method of accounting, the Company allocated the purchase price to the fair value of the assets acquired, including identified intangible assets. The allocation was based on management s estimates, which included an independent third party valuation.

Current Assets	202
Property and Equipment	282
Intangible Assets	1,084
Total Assets Acquired	1,568

The intangible assets acquired have a useful life of approximately 18 months. The following values were assigned to intangible assets; (a) developed technology $758 and (b) customer base $260.

Unaudited pro forma results of operations after giving effect to certain adjustments resulting from the acquisition of certain assets from one of the divisions of NetOctave, Inc. were as follows for the periods ended March 31, 2003 and March 31, 2002. The amounts are shown as if the acquisition had occurred at the beginning of each period presented:

	For the three months ended March 31,		For the nine months ended March 31,	
	2003	2002	2003	2002
Proforma revenues	**8,643**	**6,341**	**23,976**	**16,669**
Net income proforma	**4,892**	**(1,952)**	**3,465**	**(8,783)**
Earnings/(loss) per share basic proforma	**0.24**	**(0.10)**	**0.18**	**(0.47)**
Earnings/(loss) per share dilutive pro forma	**0.19**	**(0.10)**	**0.14**	**(0.47)**

5. Litigation

On August 24, 1998, the Company announced, among other things, that due to a review of its revenue recognition practices relating to distributors and resellers, it would restate prior financial results. After the August 24, 1998 announcement, twenty-five purported class action lawsuits were filed by alleged shareholders against the Company and certain former officers and directors. Pursuant to an order issued by the Court, these actions have been consolidated into one action, styled Stephen Cheney, et al. v. CyberGuard Corporation, et al., Case No. 98-6879-CIV-Gold, in the United States District Court, Southern District of Florida. On August 23, 1999, the plaintiffs filed a Consolidated and Amended Class

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CYBERGUARD CORPORATION

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(Unaudited)

Action Complaint. This action seeks damages purportedly on behalf of all persons who purchased or otherwise acquired the Company s common stock during various periods from November 7, 1996 through August 24, 1998. The complaint alleges, among other things, that as a result of accounting irregularities relating to the Company s revenue recognition policies, the Company s previously issued financial statements were materially false and misleading and that the defendants knowingly or recklessly published these financial statements which caused the Company s common stock prices to rise artificially. The action alleges violations of Section 10(b) of the Securities Exchange Act of 1934 (Exchange Act) and SEC Rule 10b-5 promulgated thereunder and Section 20(a) of the Exchange Act. Subsequently, the defendants, including the Company, filed their respective motions to dismiss the Consolidated and Amended Class Action Complaint. On July 31, 2000, the Court issued a ruling denying the Company s and Robert L. Carberry s (the Company s CEO from June 1996 through August 1998) motions to dismiss. The court granted the motions to dismiss with prejudice for defendants William D. Murray (the Company s CFO from November 1997 through August 1998), Patrick O. Wheeler (the Company s CFO from April 1996 through October 1997), C. Shelton James (the Company s former Audit Committee Chairman), and KPMG Peat Marwick LLP (KPMG). On August 14, 2000, the plaintiffs filed a motion for reconsideration of that order. The Company filed an answer to the plaintiffs Consolidated and Amended Class Action Complaint on August 24, 2000. On March 20, 2001, the Court ruled on the plaintiffs motion for reconsideration that the previously dismissed defendants William D. Murray, Patrick O. Wheeler and C. Shelton James should not have been dismissed from the action and shall be defendants in this action under the control person liability claims under Section 20(a) of the Exchange Act, and that the plaintiffs may amend the Consolidated and Amended Class Action Complaint to bring claims against C. Shelton James under Section 10(b) of the Exchange Act and Rule 10b-5 promulgated thereunder. On April 5, 2001, the plaintiffs filed their Second Consolidated and Amended Class Action Complaint to include amended claims against C. Shelton James. On May 10, 2001, the Company filed an answer and affirmative defenses to plaintiffs Second Consolidated and Amended Class Action Complaint. On August 14, 2002, the Court granted the plaintiffs Motion for Class Certification and certified the class to include all investors who acquired the Company s common stock between November 7, 1996 and August 24, 1998 and were damaged by the purchase of such stock. The trial is scheduled for March 2004. The parties are currently conducting discovery. We are unable at this time to estimate the loss, if any, that the Company may incur if we are unsuccessful in defending this suit.

The Company s obligation to indemnify its officers and directors under the aforementioned lawsuit is insured to the extent of the limits of the applicable insurance policies. The Company has notified its insurance carrier of the existence of the lawsuit, and the carrier has sent the Company a reservation of rights letter. The Company intends to vigorously defend this action, and believes that in the event that it is unsuccessful, insurance coverage will be available to defray a portion, or substantially all, of the expense of defending and settling the lawsuit or paying a judgment. However, the Company is unable to predict the ultimate outcome of the litigation. There can be no assurance that the Company will be successful in defending the lawsuit or, if unsuccessful, that insurance will be available to pay all or any portion of the expense of the lawsuit. If the Company is unsuccessful in defending the lawsuit and the insurance coverage is unavailable or insufficient, the resolution of the lawsuit could have a material adverse effect on the Company s consolidated financial position, results of operations, and cash flows. The Company s consolidated financial statements do not include any adjustments related to these matters.

On September 16, 1999, the Company filed a lawsuit against KPMG and August A. Smith, the KPMG engagement partner. The lawsuit was in the Circuit Court of the 17^{th} Judicial Circuit in and for Broward County, Case No. 00-004102-CACE-14. On May 1, 2000, the Company filed the First Amended Complaint, alleging that KPMG failed to properly audit the Company s financial statements and provided

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(Unaudited)

inaccurate advice on accounting matters for fiscal years 1996, 1997 and 1998. The action alleges professional malpractice, breach of fiduciary duty, breach of contract and breach of implied duty of good faith, and seeks damages in excess of $10 million. KPMG and Mr. Smith filed motions to dismiss, which were denied. In August 2000, KPMG and Mr. Smith filed their answers and KPMG filed counterclaims against the Company, alleging the Company s breach of contract, negligent misrepresentation and abuse of process, and seeking an unspecified amount of damages consisting of unpaid service fees and legal fees and costs. The Company filed an answer to KPMG s counterclaims and moved to dismiss KPMG s abuse of process counterclaim. On April 9, 2001, the Court dismissed the abuse of process counterclaim with prejudice. On February 13, 2003, the parties settled the lawsuit with the only consideration being the exchange of mutual releases from liability.

On November 14, 2002, the Company filed a lawsuit against Data Return Corporation in the United States District Court of the Northern District of Texas, alleging breach of contract, and seeking, among other remedies, damages of approximately $4 million. On December 9, 2002, Data Return Corporation filed an answer and affirmative defenses, and also counterclaims against the Company, alleging breach of contract, breach of warranty, fraud, negligent misrepresentation and deceptive trade practices, and seeking unspecified damages. On December 30, 2002, CyberGuard filed its answer and affirmative defenses to the counterclaim and a motion to dismiss the fraud, negligent misrepresentation and deceptive trade practices counterclaims. In February 2003, the Company learned that Data Return Corporation filed for bankruptcy protection under Chapter 11 in the United States Bankruptcy Court, District of Massachusetts. At this time, it is impossible to determine whether the Company will be able to recover any amounts from Data Return Corporation even if the Company is successful in pursuing its claims.

The Company is involved from time to time, in the ordinary course of its business, in litigation relating to the conduct of its business. The Company believes that these other litigation matters will not have a material adverse effect on its consolidated financial position, results of operations or cash flows.

6. Income tax benefit

The Company recorded an income tax benefit of $4,169 as of March 31, 2003, primarily as a result of the reversal of a portion of the deferred tax asset valuation allowance. The reversal of the allowance was made because we believe it is more likely than not that the US Net operating loss carryforwards deferred tax asset will be realized to the extent of the $4,169 tax benefit recorded. Our basis that it is more likely than not is our positive current financial results both in the US and on a consolidated basis, and our future US projections through the end of fiscal year 2005. The company s current projection reflects approximately $11.5 million in US taxable income from normal and recurring operations through the end of fiscal year 2005. This projection of $11.5 million is the minimum amount of future US taxable income that would have to be generated to realize the $4,169 deferred tax asset. Our current level of pretax earnings for financial reporting purposes would be sufficient to generate that minimum amount of US taxable income that would have to be generated through the end of fiscal year 2005. Our projection is based on continued growth in the business at market growth rates and maintaining operating margins in the US of approximately 15 to 20% through the end of fiscal year 2005. Our projections do not include significant improvement in gross margins or cost reductions. The Company s net operating loss carryforwards begin to expire in 2010.

The factors which we will consider in evaluating when, and if, it would be appropriate to reverse the entire valuation allowance would include: the sufficient passage of time in which we have achieved our projections and utilized the tax net operating loss carryforwards as planned, changes in the industry, our product life-cycle, profitability trends, and tax law changes.

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

This Form 10-Q contains forward-looking statements about future results, which are subject to risks, and uncertainties, including those discussed below. These statements relate to future events or our future financial performance. In many cases you can identify forward-looking statements by terminology such as may , will , should , expects , plans , anticipates , believes , estimates , predicts , potential , intend , or co of such terms and other comparable terminology. However, the absence of these words does not mean that the statements are not forward-looking. Forward-looking statements include statements about our plans, objectives, expectations, intentions and other statements that are not historical facts. They are subject to known and unknown risks and uncertainties and assumptions that could cause our actual results to differ materially from those expected or implied by the forward-looking statements. Our actual results could differ materially from those anticipated in the forward-looking statements for many reasons, including, but not limited to, the risks described in Part II, Item 7, of the Company s 10-K for the year ended June 30, 2002. You should not unduly rely on these forward-looking statements, which apply only as of the date of this quarterly report. We undertake no obligation to update any forward-looking statements to reflect new information, circumstances or events after the date of this report. These forward-looking statements are only predictions.

The Company provides a full suite of products and services for the network security industry. The products offered by the Company include the CyberGuard® Firewall and VPN, proprietary and third party technology and consulting and support services.

Results of Operations

The quarter ended March 31, 2003 compared to the quarter ended March 31, 2002

Net Revenues

Net revenues consist primarily of the network security products and maintenance contracts related to these products. For the quarter ended March 31, 2003, net revenues increased by $2,352 to $8,643 compared to $6,291 for the quarter ended March 31, 2002. The increase was comprised of an increase in product sales of $1,621 and services of $731. International revenue represented approximately 51% of total revenues for the three months ended March 31, 2003 compared to approximately 71% for the three months ended March 31, 2002. The growth in revenues and the percentage increase in domestic revenue resulted from strong growth in the US market, primarily in the government sector.

n Network security product revenue accounted for 71% of revenue during the quarter ended March 31, 2003 compared to 72% of revenues during the quarter ended March 31, 2002.

Service revenue includes maintenance contracts related to new product sales, renewal maintenance contracts for products previously deployed, training and consulting services. Revenue from maintenance contracts represented 88% of service revenue for the quarter ended March 31, 2003 and 89% of service revenue for the quarter ended March 31, 2002. Support services for network security products accounted for 29% of revenues during the quarter ended March 31, 2003 as compared to 28% of revenues during the quarter ended March 31, 2002. The increase in maintenance revenue accounted for 85% of the increase in service revenue. The increase in service revenue corresponds to the growth in the Company s customer base and its timing of renewal maintenance.

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Gross Profit

Gross profit as a percentage of revenues increased to 76% for the quarter ended March 31, 2003 compared to 70% for the quarter ended March 31, 2002. This increase reflects lower hardware components cost for the past twelve months, which represents 69% of the gross profit increase. The service revenue increased because of a growing customer base while service costs grew at a slower rate than revenue.

The Company s gross margin has been, and will continue to be, affected by a variety of factors including, competition, the mix and average selling prices of products, new product introductions and enhancements, and the fluctuations in manufacturing volumes. We must continue to manage each of these factors effectively for our gross margins to remain at their current level.

Operating Expenses, Other Income and Expense and Net Income

Research and development expense includes salaries, non-capitalized equipment, software, software tools, and depreciation from capital equipment. Research and development expense increased by $447 to $1,686 for the quarter ended March 31, 2003 compared to $1,239 for the quarter ended March 31, 2002. Eighty-one percent of the cost increase is the result of the acquisition of NetOctave. The balance is the result of the return to full salary following the completion of the special option program discussed in Part I, Item 1, Footnote 7 of the 10Q filed with the SEC for quarter ending December 31, 2001. As a percentage of total revenue, research and development expense decreased to 19.5% for the quarter ended March 31, 2003 from 19.7% for the quarter ended March 31, 2002. The lower percentage is primarily the result of an increase in revenues.

We expect to increase our research and development costs in total dollars to enhance and expand our current product offerings and develop new products. We plan to continue to make the necessary investment in research and development to keep our products at a competitive advantage.

Selling, general and administrative expense includes salaries, commissions, costs associated with the executive, human resource, finance and administrative support functions, and legal and accounting professional services. Selling, general and administrative expense increased by $838 to $3,917 for the quarter ended March 31, 2003 from $3,079 for the quarter ended March 31, 2002.

The increase in selling, general and administrative expenses for the quarter ended March 31, 2003, of $838 is primarily attributable to increases in labor costs which accounts for 58% of the increase. This would include sales training, marketing, inside sales staff and expansion of personnel within our US Government sales force. Other cost increases included higher expenditures related to advertising and co-operative marketing.

Total other income increased $10 for the quarter ended March 31, 2003 to $6 compared to an expense of $4 for the quarter ended March 31, 2002.

The Company recorded an income tax benefit of $4,169 as of March 31, 2003, primarily as a result of the reversal of a portion of the deferred tax asset valuation allowance. The reversal of the allowance was made because we believe it is more likely than not that the US Net operating loss carryforwards deferred tax asset will be realized to the extent of the $4,169 tax benefit recorded. Our basis that it is more likely than not is our positive current financial results both in the US and on a consolidated basis, and our future US projections through the end of fiscal year 2005. The company s current projection reflects approximately $11.5 million in US taxable income from normal and recurring operations through the end of fiscal year 2005. This projection of $11.5 million is the minimum amount of future US taxable income that would have to be generated to realize the $4,169 deferred tax asset. Our

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current level of pretax earnings for financial reporting purposes would be sufficient to generate that minimum amount of US taxable income that would have to be generated through the end of fiscal year 2005. Our projection is based on continued growth in the business at market growth rates and maintaining operating margins in the US of approximately 15 to 20% through the end of fiscal year 2005. Our projections do not include significant improvement in gross margins or cost reductions. The Company s net operating loss carryforwards begin to expire in 2010.

We believe this is a conservative approach in determining the deferred tax asset that may be realized. The risk factors discussed in Part II, Item 7 of Form 10K for the fiscal year ended June 30, 2002 could adversely affect our ability to generate future taxable income, thereby also adversely impacting our ability to realize the deferred tax asset. We will continue to evaluate each quarter the amount, if any, of additional reduction of the valuation allowance that should be made. This will be based on management s estimate and conclusions regarding the ultimate realization of the deferred tax asset, including but not limited to, the company s recent positive financial results as well as projected earnings over a two-year period. These projections are based upon products currently being sold and markets that currently produce sales. The impact of further reductions of the valuation allowance will be to record a tax benefit, which will increase net income in the period the determination is made.

The factors which we will consider in evaluating when, and if, it would be appropriate to reverse the entire valuation allowance would include: the sufficient passage of time in which we have achieved our projections and utilized the tax net operating loss carryforwards as planned, changes in the industry, our product life-cycle, profitability trends, and tax law changes.

Net income for the quarter ended March 31, 2003 was $5,148 compared to net income of $81 for the quarter ended March 31, 2002. The increase is due primarily to the reversal of a portion of the deferred tax valuation allowance.

The nine-month period ended March 31, 2003 compared to the nine-month period ended March 31, 2002

Net Revenues

Net revenues consist primarily of the network security products and maintenance contracts related to these products. For the nine-month period ended March 31, 2003, net revenues increased by $7,357 to $23,976 compared to $16,619 for the nine-month period ended March 31, 2002. The increase was comprised of an increase in product sales of $5,320 and services of $2,037. International revenue represented approximately 49% of total revenues for the nine-month period ended March 31, 2003 compared to approximately 61% for the nine-month period ended March 31, 2002.

The increase in revenues for the nine-month period ended March 31, 2003 is attributable to several key factors:

- New channel partner revenue contribution
- Strong government purchases, particularly in the US market
- Continued development and contribution from the Europe, Middle East and Africa region
- More seasoned sales force

All three worldwide regions experienced significant product revenue growth during the nine-month period ended March 31, 2003. Network security product revenue accounted for 70% of revenue during the nine-month period ended March 31, 2003 compared to 69% of revenues during the nine-month period ended March 31, 2002.

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Service revenue includes maintenance contracts related to new product sales, renewal maintenance contracts for products previously deployed, training and consulting services. Revenue from maintenance contracts represented 91% of service revenue for the nine-month period ended March 31, 2003 and 89% of service revenue for the nine-month period ended March 31, 2002. Support services for network security products accounted for 30% of revenues during the nine-month period ended March 31, 2003 compared to 31% of revenues during the quarter ended March 31, 2002. The increase in service revenue corresponds to the growth in the Company s customer base and its timing of renewal maintenance.

Gross Profit

Gross profit as a percentage of revenues increased to 75% for the nine-month period ended March 31, 2003 compared to 72% for the nine-month period ended March 31, 2002. This increase reflects lower components cost for the past twelve months. In addition, service revenue increased because of a growing customer base while service costs grew at a slower rate than revenue.

The Company s gross margin has been, and will continue to be, affected by a variety of factors including, competition, the mix and average selling prices of products, new product introductions and enhancements, and the fluctuations in manufacturing volumes. We must continue to manage each of these factors effectively for our gross margins to remain at their current level.

Operating Expenses, Other Income and Expense and Net Income

Research and development expense includes salaries, non-capitalized equipment, software, software tools, and depreciation from capital equipment. Research and development expense increased by $343 to $3,941 for the nine-month period ended March 31, 2003 compared to $3,598 for the nine-month period ended March 31, 2002. The increase is primarily the result of additional labor related expenses, including NetOctave staff, 90% of whom are product engineers. The return to full salary following the completion of the special option program discussed in Part I, Item 1, Footnote 7 of the 10Q filed with the SEC for quarter ending December 31, 2001, also contributed toward an increase in labor related expenses. Capitalized software costs for the nine-month period ended March 31, 2003 were $179 compared to $172 for the nine-month period ended March 31, 2002. As a percentage of total revenue, research and development expense decreased to 16.4% for the nine-month period ended March 31, 2003 from 21.6% for the nine-month period ended March 31, 2002. The lower percentage is primarily the result of an increase in revenues.

We expect to increase our research and development costs in total dollars to enhance and expand our current product offerings and develop new products. We plan to continue to make the necessary investment in research and development to keep our products at a competitive advantage.

Selling, general and administrative expense includes salaries, commissions, costs associated with the executive, human resource, finance and administrative support functions, and legal and accounting professional services. Selling, general and administrative expense increased by $1,748 to $10,782 for the nine-month period ended March 31, 2003 from $9,034 for the nine-month period ended March 31, 2002.

The increase in selling, general and administrative expenses for the nine-month period ended March 31, 2003, of $1,748 is attributable to increased headcount for sales training, marketing and inside sales staff, expansion of personnel within our US Government sales force and severance costs related to employee termination in the Europe, Middle East and Africa region. Other cost increases included higher expenditures related to advertising and co-operative marketing.

Total other income increased $133 for the nine-month period ended March 31, 2003 to $127 compared to an expense of $6 for the nine-month period ended March 31, 2002. The increase in other

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income is due primarily to a foreign currency gain of $75 for the nine-month period ended March 31, 2003, compared to a foreign currency loss of $29 for the nine-month period ended March 31, 2002. Net interest income increased to $85 for the nine-month period ended March 31, 2003 from $40 for the nine-month period ended March 31, 2002.

The Company recorded an income tax benefit of $4,169 as of March 31, 2003, primarily as a result of the reversal of a portion of the deferred tax asset valuation allowance. The reversal of the allowance was made because the Company believes it is more likely than not that this portion of the deferred tax asset will be realized. The computation of our deferred tax asset and valuation allowance is based on taxable income we expect to earn over the next two years which will include the utilization of previously accumulated net operating tax losses. We believe this is a conservative approach in determining the deferred tax asset that may be realized. The risk factors discussed in Part II, Item 7 of Form 10K for the fiscal year ended June 30, 2002 could adversely affect our ability to generate future taxable income, thereby also adversely impacting our ability to realize the deferred tax asset. We will continue to evaluate each quarter the amount, if any, of additional reduction of the valuation allowance that should be made. This will be based on management s estimate and conclusions regarding the ultimate realization of the deferred tax asset, including but not limited to, the company s recent positive financial results as well as projected earnings over a two-year period. These projections are based upon products currently being sold and markets that currently produce sales. The impact of further reductions of the valuation allowance will be to record a tax benefit, which will increase net income in the period the determination is made.

The factors which we will consider in evaluating when, and if, it would be appropriate to reverse the entire valuation allowance would include: the sufficient passage of time in which we have achieved our projections and utilized the tax net operating loss carryforwards as planned, changes in the industry, our product life-cycle, profitability trends, and tax law changes.

Net income for the nine-month period ended March 31, 2003 was $7,588 compared to a net loss of $717 for the nine-month period ended March 31, 2002. The increase is due primarily to the reversal of a portion of the deferred tax valuation allowance.

Liquidity and Capital Resources

At March 31, 2003, the Company had cash and cash equivalents on hand of $10,538 representing an increase of $4,372 from $6,166 as of June 30, 2002. Net cash provided by operating activities during the nine-month period ended March 31, 2003 of $3,714 was primarily attributable to net income from operations of $7,588 combined with increases in accounts payable, accrued expenses and deferred revenue, offset by a deferred tax benefit of $4,249, an increase in accounts receivable, other current assets and inventory. Net cash used in investing activities during the nine-month period ended March 31, 2003 of $794 related to the acquisition of certain assets of NetOctave, the purchase of property and equipment and the capitalization of software costs. Cash provided by financing activities during the nine-month period ended March 31, 2003 reflects the proceeds from stock options exercised and purchases made through the Company s Employee Stock Purchase Plan, net of repayments on a note payable.

The Company s principal sources of liquidity at March 31, 2003, consisted of cash, accounts receivable, and vendor trade credit.

We believe our existing cash; cash equivalents and short-term investments will be sufficient to meet our cash requirements at least through the next twelve months. However, we may be required or could elect to seek additional funding prior to that time. Our future capital requirements will depend on many

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factors, including our rate of revenue growth, the timing and extent of spending on support, product development efforts, expansion of sales and marketing, the timing of introductions of new products and enhancement to existing products, and market acceptance of our products. Other recent and possible future events that could also materially impact the Company s ability to successfully execute on its business plans are described in Information Relating to Forward Looking Statements of this Item on Form 10-Q. We are not aware of any known demands, commitments, events or uncertainties that will result or that are reasonably likely to result in our liquidity increasing or decreasing in a material way.

We have no other agreements or arrangements for third parties to provide us with sources of liquidity and capital resources, including off balance sheet arrangements.

CRITICAL ACCOUNTING POLICIES

Our discussion and analysis of financial conditions and results of operations is based on our consolidated financial statements, which have been prepared in accordance with generally accepted accounting principles in the United States. The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the amounts reported in the consolidated financial statements and accompanying notes. On an on-going basis, we evaluate significant estimates used in preparing our financial statements, including revenue recognition, bad debt, software development cost, inventory valuation, and reserve for deferred taxes. We based our estimates on historical experience and various other assumptions that we believe to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying value of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions.

We believe the following critical accounting policies affect the more significant judgments and estimates used in preparing our consolidated financial statements:

Revenue Recognition

Revenue recognition rules for software companies are very complex. CyberGuard follows very specific and detailed guidelines in measuring revenue; however, certain judgments affect the application of our revenue policy. The discretion involved in this process makes revenue results difficult to predict, and any shortfall in revenue or delay in recognizing revenue could cause our operating results to vary significantly from quarter to quarter and could result in future operating losses.

Our revenue is derived from two primary sources:

(i) Product revenues which includes revenue from our firewall/VPN appliance, and

(ii) Service revenue, which is primarily maintenance, which provides for customer support.

Revenues from product sales are recognized only when a contract or agreement has been executed, delivery of the product has occurred, the fee is fixed and determinable and we believe collection is probable. Product revenue is generally recognized on product shipment; this includes the transfer of both title and risk of loss, provided that no significant obligations remain. There is no product right of return available to the customer. We defer revenues on product sales for new value added resellers where we are unable to determine the ability of the reseller to honor a commitment to make fixed or determinable payment. Revenue will be deferred until the resellers demonstrate consistency of payment within terms and there are no product returns for a three-month period. For the quarter ended March 31, 2003, two resellers were reclassified from cash basis to accrual. During the nine months ended March 31, 2003, fifteen (15) resellers, net, were changed from cash basis to accrual, based on a reasonable assurance of collectibility from

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evaluating their payment histories and no product returns. The impact of the reclassification did not have a material effect on revenue.

Service revenues consist primarily of the annual fee for maintenance (post-contract customer support) and maintenance renewals from our existing customers and are recognized ratably on a monthly basis over the service contract term. These services provide our customers access to our worldwide support organization for technical support, unspecified product updates/enhancements on a when and if available basis and general security information with the exception of certain product sales that are sold with annual maintenance (for which vendor-specific objective evidence of fair value exists). The Company does not have any transactions with multiple elements/arrangements. All products and services are separately contracted.

The Company also provides other professional support services, such as training and consulting, which are available under service agreements and charged for separately. These services are generally provided under time and materials contracts and revenue is recognized as the service is provided.

Bad Debts

We maintain allowances for doubtful accounts for estimated losses resulting from the inability of our customers to make required payments. Significant judgment is required when we assess the ultimate realization of receivables, including the probability of collection and the credit-worthiness of each customer. In estimating the allowance for doubtful accounts, we analyze our accounts receivable aging, historical bad debts, customer credit-worthiness, current economic trends and other factors. If the financial condition of our customers were to deteriorate, resulting in an impairment of their ability to make payments, additional allowance might be required.

Software Development Costs

The Company capitalizes costs on a product by product basis related to the development of certain software products in accordance with Statement of Financial Accounting Standards No. 86, Accounting For the Costs of Computer Software to be Sold, Leased, or Otherwise Marketed (SFAS No. 86) which requires capitalization to begin when technological feasibility has been established and ends when the product is available for general release to customers. Software development costs incurred prior to technological feasibility, defined by implementation of a beta project, are considered research and development costs and are expensed as incurred. Capitalized costs are amortized on a straight-line method over the remaining estimated economic life of the product, which we estimate to be two years, which reflects the rapid changes in security software. Amortization starts when the product is available for general release to customers. Unamortized capitalized software cost is evaluated at each balance sheet date and compared to the net realizable value. Any excess capitalized cost above net realizable value will be written off. No such impairment existed at March 31, 2003.

Inventory Valuation

Inventories consist primarily of component parts and computer hardware and are carried at the lower of cost, determined by the First-In-First-Out (FIFO) method, or market. We write our inventories down to estimated market value based on assumptions of our future demand, based on projected product releases and market conditions. Variation in market trends, customer preferences, introduction of new products (replacing existing products) or technological advances could, however, significantly affect these estimates and result in additional inventory write-downs.

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Deferred Taxes

The Company recorded an income tax benefit of $4,169 as of March 31, 2003, primarily as a result of the reversal of a portion of the deferred tax asset valuation allowance. The reversal of the allowance was made because we believe it is more likely than not that the US Net operating loss carryforwards deferred tax asset will be realized to the extent of the $4,169 tax benefit recorded. Our basis that it is more likely than not is our positive current financial results both in the US and on a consolidated basis, and our future US projections through the end of fiscal year 2005. The company s current projection reflects approximately $11.5 million in US taxable income from normal and recurring operations through the end of fiscal year 2005. This projection of $11.5 million is the minimum amount of future US taxable income that would have to be generated to realize the $4,169 deferred tax asset. Our current level of pretax earnings for financial reporting purposes would be sufficient to generate that minimum amount of US taxable income that would have to be generated through the end of fiscal year 2005. Our projection is based on continued growth in the business at market growth rates and maintaining operating margins in the US of approximately 15 to 20% through the end of fiscal year 2005. Our projections do not include significant improvement in gross margins or cost reductions. The Company s net operating loss carryforwards begin to expire in 2010.

The factors which we will consider in evaluating when, and if, it would be appropriate to reverse the entire valuation allowance would include: the sufficient passage of time in which we have achieved our projections and utilized the tax net operating loss carryforwards as planned, changes in the industry, our product life-cycle, profitability trends, and tax law changes.

Information Relating to Forward Looking Statements

Statements regarding future products, prospects, profitability, business plans and strategies, future revenues and revenue sources, future liquidity and capital resources, future computer network security market directions, future acceptance of the Company s products and possible growth in markets, as well as all other statements contained in this Report on Form 10-Q that are not purely historical are forward-looking statements.

Forward-looking statements are based upon assumptions and analyses made by the Company in light of current conditions, future developments and other factors the Company believes are appropriate in the circumstances, or information obtained from third parties and are subject to a number of assumptions, risks and uncertainties. Readers are cautioned that forward-looking statements are not guarantees of future performance and that the actual results might differ materially from those suggested or projected in the forward-looking statements. Accordingly, there can be no assurance that the forward-looking statements will occur or that results will not vary significantly from those described in the forward-looking statements. Some of the factors that might cause future actual events to differ from those predicted or assumed include: future advances in technologies and computer security; the Company s history of annual net operating losses and the financing of these losses through the sale of assets and newly issued Company securities; the Company s ability to execute on its business plans; the Company s dependence on outside parties such as its key customers and alliance partners; competition from major computer hardware, software, and networking companies; risk and expense of government regulation and effects on changes in regulation; the limited experience of the Company in marketing its products; uncertainties associated with product performance liability; risks associated with growth and expansion; global economic conditions, overall network security spending, risks associated with obtaining and maintaining patent and intellectual property right protection, uncertainties in availability of expansion capital in the future and other risks associated with capital markets, including the events of September 11, 2001 and its repercussions. In addition, certain events that have occurred also are factors that might cause future actual events to differ from those predicted or assumed, including: the impact of the restatement of financial results for the Company s fiscal year ended June 30, 1997 and quarters ended

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September 30, 1997, December 31, 1997 and March 31, 1998; the completion of the numerous organizational changes and the assembly of a new management team for CyberGuard; the outcome of a class action lawsuit against the Company relating to the restatement of financial results for the fiscal periods noted above. In addition, the forward-looking statements herein involve assumptions, risks and uncertainties, including, but not limited to economic, competitive, operational, management, governmental, regulatory, litigation and technological factors affecting the Company s operations, liquidity, capital resources, markets, strategies, products, prices and other factors discussed elsewhere herein and in the other documents filed by the Company with the Securities and Exchange Commission. Many of the foregoing factors are beyond the Company s control.

The Company s future success is based largely on its ability to develop and sell increasingly technologically advanced network security solutions in sufficient volume and at sufficient prices to become profitable on a consistent basis. In addition, the network security market is characterized by extremely rapid technological change, requiring rapid product development. The velocity of technological change has accelerated, and the Company believes that it is important to its future that it keeps pace with these changes. The Company believes that competition will continue to intensify in the rapidly evolving markets in which the Company is involved, and that the continued development of technologically advanced products will be necessary to keep our products current. The Company believes that its ability to generate adequate cash flow from operations will be critical to its future.

Item 3. Quantitative and Qualitative Disclosures Concerning Market Risk

We have limited exposure to financial market risks, including changes in interest rates. The fair value of our investments or related income would not be significantly impacted by a 100 basis point increase or decrease in interest rates due mainly to the short-term nature of the major portion of our investments. A fluctuation in interest rates would not significantly affect interest expense on debt obligations since a significant portion of the debt obligation is at a fixed rate of interest.

The Company uses the U.S. Dollar as its reporting currency for financial statement purposes. The Company conducts business in numerous countries around the world through its European subsidiary that uses the local currency to denominate its transactions. Therefore, the Company is subject to certain risks associated with fluctuating foreign currencies.

Due to the long-term nature of the Company s investment in this subsidiary, the translation adjustments resulting from these exchange rate fluctuations are excluded from the results of operations and recorded in a separate component of consolidated stockholders equity. The Company monitors its currency exposure but does not hedge its translation exposure due to the high economic costs of such a program and the long-term nature of its investment in its European subsidiary.

Item 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

Within the 90 days prior to the date of filing this Quarterly Report on Form 10-Q, the Company carried out an evaluation, under the supervision and with the assistance of the Chief Executive Officer (CEO), the Chief Financial Officer (CFO), the Company s Disclosure Control Procedures Committee, and Company management, of the effectiveness of the design and operation of the Company s disclosure controls and procedures pursuant to Exchange Act Rule 13a-14. This evaluation also considered the proposed amendments to Rule 13a-14 described in Securities and Exchange Commission Release Nos. 33-8183 and 34-46701. Based upon that evaluation, the Chief Executive

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Officer and the Chief Financial Officer concluded that the Company s disclosure controls and procedures are effective in timely alerting them to material information relating to the Company (including its consolidated subsidiaries) required to be included in the Company s periodic SEC filings. There have been no significant changes in the Company s internal controls or in other factors that could significantly affect internal controls subsequent to the date of the evaluation.

Limitations on the Effectiveness of Controls

The Company maintains a system of internal accounting controls to provide reasonable assurance that assets are safeguarded and that transactions are executed in accordance with management s authorization and recorded properly to permit the preparation of financial statements in accordance with generally accepted accounting principles. We have designed our disclosure controls procedures to provide a reasonable level of assurance of reaching our desired disclosure control objectives. We believe our disclosure controls and procedures are effective in reaching that level of reasonable assurance. However, the Company s management, including the CEO and CFO, does not expect that the Company s disclosure controls or internal controls will prevent all errors and all potential fraud. A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within the Company have been detected. These inherent limitations include the realities that judgments in decision-making can be faulty, and that breakdowns can occur because of a simple error or mistake. Additionally, controls can be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the controls. The design of any system of controls also is based in part upon certain assumptions about the likelihood of future events, and there can be no absolute assurance that any design will succeed in achieving its stated goals under all potential future conditions. Because of the inherent limitations in a cost-effective control system, misstatements due to error or fraud may occur and not be detected.

PART II: OTHER INFORMATION

Item 1. Legal Proceedings

Litigation

On August 24, 1998, the Company announced, among other things, that due to a review of its revenue recognition practices relating to distributors and resellers, it would restate prior financial results. After the August 24, 1998 announcement, twenty-five purported class action lawsuits were filed by alleged shareholders against the Company and certain former officers and directors. Pursuant to an order issued by the Court, these actions have been consolidated into one action, styled Stephen Cheney, et al. v. CyberGuard Corporation, et al., Case No. 98-6879-CIV-Gold, in the United States District Court, Southern District of Florida. On August 23, 1999, the plaintiffs filed a Consolidated and Amended Class Action Complaint. This action seeks damages purportedly on behalf of all persons who purchased or otherwise acquired the Company s common stock during various periods from November 7, 1996 through August 24, 1998. The complaint alleges, among other things, that as a result of accounting irregularities relating to the Company s revenue recognition policies, the Company s previously issued financial statements were materially false and misleading and that the defendants knowingly or recklessly published these financial statements which caused the Company s common stock prices to rise artificially. The action alleges violations of Section 10(b) of the Securities Exchange Act of 1934

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(Exchange Act) and SEC Rule 10b-5 promulgated thereunder and Section 20(a) of the Exchange Act. Subsequently, the defendants, including the Company, filed their respective motions to dismiss the Consolidated and Amended Class Action Complaint. On July 31, 2000, the Court issued a ruling denying the Company s and Robert L. Carberry s (the Company s CEO from June 1996 through August 1998) motions to dismiss. The court granted the motions to dismiss with prejudice for defendants William D. Murray (the Company s CFO from November 1997 through August 1998), Patrick O. Wheeler (the Company s CFO from April 1996 through October 1997), C. Shelton James (the Company s former Audit Committee Chairman), and KPMG Peat Marwick LLP (KPMG). On August 14, 2000, the plaintiffs filed a motion for reconsideration of that order. The Company filed an answer to the plaintiffs Consolidated and Amended Class Action Complaint on August 24, 2000. On March 20, 2001, the Court ruled on the plaintiffs motion for reconsideration that the previously dismissed defendants William D. Murray, Patrick O. Wheeler and C. Shelton James should not have been dismissed from the action and shall be defendants in this action under the control person liability claims under Section 20(a) of the Exchange Act, and that the plaintiffs may amend the Consolidated and Amended Class Action Complaint to bring claims against C. Shelton James under Section 10(b) of the Exchange Act and Rule 10b-5 promulgated thereunder. On April 5, 2001, the plaintiffs filed their Second Consolidated and Amended Class Action Complaint to include amended claims against C. Shelton James. On May 10, 2001, the Company filed an answer and affirmative defenses to plaintiffs Second Consolidated and Amended Class Action Complaint. On August 14, 2002, the Court granted the plaintiffs Motion for Class Certification and certified the class to include all investors who acquired the Company s common stock between November 7, 1996 and August 24, 1998 and were damaged by the purchase of such stock. The trial is scheduled for March 2004. The parties are currently conducting discovery.

The Company s obligation to indemnify its officers and directors under the aforementioned lawsuit is insured to the extent of the limits of the applicable insurance policies. The Company has notified its insurance carrier of the existence of the lawsuit, and the carrier has sent the Company a reservation of rights letter. The Company intends to vigorously defend this action, and believes that in the event that it is unsuccessful, insurance coverage will be available to defray a portion, or substantially all, of the expense of defending and settling the lawsuit or paying a judgment. However, the Company is unable to predict the ultimate outcome of the litigation. There can be no assurance that the Company will be successful in defending the lawsuit or, if unsuccessful, that insurance will be available to pay all or any portion of the expense of the lawsuit. If the Company is unsuccessful in defending the lawsuit and the insurance coverage is unavailable or insufficient, the resolution of the lawsuit could have a material adverse effect on the Company s consolidated financial position, results of operations, and cash flows. The Company s consolidated financial statements do not include any adjustments related to these matters. We are unable at this time to estimate the loss, if any, that the Company may incur if we are unsuccessful in defending this suit.

On September 16, 1999, the Company filed a lawsuit against KPMG and August A. Smith, the KPMG engagement partner. The lawsuit was in the Circuit Court of the 17th Judicial Circuit in and for Broward County, Case No. 00-004102-CACE-14. On May 1, 2000, the Company filed the First Amended Complaint, alleging that KPMG failed to properly audit the Company s financial statements and provided inaccurate advice on accounting matters for fiscal years 1996, 1997 and 1998. The action alleges professional malpractice, breach of fiduciary duty, breach of contract and breach of implied duty of good faith, and seeks damages in excess of $10 million. KPMG and Mr. Smith filed motions to dismiss, which were denied. In August 2000, KPMG and Mr. Smith filed their answers and KPMG filed counterclaims against the Company, alleging the Company s breach of contract, negligent misrepresentation and abuse of process, and seeking an unspecified amount of damages consisting of unpaid service fees and legal fees and costs. The Company filed an answer to KPMG s counterclaims and moved to dismiss KPMG s abuse of process counterclaim. On April 9, 2001, the Court dismissed the abuse of process counterclaim with prejudice. On February 13, 2003, the parties settled the lawsuit with the only consideration being the

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exchange of mutual releases from liability.

On November 14, 2002, the Company filed a lawsuit against Data Return Corporation in the United States District Court of the Northern District of Texas, alleging breach of contract, and seeking, among other remedies, damages of approximately $4 million. On December 9, 2002, Data Return Corporation filed an answer and affirmative defenses, and also counterclaims against the Company, alleging breach of contract, breach of warranty, fraud, negligent misrepresentation and deceptive trade practices, and seeking unspecified damages. On December 30, 2002, CyberGuard filed its answer and affirmative defenses to the counterclaim and a motion to dismiss the fraud, negligent misrepresentation and deceptive trade practices counterclaims. In February 2003, the Company learned that Data Return Corporation filed for bankruptcy protection under Chapter 11 in the United States Bankruptcy Court, District of Massachusetts. At this time, it is impossible to determine whether the Company will be able to recover any amounts from Data Return Corporation even if the Company is successful in pursuing its claims.

The Company is involved from time to time, in the ordinary course of its business, in litigation relating to the conduct of its business. The Company believes that these other litigation matters will not have a material adverse effect on its consolidated financial position, results of operations or cash flows.

Item 2. Changes in Securities and Use of Proceeds

None

Item 3. Defaults upon Senior Securities

None

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

None.

Item 5. Other Information

Richard L. Scott resigned from the Board of Directors on March 4, 2003. On April 23, 2003, Kenneth C. Jenne II, was appointed to the Board of Directors.

Item 6. Exhibits and Reports on Form 8-K

(a) Exhibits:

Exhibit No.	Exhibit Description
2.1	Asset Purchase Agreement dated January 22, 2003 by and between NetOctave, Inc. and CyberGuard Corporation (1)
99.01	Certification by Scott J. Hammack, Chief Executive Officer, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
99.02	Certification by Michael D. Matte, Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

(b) Reports filed on Form 8-K during the quarter ended March 31, 2003:

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During the quarter ended March 31, 2003, the Company filed two Current Reports on Form 8-K: on January 27, 2003, Item 5 and on March 13, 2003, Item 2. Both reports were filed in connection with the Company s acquisition of certain assets of NetOctave, Inc.

(1) Incorporated herein by reference from the Form 8-K dated March 4, 2003 and filed with the SEC on March 13, 2003.

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SIGNATURES

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

Date: July 11, 2003	CyberGuard Corporation	
	By:	/s/ Scott J. Hammack
		Chairman and Chief Executive Officer
	By:	/s/ Michael D. Matte
		Vice President of Finance and Chief Financial Officer
		(Principal Financial and Accounting Officer)

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CERTIFICATIONS

I, Scott J. Hammack, certify that:

1. I have reviewed this quarterly report on Form 10-Q for CyberGuard Corporation;

2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;

3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report;

4. The registrant s other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and we have:

a) Designed such disclosure controls and procedures to ensure the material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;

b) Evaluated the effectiveness of the registrant s disclosure controls and procedures as of a date within 90 days prior to the filing date of this quarterly report (the Evaluation Date); and

c) Presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;

5. The registrant s other certifying officers and I have disclosed, based on our most recent evaluation, to the registrant s auditors and the audit committee of registrant s board of directors (or persons performing the equivalent function):

a) All significant deficiencies in the design or operation of internal controls which could adversely affect the registrant s ability to record, process, summarize and report financial data and have identified for the registrant s auditors any material weaknesses in internal controls; and

b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant s internal controls; and

6. The registrant s other certifying officers and I have indicated in this quarterly report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Date: July 11, 2003

/s/ SCOTT J. HAMMACK

Scott J. Hammack

Chief Executive Officer

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I, Michael D. Matte, certify that:

1. I have reviewed this quarterly report on Form 10-Q for CyberGuard Corporation;

2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;

3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report;

4. The registrant s other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and we have:

a) Designed such disclosure controls and procedures to ensure the material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;

b) Evaluated the effectiveness of the registrant s disclosure controls and procedures as of a date within 90 days prior to the filing date of this quarterly report (the Evaluation Date); and

c) Presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;

5. The registrant s other certifying officers and I have disclosed, based on our most recent evaluation, to the registrant s auditors and the audit committee of registrant s board of directors (or persons performing the equivalent function):

a) All significant deficiencies in the design or operation of internal controls which could adversely affect the registrant s ability to record, process, summarize and report financial data and have identified for the registrant s auditors any material weaknesses in internal controls; and

b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant s internal controls; and

6. The registrant s other certifying officers and I have indicated in this quarterly report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Date: July 11, 2003

/s/ MICHAEL D. MATTE

Michael D. Matte

Chief Financial Officer

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Exhibit Index

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