CYBERGUARD CORP
Form 10-K/A
October 23, 2003
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SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K/A

AMENDMENT No. 1

FOR ANNUAL AND TRANSITION REPORTS

PURSUANT TO SECTIONS 13 OR 15(d) OF THE

SECURITIES EXCHANGE ACT OF 1934

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

For the fiscal year ended June 30, 2003

OR

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

Commission File Number 0-24544

CYBERGUARD CORPORATION

(Exact Name of Registrant as Specified in its Charter)

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

Registrant s telephone number, including area code: (954) 958-3900

Securities Registered Pursuant to Section 12(b) of the Act:

None

Securities Registered Pursuant to Section 12(g) of the Act:

Common Stock, par value $.01 per share

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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of Registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. ¨

Indicate by check mark whether the registrant is an accelerated filer (as defined in Exchange Act Rule 12b-2). Yes x No ¨

State the aggregate market value of the voting and non-voting common equity held by non-affiliates computed by reference to the price at which the common equity was last sold, or the average bid and asked price of such common equity, as of the last business day of the registrant s most recently completed second fiscal quarter: $77,383,165.

As of August 27, 2003, 21,392,058 shares of the Registrant s Common Stock, par value $.01 per share were issued and outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

Definitive Proxy Statement for the Registrant s 2003 Annual Meeting of Shareholders (incorporated in Part III to the extent provided in Items 10, 11, 12, 13, and 14 hereof).

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PART I

ITEM 1. BUSINESS

Overview

We develop, market and support a broad family of integrated internet security solutions. Our security appliance solutions include key security technology such as firewalls and Virtual Private Networking (VPN). Our appliances are built upon a highly secure operating system and proprietary software designed to identify network and application attacks and prevent them from reaching mission-critical resources. Our firewall technology combines stateful packet inspection and application proxy to deliver the highest level of security and performance for an enterprise s network. We believe that our ability to inspect each packet of network traffic at the application layer provides some of the highest levels of protection.

The rise in vulnerabilities of security products potentially provides ways for hackers to compromise enterprises networks and applications. Our highly secure appliance combines multi-gigabit performance and centralized management and provides the Company a key differentiator with current and potential customers.

Our target customers are large enterprises, including Global 2000 companies, major financial institutions and government entities worldwide. Our appliances are sold to end-users directly and indirectly by a direct sales force and resellers in the United States and in over 30 foreign countries.

We were incorporated in 1994 in connection with a spin-off from Harris Corporation. At that time, we produced computers for the real-time computing market as well as our firewall for the secure computing market. We changed our name from Harris Computer Systems Corporation in June 1996 following the sale of our real-time computer business. The Company has two subsidiaries, CyberGuard Europe Ltd. and CYBG Consultant, Inc. CyberGuard Europe Ltd. serves as our United Kingdom Sales and marketing office and Europe, Middle East and Africa distribution point. CYBG Consultant, Inc. is a dormant company and is in the process of being dissolved.

Industry Background

Increase in internet Usage and Security Attacks

Large enterprises and government entities increasingly communicate with their partners, suppliers, employees and customers over the internet. As the amount of information delivered over or accessible through the internet continues to expand, maintaining security of sensitive data and confidential communications is increasingly essential. In recent years, the frequency and severity of attempted breaches of network security has been increasing, and, in many instances, the vulnerabilities have been in the existing security infrastructure set in place to protect the networks and applications. According to the 2003 CSI/FBI Computer Crime and Security Survey, 56% of the respondents reported unauthorized use of their networks or applications. Additionally, the surveys found that only 30% of those who suffered serious attacks reported them to law enforcement.

Security attacks are becoming not only more prevalent but also more sophisticated and severe. This is a consequence, in part, of the availability of tools and information outlining how to make these attacks, an increase in the number of connections that are vulnerable to attack, and an increase in the overall amount of confidential information accessible through or delivered over the internet. The new breed of attacks directly targets applications, often attempting to exploit vulnerabilities inherent in the applications themselves or in the underlying communications protocols. A recent example of this trend is the SQL Slammer worm that struck in early 2003, demonstrating that application level protection is still not widely deployed. According to the Gartner Group, a leading technology research firm, over 70% of web attacks occurs at the application layer. By targeting applications directly, hackers generally attempt to achieve one of the following goals:

- denying service to legitimate users (denial-of-service attacks);
- gaining administrator access to servers and clients;
- gaining access to back-end databases;
- installing Trojan horse software that bypasses security and enables access to applications; and
- installing software on a server that runs in sniffer mode and captures user identifications and passwords.

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According to the Yankee Group, a leading communications and networking research firm, the web application security market is expected to be a $1.7 billion market in 2007, up from $140 million in 2002, reflecting a compound annual growth rate of 65%. Modern technologies require that security solutions have a much more intimate level of knowledge of applications. Emerging applications utilizing XML and Simple Object Access Protocol (SOAP) require web application layer security solutions to monitor the content of packets at wire-speed.

Preventing Attacks with Firewalls and Secure Virtual Private Networks

To protect network security breaches, governments and enterprises are deploying firewalls at their perimeter where their networks connect to the internet or other networks. Firewalls help prevent unauthorized network access by establishing a perimeter defense between two networks, such as an enterprise s network and the internet. Firewalls are software-based or hardware-based products that enable users to establish security policies designed to permit only authorized traffic into and out of a connected network. Additionally, government entities and enterprises are seeking to save time and decrease costs by using existing networks, such as the internet, to create VPNs in lieu of private, dedicated communications networks and dial-up remote access networks. VPNs allow access to an internal network through the internet and are deployed by creating links, referred to as tunnels, running over a public network to connect two or more locations. IDC, a leading technology and telecommunications research firm, estimates the firewall and VPN market was in excess of 1 billion in 2001 and expects it to grow to $3.77 billion in 2006, a compound annual growth rate of approximately 24%. The Gartner Group estimates that the overall firewall and VPN equipment market grew by over 27% in 2002 from 2001. Additionally, according to the Gartner Group, the markets that serve mid-size and large enterprises grew the fastest, 27.1% and 39.8%, respectively, from 2001 to 2002.

There are three basic types of firewall technologies: packet filtering, stateful packet inspection and application proxy.

Packet filtering firewalls control access to a network by analyzing the incoming and outgoing packet and allowing the packet to pass or halting the package based on the IP addresses of the source and destination.

Stateful packet inspection firewalls analyze packets at the network layer in order to assess the legitimacy/authenticity of the overall packet. Stateful packet inspection firewalls analyze packet headers to make a decision based on a rule set. The decision to block or allow access is applied to all subsequent packets in the session. This technology can be effective at blocking network-level attacks but leaves servers vulnerable to application layer attacks.

Application proxy firewalls operate at the application layer and inspect both the protocol and the application data. Application proxy firewalls receive data from one computer, inspect it according to a defined rule set, and then if acceptable to the rule set, pass the data to the protected computer. Application proxies look deeper into the packet and can make pass/drop decisions based on the wider range of information in the application protocol headers. Additionally, a connection is never made from the outside to the inside of the network.

Limitations of Existing Security Solutions

We believe many of today s security solutions fail to address a number of key requirements, including the following:

Limited application-level protection. Packet filtering and stateful packet inspection firewalls are able to enforce security policies based on who or what gets to connect to which server or computer. However, the content of the packets allowed through is invisible to these firewalls. They typically look only at header information and, thus, have limited ability to block attacks based on the packet content. Application proxy firewalls overcome this because they look at the packet at the application layer and can look for more specific pieces of information.

Sacrifice performance for security. Historically, the drawback with using the application proxy model has been its slower speed. However, this issue can be addressed by adaptive proxy technology. By combining the merits of both proxy and packet filtering technology, an adaptive proxy firewall works by analyzing the first part of

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a connection at the application layer as a standard proxy firewall does; however, once the firewall has enough information to clear the traffic through the rule set, subsequent packets are filtered through the network layer.

Difficulty of network integration. Many existing security solutions are complicated and require significant configuration before they can effectively be deployed. Enterprises and government entities frequently lack the personnel or expertise to integrate these products into their existing network, resulting in installations that are time consuming and expensive to deploy and manage. Furthermore, implementations of existing solutions may require compromises in network design in ways that reduce reliability and performance.

Difficulties with software-based solutions. Traditionally, enterprises have deployed firewalls and VPNs as software solutions. These solutions have failed to address a number of key network security requirements such as high performance, ease of installation, and ability to block processing-intensive network attacks. Also, software-based firewalls run on personal computers or workstations, which are generally susceptible to hacker attacks.

The CyberGuard Solution

We provide a broad portfolio of network security products that deliver high performance, cost effective security for enterprises and government entities worldwide. Our security appliances deliver integrated firewall and VPN capabilities into a single device and further integrate with third party security solutions such as anti-virus, content filtering and authentication systems. Our appliances are built using a highly secure, hardened operating system and combine stateful packet inspection and application proxy technologies.

Key benefits of our security products include:

Multi-level security. Our security appliances offer multi-level security by combining our highly secure operating system with application-level protection.

> *Highly secure operating system.* Our multi-level security solution treats each layer of the hardened operating system discretely, separating the network from the system levels a unique feature that restricts access to the operating system by would-be hackers.
>
> *Application-level protection.* Our appliances combine a hybrid methodology of stateful packet inspection and application proxies to provide deeper inspection of every packet that traverses the firewall. The application proxies make decisions on the types of data and commands allowed by looking at the application layer of the packet.

High performance appliances. Our high performance firewall/VPN appliances can be deployed in mission-critical environments such as data centers, corporate extranets, major e-commerce web sites and government networks. . Our multi-gigabit firewall/VPN solutions have been deployed in enterprises and government entities worldwide*Ease of implementation and management.* Our appliances are designed to require minimal configuration so that they can be deployed quickly and cost-effectively in a network. Our appliances use industry standard protocols and management interfaces enabling interoperability with a broad range of third-party products. Our products can be configured and managed remotely using industry standard interfaces, including a built in web-based user interface or a command line user interface. In addition, our solutions provide the ability to centrally manage and monitor multiple remote appliances, individually or within groups, from one central station known as the firewall manager.

Low cost of ownership. Our appliances are designed to minimize installation and maintenance costs of security, which allows our customers to limit the expenses of hiring IT personnel required to implement and maintain an effective security solution.

High reliability and availability. Our appliances support an optional high availability configuration that combines two appliances to operate as a single logical unit. If there is a disruption in network connectivity or if the primary appliance fails, the secondary appliance is designed to automatically take over to provide continuous network connectivity. All configuration changes are automatically synchronized between the appliances in the high availability pair. For critical connections, such as those to mission-critical government and e-commerce sites, this high availability configuration minimizes the risk of lost network connectivity. Additionally, to ensure constant availability, our solution offers central management fail-over, a mechanism that allows a back-up firewall manager to take over management duties for the primary firewall manager. The back-up manager can be located anywhere in the world, remote from the primary appliance manager.

Strategy

Our mission is to be a leading supplier of firewall/VPN appliances by delivering the best performing security products and services in the world. We are positioning ourselves to realize this objective with a growth strategy that includes the following elements:

Extend our application-level security capabilities. We intend to enhance our application-level technology through continued internal development. We believe we support one of the broadest sets of application proxies in the industry. We intend to introduce additional application proxies to support voice over internet Protocol (VoIP) communications technology as well as key proxies for XML and SOAP applications. We intend to continue to enhance our support of our existing application proxies to accelerate the performance of our solutions.

Maintain focus on customer service and support. We believe that one of our competitive advantages is our commitment to customer service and support. We intend to continue our focus on satisfying customer needs by providing customized solutions and offering our customers support in solving complex security-related problems. We believe that delivering excellent customer service also provides a source of additional sales leads for our products.

Further penetrate and expand our existing customer base. We intend to leverage our technology, both product and customer service to continue to drive sales to new customers and to further penetrate our existing customers. We have an established customer base of Global 2000 companies and government entities worldwide in which we have developed strong relationships. We intend to generate incremental sales from these relationships by penetrating areas within our existing customers that are not currently using our security solutions. Additionally, we intend to broaden our customer base through the expansion of our sales force and continued enhancement of our channel distribution network.

Heighten our brand awareness and strengthen distribution channels. We intend to continue to expand domestically and internationally through enhanced marketing programs and sales activities designed to strengthen our brand and distribution channels. As part of our education-oriented marketing strategy, we intend to continue to expand our brand-building activities, emphasizing the unique factors and technologies that differentiate us from the competition. Our growing network of value-added resellers and distributors provides us with a key instrument to access new markets and customers while further penetrating our existing customer base. We intend to grow our distribution channels by establishing additional relationships with value-added resellers, system integrators and distributors that sell security solutions to large enterprises and government entities.

Extend our product offerings. We intend to leverage our strength and expertise in firewall/VPN systems to further extend our core technologies and continue to develop new complementary products. We also intend to enhance our firewall/VPN products by adding integrated functions and developing new application proxies. We seek to continue to develop complementary technologies and expect to announce new products in fiscal year 2004. For example, in fall 2003, we intend to begin shipping our next generation central management solution called Global Command Center designed to simplify management of multiple firewalls and VPNs. *Continue to grow our business organically as well as through strategic acquisitions.* We are positioned to benefit from the projected growth in the industry and intend to do so organically by adding additional personnel, particularly in the sales and engineering areas. We also intend to pursue strategic acquisitions that provide additional technology expertise, complementary product offerings, additional geographic reach and new customer opportunities.

Products

Firewall/VPN Products

We produce a line of premium firewall/VPN appliances built on technology that is based on a multi-level secure operating system to handle high-volume, high-bandwidth environments. We believe the use of our firewall/VPN solutions provide our customers with an added layer of security.

Our products include a series of firewall/VPN appliances designed to offer network security solutions by providing the combination of high security, high performance and ease of use for global customers including major banks, financial institutions, corporations and government entities. All of our firewalls are built on our custom, secure operating system. The versatile architecture used in our appliances allows for customers to choose stateful

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packet inspection or application proxies to inspect each and every packet. Our appliances include: SL 3200; KS 1000/1500; FS 250/500 and LX. The following table illustrates the major performance features of our appliances:

Appliance	Sustained Throughput	Simultaneous Connections
SL 3200	Up to 3.2 gbps	Greater than 2 million
KS 1000/1500	1.0 to 1.5 gbps	Greater than 1 million
FS 250/500	250 to 500 mbps	250,000 to 500,000
LX	Up to 150 mbps	Up to 150,000

Our appliances carry a high level of security certifications and offer an integrated solution designed specifically for large enterprises and government entities that require high levels of security. Our appliances contain features to customize a solution for the customer depending on the customer s specific needs and requirements. These features include:

- stateful packet inspection;
- application proxies;
- central management;
- static network address;
- split domain name service;
- link aggregation;
- network time protocol support;
- high availability;
- security auditing and alarms;
- secure remote administration;
- dynamic network address;
- graphical user interface;
- virtual private networking;
- automatic system update; and
- automated audit log archiving.

Global Command Center

Our Global Command Center product is designed to enable large enterprises and government entities to implement and manage security policies easily and consistently across complex, geographically dispersed networks of firewalls and VPNs. It is designed to allow network administrators to manage network security from a centrally located position and is intended to be introduced in the fall of calendar year 2003. Global Command Center utilizes object-based management which allows administrators to define an object, such as a firewall, group of firewalls, network or interfaces, once, and then reuse those objects wherever they are needed. When security policies change, an administrator can modify the objects and implement the changes instantly throughout the enterprise. Specifically, Global Command Center is currently designed to enable customers to:

- centrally monitor and audit firewall and VPN activity;
- back-up and restore firewall and VPN configurations;
- simplify routine administrative tasks; and

manage ongoing changes to security policies.

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Professional Services

We market several specific types of consulting services including security assessments and technical education and training programs.

Security assessments. We conduct security assessments as part of our professional services offerings. These security assessments can be conducted either external or internal to a customer s network. We can conduct penetration testing from both a remote location and from an internal authenticated user perspective. We also analyze and review network and telecommunications usage policies, system administration polices, corporate data security policies and management controls, internal audit procedures and incident handling and review procedures.

Technical education and training programs. Recognizing that the educated consumer is our most valued customer, we are developing a certification track for our suite of network security solutions. The courses are expected to include CyberGuard Security Foundations, CyberGuard Firewall Security Administrator, and CyberGuard Firewall Security Officer. These offerings are designed to create a complete network security certification. Additionally, training seminars are available for three different levels of experience and requirements: executive, administrator, and employee. In addition, individualized seminars can be scheduled covering advanced security topics, including specific responses to the results of external and internal security assessments.

Customer Support

We believe that service is a key differentiator for us. Our worldwide customer support center provides 24-hour support via telephone and over the internet through CyberGuard On-line. Our knowledgeable support team is versed in real-world enterprise environments, and they have each obtained certifications in networking, firewalls and security. Our support staff is highly trained and qualified, level-2 experienced security professionals. In addition support staff has access to information and services. Our customers have access to security tips, technical services and incident placement through CyberGuard On-line.

Third Party Products and Services

We resell the following products that can be integrated into our appliances:

F-Secure Anti-Virus. F-Secure Anti-Virus is a Windows-based gateway anti-virus product that works in conjunction with our appliances to provide detection and disinfection for internet-borne viruses and malicious code. By automatically scanning HTTP, FTP and SMTP traffic for malicious code, F-Secure Anti-Virus is designed to stop viruses before they can compromise enterprise security. The scanning is done in real time as the data is transmitted through the firewall, thus allowing for better management of internet use and increased productivity.

Websense Enterprise v4.4. Websense Enterprise v4.4, Allows users to analyze, manage and report on traffic flowing from their internal networks to the internet. Using pass-through technology, Websense Enterprise is tightly integrated with our firewall. We believe this gives customers an accurate, reliable and scalable internet filtering solution.

High Availability Firewall. We offer our high availability firewall configuration through technology licensed from Legato Systems. This solution is designed to help ensure continuous operation and security of mission critical firewalls. Our high availability firewall delivers protection by automatically monitoring, failing-over and restarting firewalls when necessary or appropriate.

Product Development

The following table illustrates the significant products and product enhancements that we introduced during the second half of our fiscal year ended June 30, 2003 and that we anticipate introducing during our fiscal year ending June 30, 2004.

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PRODUCT OR SOFTWARE UPGRADE	INTRODUCTION	DESCRIPTION
Software Version 5.1	May 2003	New software release for our appliance portfolio that includes high availability state synchronization and PKI support
SL 3200	July 2003	New, faster, more powerful, high-end appliance with 3.2 gigabit throughput
Global Command Center	Fall 2003	New software release for centralized enterprise security management
Software Version 5.2	Fall 2004	New software release for our appliance portfolio that is expected to include LDAP authentication, CVP 2/3 support, Proxies (Accelerated Application Awareness, UDP, VoIP), SOCKS5

We develop our new products and features internally through our engineering staff and through third-party licensing agreements. Currently, we have approximately 44 full-time employees and 6 independent contractors devoted to product development. We supplement our development staff from time to time with contract engineers as needed to meet product demands in the market.

For the fiscal years ended June 30, 2003, June 30, 2002, and June 30, 2001, the Company spent approximately $5.9 million, $4.7 million and $5.5 million, respectively, on research and development, an equivalent of 17%, 21% and 22%, , respectively, of total sales during such periods.

Security Certifications

Our products continue to earn high level, independent security certifications and evaluations.

We maintain a commitment to be a leader in providing certified security solutions. Some examples of our security certifications include:

We believe that we were the first firewall appliance to complete the Common Criteria evaluation for our networking software and were awarded Evaluation Assurance Level 4. In addition, we received an augmented Evaluation Assurance Level 4 certificate under the Common Criteria Assurance Maintenance Scheme. This allows for continuing certification of any patches enhancements or upgrades without further evaluation;

We are currently engaged in Common Criteria evaluation of the latest version of our products at Evaluation Assurance Level 4 and claiming conformance to the following two U.S. Department of Defense protection profiles:

(1) Application-level Firewall with Remote Administration & Single-use Authentication Delegated to the IT Environment Protection Profile for Medium Robustness Environment Version 1.0; and

(2) Traffic-Filter Firewall with Remote Administration & Single-use Authentication Delegated to the IT Environment Protection Profile for Medium Robustness Environments Version 1.0.

We achieved the Federal Information Processing Standard (FIPS) certification.

Our firewall appliance line has been recognized by ICSA Labs, a division of TruSecure Corporation, as having achieved ICSA Labs Firewall Certification Versions 3.0a and 4.0.

We have been certified at all four levels offered by the VPNC

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Strategic Relationships

We have strategic alliances with third parties for assistance in the development of certain components of our products. Some of these strategic alliances relate to our encryption, token authentication and virus detection products. We seek such alliances to continue efforts to develop additional products or enhancements to our existing products. We rely heavily on our strategic partners to resell products in the United States, Asia, the United Kingdom, Europe, the Middle East and Latin America.

We have entered into several strategic alliances to offer and sell our products within and outside the United States. Some of these strategic alliances relate to the Company s encryption, token authentication, intrusion detection and virus detection products. The Company relies on third parties for assistance in the development of certain of the Company s products under development. The Company seeks such alliances to continue efforts to develop additional products or enhancements to the Company s existing products.

We outsource all of its hardware manufacturing and assembly, primarily to one third-party manufacturer and assembly house, Omni Tech Corporation, and we do not have a long term manufacturing contract with this company. We have only recently established arrangements with an alternative manufacturer and assembly house and we may not be able to meet the demands for our products if we were to lose our relationship with our primary manufacturer and assembly house. Our operations could be disrupted for an extended period of time if we have to switch to a replacement vendor. A prolonged interruption in our hardware supply could result in a loss of customer orders and revenue and diminish the reputation of our brands.

There can be no assurance that we will be able to enter into future collaborative arrangements on favorable terms, or at all. Even if we are successful in entering into such collaborative agreements, there can be no assurance that any such arrangement will be successful. The success of any such arrangement is dependent on, among other things, the skills, experience and efforts of the third party s employees responsible for the project, the third party s commitment to the arrangement, and the financial condition of the third party, all of which are beyond our control.

Customers and Markets

We have traditionally served very large enterprises for which internet security is a top priority, including government entities, utilities and financial institutions. During our fiscal year ended June 30, 2003, we provided products and services to these customers worldwide. No single customer or reseller represented 10% or more of our revenue during our fiscal year ended June 30, 2003.

We supply our products to value-added resellers, distributors and system integrators who ultimately sell to and support end users. In turn, we support these reseller channels through training and education, marketing support, consulting and interaction with our direct sales force.

Target markets for our products include governments, financial institutions, insurance companies, healthcare institutions, telecommunications companies and companies that offer managed security and networking services to businesses and consumers.

Sales and Marketing

Sales. We employ a worldwide sales force focused on increasing sales directly and through our growing global network of regional value-added resellers, distributors and system integrators.

By complementing our direct sales force with a reseller sales model we are able to reach many more prospects through these channel partner relationships than we otherwise could. Additionally, we are able to create a variable cost for sales as opposed to a direct sales force that would require an initial and continuous cost. Furthermore, technically trained partners give us the ability to support customers in more geographic areas than we could do our own.

We employ four regional sales vice presidents who are responsible, respectively, for U.S. commercial business, U.S. federal business, EMEA (Europe, Middle East, Africa), and the Pacific Rim. Each employs a team of regional sales managers to generate sales through their regional channel partners and with select direct customers. The sales force focuses its sales and marketing efforts on key vertical sectors that traditionally require the highest levels of security, including financial services, government, healthcare, insurance, and telecommunications. We also maintain a dedicated team of inside sales professionals who are responsible for developing new channel partner relationships and assisting their regional sales managers throughout the sales cycle. In addition, we have a global team of technical support engineers who provide pre- and post-sales technical advice and support with respect to our products.

We have a dedicated federal division to take advantage of the opportunities in the government vertical market and we recently opened a federal sales office in Washington, D.C. metro area. This specialized team focuses exclusively on meeting the needs and information security requirements of the U.S. government.

Marketing. Our marketing efforts are focused on three major objectives: (1) creating broad market awareness of our brand; (2) identifying and developing new channel partner relationships; and (3) generating end-user sales leads that our direct sales force can funnel to channel partners for further sales development.

Direct marketing activities include advertising, publishing technical and educational articles in industry journals, participating in industry tradeshows, product technology conferences, regional educational seminars, direct mail, electronic mail, public and media relations, telemarketing, on-going customer and third-party communication programs, sales training and marketing on our web site. We also generate interest in and educate potential customers about computer and network security through speaking engagements, contributed articles, media interviews and outreach to industry analysts.

We extend our marketing reach by supporting our channel partners via a co-op marketing program. This program enables our channel partners to accrue credits based on a percentage of their product revenue, and then use these credits to offset up to half of the costs for advertising, trade shows, and other marketing activities that support our brand and help generate leads.

As of June 30, 2003, we had 27 employees in our sales and marketing organization.

Competition

The market for network security products is intensely competitive and characterized by frequent technological change. We believe that competition in this market is likely to persist and intensify as demand for internet security products continues to increase.

At the same time, we believe that we enjoy certain advantages because of our high level of independently evaluated security technology; our firewall/VPN appliance strategy that offers a custom, secure operating system, multi-level security, high performance and functionality; a commitment to service and support; and a strong core of developers who helped create our original technology, which continues to earn industry awards and certifications even as it evolves to meet new security demands.

In market segments requiring the highest levels of network security, we compete with Secure Computing Corporation, which also offers a firewall with a security-enhanced operating system. We also compete with security vendors such as Check Point Software Technologies Ltd., Cisco Systems, Inc., and NetScreen Technologies, Inc. These companies   products may be considered to be alternatives to our products. Certain companies, such as Microsoft Corporation, now offer network-related security products that could eventually compete with our firewall/VPN products.

CyberGuard believes that the principal competitive factors affecting the market for computer and network security products include the product   s level of security, performance and reliability, technical features including interoperability and functionality, ease of use, capabilities, customer service and support, integration of products, manageability of products, brand name recognition, Company reputation, distribution channels and lower total cost of ownership. Based on its understanding of the features of the products and services offered by CyberGuard   s competitors, the Company believes that its products currently compete favorably with respect to most of those factors. Based on its experience and understanding of the existing network security market, CyberGuard believes that potential purchasers of its security products who do not differentiate between the level of security provided by competing security products are as likely to base their purchasing decisions on price, ease of use, or other considerations as they are to base such decisions on the level of security provided. In circumstances where a potential purchaser   s primary concern is the level of security provided by products being considered, the Company believes that its products compete favorably

CyberGuard is the only firewall provider to be enrolled in an ongoing assurance maintenance program which is a process under common criteria, of ongoing evaluation to ensure that upgrades and enhancements to the originally certified technology retain their certification. It is customary for vendors to periodically release patches, when a change is made to the product. When a change is made, the product is no longer the same as the original product that was certified. Without the ongoing evaluation that enrollment in assurance maintenance guarantees, a product that has been patched or changed in any way loses its original certification.

Additionally, CyberGuard currently has a history of no publicly reported vulnerabilities. Over the past few years various security vulnerabilities have been discovered in many of our competitors firewall products. Many of these exploits have been publicly documented by highly respected security organizations. At this time we are aware of no documented vulnerability on the CyberGuard firewall in any of these organizations.

Patents and Proprietary Technology

The Company relies upon license agreements with customers; trademark, copyright and trade secret laws; employee conflict of interest and third-party non-disclosure agreements and other methods to protect the trade secrets, proprietary know-how and other proprietary rights on which the Company s business depends. There can be no assurance that these agreements will not be breached, that the Company will have adequate remedies for any breach, or that the Company s trade secrets will not otherwise become known to or independently developed by competitors. The Company has some pending patent applications to cover certain aspects of its technology. The Company has received trademark registration in the United States, Canada and numerous other countries for its CyberGuard® firewall mark and its CyberGuard logo.

Various companies hold patents, copyrights, and other intellectual property rights covering a variety of competing products and processes. We have from time to time received, and may in the future receive, communications from third parties claiming that we may be infringing certain of such parties patents and/or other intellectual property rights. The Company may be unable to avoid infringement of third party intellectual rights and may have to obtain a license, defend an infringement action, or challenge the validity of another party s intellectual property rights in court. Intellectual property litigation is costly and time consuming, and the Company may be unable to prevail in any such litigation or devote sufficient resources to even pursue such litigation. A license may be unavailable on terms and conditions acceptable to the Company, if at all. If the Company does not obtain a license under another party s intellectual property rights and if it were found liable for infringement, the Company may be liable for significant money damages, may encounter significant delays in bringing products to market, or may be precluded from participating in the manufacture, use, or sale of products requiring such licenses. Any allegation of infringement, infringement claim or other litigation against or by us could have a material adverse effect on our results of operations and financial condition.

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Government Regulation

Our security products are subject to export restrictions administered by the U.S. Department of Commerce. Export controls on cryptographic products permit the export of encryption products outside the U.S. only with the required level of export license or through an export license exception. The effect of these regulations is to create delays in the introduction of the products in international markets, and, in some cases, to prohibit them altogether.

Employees

As of June 30, 2003, we employed approximately 134 full-time employees and six contract engineers. All of our employees and contract engineers are bound by agreements containing confidentiality and conflict of interest provisions.

Geographic Information

The information set forth in the Financial Statements included in this Report on Form 10-K regarding revenue, total assets, and Note 13 Geographic Information, is hereby incorporated by reference into this Part I, Item 1.

Available Information

The Company s internet website address is www.cyberguard.com. The Company makes available free of charge through its website its periodic reports as soon as reasonably practicable after filing.

ITEM 2. PROPERTIES

Our corporate headquarters are located at 2000 West Commercial Blvd, Ft. Lauderdale, Florida. This facility has approximately 26,000 square feet and provides office space for our executive team, research and development, sales and worldwide customer support organizations. The lease expires in August 2004. We are currently in negotiations to move to a new 30,000 square foot facility, which would be located in the same general area.

We also lease facilities in Maryland, North Carolina, Illinois, the United Kingdom and Germany.

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ITEM 3. LEGAL PROCEEDINGS

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 (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.

In July 2003, the Company entered into a Memorandum of Understanding to settle this lawsuit. The settlement amount of $10 million will require the Company to incur a one-time charge of $3.9 million in the fourth quarter of its fiscal year ending June 30, 2003 for the amount in excess of the insurance coverage and related costs. The Company s portion of the settlement amount will be payable by the Company in cash or in a combination of cash and equity, at the Company s option. The terms of the settlement are subject to approval by the court, and there can be no assurance that the court will approve this proposed settlement of the lawsuit.

If the court does not approve the settlement, there can be no assurance that the Company will ultimately be successful in defending the lawsuit, or that if the Company is unsuccessful, that there will be sufficient insurance coverage to cover any expense of the lawsuit and/or any judgment rendered against the Company. 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 initially notified its insurance carrier of the existence of the lawsuit, and the carrier has sent the Company a reservation of rights letter. If the settlement is not approved by the court, 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 assuming the court does not approve the settlement.

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 has 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 various 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 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

No matters were submitted to a vote of security holders during the fourth quarter of the fiscal year ended June 30, 2003.

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PART II

ITEM 5. MARKET FOR REGISTRANT S COMMON EQUITY AND RELATED STOCKHOLDER MATTERS

From January 13, 1999 to March 18, 2002, the Company s securities were traded by market makers through the pink sheets again under the symbol CYBG. On March 19, 2002, the Company began trading on the OTC Bulletin Board under the symbol CYBG. On June 11, 2002, the Company s Common Stock began trading on the American Stock Exchange under the ticker symbol CFW . Finally, on July 8,, 2003, the Company s Common Stock ceased trading on the American Stock Exchange and commenced trading on the NASDAQ National Market under the symbol CGFW.

The Company is current in its reporting responsibilities pursuant to the Exchange Act.

There were approximately 3,656 holders of record of Common Stock as of June 30, 2003. The table below sets forth, for the quarters indicated, the high and low sales prices for the Company s Common Stock as reported by NASDAQ and the American Stock Exchange.

	BID PRICES	
	HIGH	LOW
FISCAL YEAR 2001		
Quarter Ended September 30, 2000	$ 6.12	$ 3.41
Quarter Ended December 31, 2000	4.25	.95
Quarter Ended March 31, 2001	5.79	1.59
Quarter Ended June 30, 2001	3.95	1.80
FISCAL YEAR 2002		
Quarter Ended September 30, 2001	$ 2.55	$ 1.3
Quarter Ended December 31, 2001	1.70	1.3
Quarter Ended March 31, 2002	4.35	1.65
Quarter Ended June 30, 2002	4.00	2.75
FISCAL YEAR 2003		
Quarter Ended September 30, 2002	$ 3.75	$ 2.00
Quarter Ended December 31, 2002	6.60	3.00
Quarter Ended March 31, 2003	7.64	5.10
Quarter Ended June 30, 2003	7.93	5.80

We have not paid cash dividends on our common stock in the past and do not anticipate paying cash dividends in the foreseeable future. We currently intend to retain all future earnings to finance the expansion of our business. Any future determination regarding cash dividend payments will be made by our Board of Directors and will depend on our earnings, capital requirements, financial condition and other factors deemed relevant by our Board of Directors.

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The number of shares issuable upon exercise of the outstanding options granted to employees and non-employee directors, as well as the number of shares remaining available for future issuance, under our equity compensation plans as of June 30, 2003 are summarized in the following table:

EQUITY COMPENSATION PLAN INFORMATION

Amounts in (000 s)

Plan Category	Number of Securities to be issued upon exercise of outstanding options, warrants and rights	Weighted-average exercise price of outstanding options, warrants and rights	Number of securities remaining available for future issuance under equity compensation plans
Equity compensation plans approved by security holders	5,435	2.46	889
Equity compensation plans not approved by security holders	143(1)	1.75	
Total	5,578	2.44	889

(1) *Represents a warrant to purchase 142,857 shares of the Company s Common Stock granted to Scott Hammack, the Company s Chief Executive Officer, on December 26, 2000 at the price of $1.75 per share. The warrant was granted to Mr. Hammack in connection with his purchase of shares of Common Stock at market value. The warrant expires on December 25, 2005.*

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ITEM 6. SELECTED CONSOLIDATED FINANCIAL DATA

The following table sets forth selected consolidated financial data that is qualified in its entirety by and should be read in conjunction with Management s Discussion and Analysis of Financial Condition and Results of Operations and our consolidated financial statements and notes thereto appearing elsewhere in this Form 10-K. The financial data for the fiscal years ended June 30, 2003, 2002, 2001 and 2000 have been derived from our audited consolidated financial statements for such periods as audited by Grant Thornton LLP. The financial data for the fiscal year ended June 30, 1999 have been derived from our audited consolidated financial statements for such period as audited by Pricewaterhouse Coopers, LLP.

	Fiscal year ended June 30,				
	2003	2002	2001	2000	1999
			As Restated*	As Restated*	
	(in thousands, except per share data)				
Statement of Operations Data:					
Revenues	$ 32,980	$ 22,340	$ 24,406	$ 18,859	$ 13,873
Cost of revenues:	8,571	7,163	7,977	6,204	5,313
Gross profit	24,409	15,177	16,429	12,655	8,560
Operating expenses					
Research and development	5,941	4,705	5,450	2,969	3,664
Selling, general and administrative	14,947	11,313	13,919	9,504	14,724
Class action settlement	3,900				
Total operating expenses	24,788	16,018	19,369	12,473	18,388
Operating income (loss)	(379)	(841)	(2,940)	182	(9,828)
Other income (expense):					
Interest income (expense), net	111	58	(830)	(3,223)	(186)
Gain (loss) on sale of assets	(33)	(18)	(106)		1,858
Other income (expense)	205	193	(90)	(92)	41
Total other income (expense)	283	233	(1,026)	(3,315)	1,713
Loss before income taxes and cumulative effect of change in accounting principle	(96)	(608)	(3,966)	(3,133)	(8,115)
Income tax benefit	4167				
Net Income (loss) before cumulative effect of change in accounting principle	4071	(608)	(3,966)	(3,133)	(8,115)
Cumulative effect of change in accounting principle			(431)		
Net income (loss)	4,071	(608)	(4,397)	(3,133)	(8,115)

Diluted income (loss) per share	$ 0.16	$ (0.03)	$ (0.33)	$ (0.34)	$ (0.90)
Balance Sheet Data:					
Current assets	$ 27,908	$ 12,605	$ 11,024	$ 8,325	$ 6,428
Total assets	35,159	14,130	13,099	10,996	8,277
Long term obligations				5,095	885
Shareholders equity	14,671	6,956	6,474	(1,952)	(2,685)

* In August 1999 and December 2000, the company executed an agreement to issue convertible debt to an investment company. The company originally determined no beneficial conversion feature existed for the convertible debt based on the fair value of the company s common stock as determined by a National valuation firm. The company subsequently reevaluated the beneficial conversion feature using the market price of the company s common stock as reflected in the pink sheets on the closing date of each transaction. As a result of the revised beneficial conversion feature calculation, the Company has recorded additional interest expense in fiscal 2001 and 2000 in the amounts of $79 and $2,157, respectively with a corresponding increase in Additional Paid in Capital. In addition, the charge for the cumulative effect of the change in accounting principle in the fiscal year 2001 has increased by $302 to $431 with a corresponding increase to Additional Paid in Capital. The restatement did not affect cash or the amount of the Company s operating losses.

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ITEM 7. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following information should be read in conjunction with Selected Financial Data and our consolidated financial statements and notes thereto appearing elsewhere in this Form 10-K. This discussion and analysis contains forward-looking statements that involve risks, uncertainties and assumptions. Actual results may differ materially from those anticipated by these forward-looking statements as a result of a number of factors, including, but not limited to, those set forth under Risk Factors and Forward-Looking Statements in this Report.

Overview

We develop, market and support a broad family of integrated network security solutions. Our security appliance solutions include key security technology such as firewalls and Virtual Private Networking (VPN). Our appliances are built upon a highly secure operating system and proprietary software designed to identify network and application attacks and prevent them from reaching mission-critical resources. Our firewall combines stateful packet inspection and application proxy technologies to deliver the highest level of security and performance for an enterprise s network. We believe that our ability to inspect each packet of network traffic at the application layer provides our customers some of the highest levels of protection. Our target customers are large enterprises, including Global 2000 companies, major financial institutions and government entities worldwide. Our appliances are sold to end-users directly and indirectly by a direct sales force and resellers in the United States and in over 30 foreign countries.

We were incorporated in 1994 in connection with a spin-off from Harris Corporation. At that time, we produced computers for the real-time computing market as well as our firewall for the secure computing market. We changed our name from Harris Computer Systems Corporation in June 1996 following the sale of our real-time computer business.

Acquisitions

On January 22, 2003, we acquired certain assets of NetOctave, Inc. NetOctave, Inc. is a manufacturer of security processors and accelerator boards and cards for the secure socket layer (SSL) and internet protocol security (IPSec) markets. As a result of the acquisition, we gained new technology, engineering talent and a customer base for the SSL and IPSec markets. The results of NetOctave, Inc. s operations have been included in our consolidated financial statements since January 22, 2003. The

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purchase consideration was approximately $1.5 million. The consideration consisted of (a) cash of $300,000, (b) a payment of up to $450,000 based upon a percentage of certain revenues recognized during the next twelve months, payable quarterly, and (c) 107,419 shares of our common stock valued at $750,000, based upon the market value of the shares at the time of issuance. NetOctave, Inc. was granted certain registration rights for the common stock it received in the transaction.

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Results of Operations

The following table sets forth certain of our consolidated statement of operations data as a percentage of revenues for the periods indicated.

	Fiscal year ended June 30,		
	2003	2002	2001
			Restated
	(in percentages)		
Revenues:			
Products	69	68	77
Services	31	32	23
Total revenues	100	100	100
Cost of revenues:			
Products	18	23	23
Services	8	9	10
Total cost of revenues	26	32	33
Gross profit	74	68	67
Operating expenses:			
Research and development	18	21	22
Selling, general and administrative	45	51	57
Class action settlement	12		
Total operating expenses	75	72	79
Operating loss	(1)	(4)	(12)
Other income (expense):			
Interest income (expense), net	0	0	(3)
Gain (loss) on sale of assets	0	0	(1)
Other income (expense)	1	1	0
Total other income (expense)	1	1	(4)
Loss before income tax and cumulative effect of change in accounting principle	0	(3)	(16)
Income tax benefit	13	0	0
Net income (loss) before cumulative effect of change in accounting principle	13	(3)	(16)
Cumulative effect of change in accounting principle	0	0	(1)

Net income (loss)	13	(3)	(17)

Fiscal Year Ended June 30, 2003 Compared to Fiscal Year Ended June 30, 2002

Total revenues. Total revenues, which consist of product sales and software maintenance and professional services revenues, increased from $22.3 million for fiscal year 2002 to $33.0 million in fiscal year 2003, or 48%. The increase in total revenues was driven by increased demands for our products due to an increased focus on security by government and commercial enterprises and increased awareness of our product brand.

The increase in total revenues was driven by increased demands for our products due to an increased focus on security by government and commercial enterprises and increased awareness of our product brand. The increase in both product and service revenue is a direct result of the number of units sold and not from price increases. Prices have remained reasonably consistent for the past 3 years.

We categorize our revenues into three geographic regions: North America; EMEA; and APAC. Revenues in North America, EMEA and APAC as a percentage of total revenues were approximately 50%, 32% and 18%, respectively, in fiscal year 2003 and 42%, 35% and 23%, respectively, in fiscal year 2002. All regions experienced increased sales in fiscal year 2003 compared to fiscal year 2002. Our total international revenues, which are revenues for customers outside North America, represented approximately 50% of the total revenues in fiscal year 2003 and 58% of total revenues in fiscal year 2002. The increase in North American sales for fiscal year 2003 is attributable to the increase in U.S. Government business. This is the result of the new government division established in fiscal 2003. The increase in North American revenues contributed to the over all reduction in international sales as a percentage of total sales

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No single customer or reseller accounted for more than 10% of our total revenue in fiscal year 2003. During 2002, one customer represented 11% of consolidated revenues. This customer represented 3% of consolidated revenues in 2003.

Product revenues. Product revenues consist primarily of firewall and VPN security appliances. Product revenues increased from $15.2 million in fiscal year 2002 to $22.6 million in fiscal year 2003, or 49%. The increase in product revenues is primarily the result of increased brand awareness, channel growth and penetrating into new markets. The majority of our product revenues for fiscal year 2003 were generated from large enterprise customers and government entities, in both domestic and international markets. Our federal division consists of a team of security engineers and sales professionals who focus solely on working with various U.S. government agencies and departments. As a result of this focus we have experienced an increase in government business activity, not only in the U.S. but also around the world.

Service revenues. Service revenues consist of maintenance contracts for technical support of our firewall/VPN appliances and professional services such as training, consulting and installation. Service revenues increased from $7.1 million in fiscal year 2002 to $10.3 million in fiscal year 2003. The increase in service revenues was due primarily to growth in annual maintenance/customer support revenues, which represents approximately 91% of total service revenues. This growth is due to the greater number of installed products during fiscal year 2003 resulting from additional product sales, as well as maintenance/customer support renewals for products sold in previous years. Revenues from training, consulting and installations were not a significant factor in the growth of service revenues from fiscal year 2002 to fiscal year 2003.

Cost of revenues and gross profit. Total cost of revenues, which includes products and services costs, increased from $7.2 million in fiscal year 2002 to $8.6 million in fiscal year 2003, or 20%. The increase was primarily due to the increased product sales and services revenues for fiscal year 2003. Total gross profit was 74% for fiscal year 2003 and 68% for fiscal year 2002. Gross profit is affected by a variety of factors including competition, the mix in average selling prices of products we currently offer, new product introduction and enhancements, fluctuation in manufacturing volumes and incremental cost of supporting the increased installed customer base. Gross profit for products was $16.7 million, or 74%, for fiscal year 2003 as compared to $10.1 million, or 66%, for fiscal year 2002. The increase in product related gross profit was the result of lower cost of hardware. The lower cost was due to technology advancements resulting in lower technology costs, additional volume discounts and competitive market conditions for hardware. Gross profit for services was $7.7 million, or 74%, for fiscal year 2003 as compared to $5.1 million, or 72%, for fiscal year 2002. The increase in service related gross profit was a result of the increased installed customer base during fiscal year 2003 and strict cost controls for all service related costs.

Operating expenses. For fiscal year 2003, total operating expenses increased to $24.8 million as compared to $16.0 million for the fiscal year 2002, or 55%. As a percentage of total revenues, operating expenses increased from 72% in fiscal year 2002 to 75% in fiscal year 2003. Included in operating expense for fiscal year 2003, was the settlement of a class action lawsuit in the amount of $3.9 million, which represents our portion of the class action litigation settlement. Excluding the one-time charge for this settlement, operating costs were $20.9 million, or 63% of total revenue. The increase in total operating expenses in fiscal year 2003 from fiscal year 2002, excluding the one-time charge, was $4.9 million, or 30%. The overall increase in operating expenses is due primarily to the increase in development costs of $1.2 million, and an increase in selling, general and administrative expenses of $3.7 million.

Research and development expenses. Research and development expenses includes salaries, non-capitalized equipment, software tools and facilities related costs. For fiscal year 2003, total research and development expenses increased to $5.9 million from $4.7 million for fiscal year 2002, or 26%. The increase is primarily the result of the acquisition of the NetOctave, Inc. assets in the third quarter of fiscal year 2003 and additional development employees hired during the year. As a percentage of total revenue, research and development expenses decreased to 18% in fiscal year 2003 compared to 21% for fiscal year 2002.

Selling, general and administrative expenses. Selling, general and administrative expenses include salaries, commissions, human resources, finance, administrative support functions, and legal and accounting professional services. Selling general and administrative expenses increased by $3.6 million or 32% to $14.9 million for fiscal year 2003 from $11.3 million for fiscal year 2002. The increase is due to an increase of approximately $2.7 million of labor related expenses, including increases in bonuses, commissions and $525,000 for bad debt expense. During Fiscal year 2003 the company s provision for bad debt expense increased to $598,000 from $97,000 in fiscal 2002. The increase in the bad debt expense was the result of two customers in the EMEA region which were fully reserved due to non-payment. These two customers represented approximately 75% of the bad debt expense for fiscal 2003. This also had a significant impact on the increase in the allowance for doubtful accounts as of June 30 2003. In addition to the two accounts above, the general reserve increased as a result of the overall increase in accounts receivables. There have been no significant changes in our collection policies or payment terms during fiscal 2003. We also recorded amortization expense of $305,000 related to the NetOctave, Inc. acquisition as well as $122,000 of additional depreciation expense for assets acquired in that transaction. As a percentage of total revenue, selling, general and administrative expenses decreased to 45% for fiscal year 2003 compared to 51% for fiscal year 2002.

Class action settlement. In June 2003, we received an offer to settle an outstanding class action lawsuit for $10.0 million. In July 2003, the Company entered into a Memorandum of Understanding to settle this lawsuit. The settlement amount of $10 million will require the Company to incur a one-time charge of $3.9 million in the fourth quarter of its fiscal year ending June 30, 2003 for the amount in excess of the insurance coverage and related costs. The Company s portion of the settlement amount will be payable by the Company in cash or in a combination of cash and equity, at the Company s option. The terms of the settlement are subject to approval by the court, and there can be no assurance that the court will approve this proposed settlement of the lawsuit.

Net interest income. Net interest income was $111,000 for fiscal year 2003 compared to net interest income of $58,000 for fiscal year 2002. The increase in net interest income was primarily the result of the significant increase in cash balances for fiscal year 2003 versus fiscal year 2002.

Other income. Other income was $205,000 for fiscal year 2003 versus $193,000 for fiscal year 2002. The decrease is the result of less foreign currency gains for fiscal year 2003 compared to fiscal year 2002.

Income tax benefit. We provide a valuation allowance for the portion of our deferred tax assets, which we cannot determine, is more likely than not to be recognized due to our cumulative losses and the uncertainty as to future recoverability. We recorded an income tax benefit of $4.2 million as of June 30, 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 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 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 our estimate and conclusions regarding the ultimate realization of the deferred tax asset, including but not limited to, our recent positive financial results as well as projected earnings over a two-year period. 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.

Net income (loss). For fiscal year 2003 we recorded net income of $4.1 million compared to a net loss of $608,000 for the fiscal year 2002. This improvement is the direct result of the increase in revenues for fiscal year 2003 versus fiscal year 2002 and a continued focus on maintaining appropriate cost controls and operating efficiencies.

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Fiscal Year Ended June 30, 2002 Compared to Fiscal Year Ended June 30, 2001

Total revenues. Total revenues decreased from $24.4 million in fiscal year 2001 to $22.3 million in fiscal year 2002, or 8%. This decrease represents a 19% decrease in product revenues, which was offset by a 25% increase in services revenues. We believe the decrease in product revenues can be attributed to slowing economic conditions that resulted in a delay or deferral in customer spending, changes in our sales and marketing organization and realignment of our direct sales to a reseller/distributor model during the year. We believe the increase in service revenues is due to the growing installed base of our products and renewals of previous years maintenance contracts.

Revenues in North America, EMEA and APAC as a percentage of total revenues were approximately 42%, 35% and 23%, respectively, in fiscal year 2002 and 49%, 35%, respectively, and 16% in fiscal year 2001. Our total international revenues, which are revenues for customers outside North America, represented approximately 58% of the total revenues in fiscal year 2002 and 51% of total revenues in fiscal year 2001. The decline in revenues for North America in Fiscal 2002 vs. Fiscal 2001 was due to an increase in sales in the APAC region while fiscal 2002 revenues for North America was impacted by the events of September 11, 2001 and the over all US economy.

One customer represented 11% of total revenue in fiscal year 2002, however, this, customer only accounted for approximately 3% of revenues in fiscal year 2003.

Product revenues. Product revenues consist primarily of firewall and VPN security appliances. Product revenues decreased from $18.7 million in fiscal year 2001 to $15.2 million in fiscal year 2002, or 19%. The decrease in product revenues is attributed to slowing economic conditions that resulted in a delay or deferral in customer spending, changes in our sales and marketing organization and realignment of our direct sales to a reseller/distributor model during the year.

Service revenues. Service revenues consist primarily of maintenance contracts for technical support of our firewall/VPN appliances and professional services such as training, consulting and installation. Service revenues increased from $5.7 million in fiscal year 2001 to $7.1 million in fiscal year 2002. The increase in service revenues was due primarily to annual maintenance/customer support revenues, which represented approximately 91% of the increase. The increase was also due to the greater number of installed products in fiscal year 2002 resulting from additional product sales, as well as service renewals for product sold in previous years. Revenues from training, consulting and installations were not a significant factor in the growth of service revenues from fiscal year 2001 to fiscal year 2002.

Cost of revenues and gross profit. Total cost of revenues, which includes products and services costs, decreased from $8.0 million in fiscal year 2001 to $7.2 million in fiscal year 2002, or 10%. The decrease was primarily due to the reduced product sales discussed above. As a percentage of total revenues, costs of revenues were 32% for fiscal year 2002 and 33% for fiscal year 2001. Total gross profit was 68% in fiscal year 2002 and 67% in fiscal year 2001. Gross profit is affected by a variety of factors including competition, the mix in average selling prices of products we currently offer, new product introduction and enhancements, fluctuation in manufacturing volumes and incremental cost of supporting the increased installed customer base. Gross profit for products was $10.1 million, or 66%, for fiscal year 2002 as compared to $13.0 million, or 70%, in fiscal year 2001. The reduction in gross profit was a result of competitive pressures resulting from the economic downturn and the introduction of a lower margin product during fiscal year 2002. Gross profit for services was $5.1 million, or 72%, for fiscal year 2002 as compared to $3.4 million, or 60%, in fiscal year 2001. The increase in service related gross profit is a result of the increased installed customer base during fiscal year 2002 and strict cost controls for all service related costs.

Operating expenses. For fiscal year 2002, total operating expenses decreased to $16.0 million compared to $19.4 million for the fiscal year 2001, or 18%. As a percentage of total revenue, operating expenses decreased from 79% in fiscal year 2001 to 72% in fiscal year 2002. The overall decrease in operating expenses can be explained in part by a reduction of the research and development expenses for fiscal year 2002 of $745,000 and a reduction in selling, general and administrative expenses of $2.6 million.

Research and development expenses. Research and development expenses include salaries, non-capitalized equipment, software tools, and facilities related costs. The decrease in research and development expenses for fiscal year 2002 versus fiscal year 2001 is in part the result of the reduction in the number of employees and the reduction in salaries specifically related to a special option salary reduction program. These items accounted for approximately $500,000 of the decrease. The balance of the decrease is due to the reduction of the use of outside contractors by the development group. As a percentage of total revenue, research and development expenses decreased to 21% in fiscal year 2002 from 22% in fiscal year 2001.

Selling, general and administrative expenses. Selling, general and administrative expenses include salaries, commissions, human resources, finance, administrative support functions, and legal and accounting professional services. Selling, general and administrative expenses decreased by $2.6 million to $11.3 million in fiscal year 2002 from $13.9 million during fiscal year 2001. The decrease reflects our continued focus on streamlining our operations, making cost effective changes in the way we operate, a reduction in the number of employees and a reduction in salary expense related to a special option salary reduction program. In fiscal year 2002, we decreased labor costs 43%, marketing costs 27%, other expenses 21%, and professional fees 10%. As a percentage of total revenue, selling, general and administrative expenses decreased to 51% for fiscal year 2002 compared to 57% for fiscal year 2001.

Net interest income (expenses). Net interest income was $58,000 for fiscal year 2002 compared to net interest expenses of $830,000 for fiscal year 2001. The decrease in interest expenses is attributable to the conversion of convertible debt in January of 2001 and the pay-off of a revolving line of credit facility in December 2001.

Other income (expenses). Other income was $193,000 for fiscal year 2002 compared to other expenses of $90,000 for fiscal year 2001. The change in other income is a result of a foreign currency translation gain of $203,000 in fiscal year 2002 compared to a loss of $159,000 for fiscal year 2001.

Net loss. For fiscal year 2002, we incurred a net loss of $608,000 versus a net loss of $4.2 million for fiscal year 2001. This improvement is the direct result of our fiscal year 2002 cost cutting measures, including reduced numbers of employees, salary reduction, decreased interest and improved operating efficiency.

Liquidity and Capital Resources

At June 30, 2003, our principal source of liquidity was $12.1 million of cash and cash equivalents, which consist principally of commercial paper and U.S. government securities. For the fiscal year 2003, our cash, cash equivalents and short-term investments increased by $6.0 million or 96% to $12.1 million from $6.2 million at June 30, 2002.

Cash provided by operating activities was $4.7 million for the fiscal year 2003. For fiscal year 2002 cash provided by operating activities was $2.5 million. The increase is the result of the significant increase in net income, off-set by various charges in current asset and liability accounts.

Net cash used in investing activities was $1.1 million in fiscal year 2003, primarily as a result of the purchase of property and equipment of $666,000, capitalized software of $179,000 and the cash portion of the acquisition of the NetOctave, Inc. assets for $300,000. Net cash used in investing activities for fiscal year 2002 was $975,000 primarily the result of the purchase of property and equipment of $805,000 and capitalized software of $172,000.

Net cash provided by financing activities was $2.4 million for fiscal year 2003 and net cash used in financing activities for fiscal year 2002 was $133,000. In fiscal year 2003, the cash provided by financing activities was primarily the proceeds from stock options exercised.

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. Our future capital requirements will depend on many factors, including our rate of revenue growth, the timing and extent of spending on support, product development efforts and expansion of sales and marketing, the timing of introductions of new products and enhancement to existing products, and market acceptance of our products. We are not

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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 cannot assure you that additional equity or financing will be available on acceptable terms or at all. Currently, we have no agreements or arrangements for third parties to provide us with sources of liquidity and capital resources.

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 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.

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. We follow 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:

- Product revenue which includes revenue from the sale of our firewall/VPN appliance; and
- Service revenue, which is primarily maintenance, related to customer support.

Revenue from product sales is 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 revenue 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 the terms specified and there are no instances where we have to take back the product because of non-payment for a three-month period.

Service revenue consists primarily of the annual fee for maintenance (post-contract customer support) and maintenance renewals from our existing customers and is 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.

We also provide 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. We capitalize costs related to the development of certain software products in accordance with Statement of Financial Accounting Standards (SFAS) No. 86, *Accounting For the Costs Of Computer Software to be Sold, Leased, or Otherwise Marketed* 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 two years and is the greater of the two amounts calculated using the methods noted in SFAS No. 86.

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 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.

Deferred Taxes. We provide a valuation allowance for that portion of deferred tax assets, which it cannot determine is more likely than not to be recognized due to the Company s cumulative losses and the uncertainty as to future recoverability. Any reversal of the allowance is made when we believe that 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 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. 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. While we have considered future taxable income and ongoing prudent and feasible tax planning strategies in assessing the need for the valuation allowance, in the event we were to determine that we would be able to realize the deferred tax asset, in the future, an adjustment to the deferred tax asset would increase income in the period the determination was made.

Recent Accounting Pronouncements

In December 2002, the FASB issued SFAS No. 148, *Accounting for Stock-Based Compensation Transition and Disclosure, an amendment of FASB Statement No. 123*. SFAS No. 148 amends FASB SFAS No. 123, *Accounting for Stock-Based Compensation*, to provide alternative methods of transition for an entity that voluntarily changes to the fair value based method of accounting for stock-based employee compensation and to require prominent disclosures about the effects on reported net income of an entity s accounting policy decisions with respect to stock-based employee compensation. SFAS No. 148 also amends APB Opinion No. 28, *Interim Financial Reporting*, to require disclosures about those effects in interim financial information. We currently accounts for its stock-based compensation awards to employees and directors under the accounting prescribed by Accounting Principles Board Opinion No. 25 and provides the disclosures required by SFAS No. 123. We currently intend to continue to account for our stock-based compensation awards to employees and directors under the accounting prescribed by Accounting Principles Board Opinion No. 25 and will adopt the additional disclosure provisions of SFAS No. 148.

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In November 2002, the FASB issued Interpretation 45 (FIN 45), *Guarantor s Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others.* For a guarantee subject to FIN 45, a guarantor is required to:

measure and recognize the fair value of the guarantee at inception (for many guarantees, fair value will be determined using a present value method); and

provide new disclosures regarding the nature of any guarantees, the maximum potential amount of future guarantee payments, the current carrying amount of the guarantee liability, and the nature of any recourse provisions or assets held as collateral that could be liquidated and allow the guarantor to recover all or a portion of its payments in the event guarantee payments are required.

FIN 45 is effective for financial statements for fiscal years ending after December 15, 2002. We are currently in compliance with the provisions of the new pronouncement.

In January 2003, the FASB issued FASB Interpretation 46 (FIN 46), *Consolidation of Variable Interest Entities*. FIN 46 clarifies the application of Accounting Research Bulletin 51, *Consolidated Financial Statements*, for certain entities that do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support from other parties or in which equity investors do not have the characteristics of a controlling financial interest (variable interest entities). Variable interest entities within the scope of FIN 46 will be required to be consolidated by their primary beneficiary. The primary beneficiary of a variable interest entity is determined to be the party that absorbs a majority of the entity s expected losses, receives a majority of its expected returns, or both. FIN 46 applies immediately to variable interest entities created after January 31, 2003, and to variable interest entities in which an enterprise obtains an interest after that date. It applies in the first fiscal year or interim period beginning after June 15, 2003, to variable interest entities in which an enterprise holds a variable interest that it acquired before February 1, 2003. At June 30, 2003 we were not a party to transactions contemplated under FIN 46.

In November 2002, the Emerging Issues Task Force reached a consensus opinion on EITF 00-21, *Revenue Arrangements with Multiple Deliverables*. The consensus provides that revenue arrangements with multiple deliverables should be divided into separate units of accounting if certain criteria are met. The consideration for the arrangement should be allocated to the separate units of accounting based on their relative fair values, with different provisions if the fair value of all deliverables is not known or if the fair value is contingent on delivery of specified items or performance conditions. Applicable revenue recognition criteria should be considered separately for each separate unit of accounting. EITF 00-21 is effective for revenue arrangements entered into in fiscal periods beginning after June 15, 2003. Entities may elect to report the change as a cumulative effect adjustment in accordance with APB Opinion 20, Accounting Changes.

In November 2002 the Emerging Issues Task Force reached a consensus opinion on EITF 02-16, *Accounting by a Customer (including a reseller) for Certain Consideration Received from a Vendor*. EITF 02-16 requires that cash payments, credits, or equity instruments received, as consideration by a customer from a vendor should be presumed to be a reduction of cost of sales when recognized by the customer in the income statement. In certain situations, the presumption could be overcome and the consideration recognized either as revenue or a reduction of a specific cost incurred. The consensus should be applied prospectively to new or modified arrangements entered into after December 31, 2002. At June 30, 2003, we were not a party to transactions contemplated by EITF 02-16.

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

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activities under SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*. In general, the SFAS No. 149 is effective for contracts entered into or modified after June 30, 2003 and for hedging relationships designated after June 30, 2003. The adoption of SFAS No. 149 did not have a material impact on our financial condition or results of operations.

On May 15, 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. It requires that an issuer classify a financial instrument that is within its scope as a liability (or an asset in some circumstances). SFAS No. 150 affects the issuer s accounting for three types of freestanding financial instruments:

- mandatory redeemable shares, which the issuing company is obligated to buy back in exchange for cash or other assets;

- instruments that do or may require the issuer to buy back some of its shares in exchange for cash or other assets; includes put options and forward purchase contracts; and

- obligations that can be settled with shares, the monetary value of which is fixed, tied solely or predominantly to a variable such as a market index, or varies inversely with the value of the issuers shares.

SFAS No. 150 does not apply to features embedded in a financial instrument that is not a derivative in its entirety. Most of the guidance in SFAS No. 150 is effective for all financial instruments entered into or modified after May 31, 2003, and otherwise is effective at the beginning of the first interim period beginning after June 15, 2003. We have not yet completed our analysis of SFAS No. 150; however, we believe that we are currently substantially in compliance with the requirements of SFAS No. 150.

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FORWARD-LOOKING STATEMENTS

Statements regarding future products, including the anticipated dates for introducing such products, future prospects, future 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 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, anticipated future developments and other factors the Company believes are appropriate in the circumstances, or upon 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 future 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 governmental regulation and effects of 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; changes in customer needs resulting from economic conditions; dependence on information systems; 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; and the events of September 11, 2001, and its repercussions. 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.

RISK FACTORS

The risks and uncertainties described below are not the only ones facing our company. Additional risks and uncertainties not presently known to us or that we currently consider immaterial may also impair our operations. If any of the following risks, or any additional risks and uncertainties, were to materialize, our business, financial condition or results of operations could be materially adversely affected. Were that to occur, the trading price of our common stock could decline.

Risks Related to Our Business

We have incurred significant losses in the past and we may not be able to sustain profitability in the future.

During two of the past three years, we incurred net losses. As of June 30, 2003, we had an accumulated deficit of approximately $81 million. Moreover, we currently expect to increase our operating expenses in connection with:

expanding into new geographic markets;

expanding into new product markets;

continuing to develop our technology;

hiring additional personnel; and

upgrading our information and internal control systems.

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We have difficulty predicting our future operating results or profitability due to volatility in general economic conditions and in particular with the internet security market. The overall weakness in the general economy and volatility of demand for our security products are two of the many factors underlying our inability to predict our revenues for a given period. We base our spending levels for product development, sales and marketing, and other operating expenses largely on expected future revenues. A large portion of our expenses are fixed for a particular quarter or a year, and therefore we may be unable to decrease our spending in time to compensate for any unexpected quarterly or annual shortfalls in revenues. As a result, any shortfall in revenue could cause our earnings to decrease or our losses to increase.

Our operating results fluctuate and can fall below expectations of analysts and investors, resulting in a decline of our stock price.

Our quarterly revenues and operating results have varied in the past and will likely continue to vary in the future due to a number of factors, many of which are outside of our control. Any of these factors could cause our stock price to decline. Our operating expenses are largely based on anticipated revenues and a high percentage of our expenses are, and will continue to be, fixed in the short term. As a result, lower than anticipated revenues for any reason could cause significant variations in our operating results from quarter to quarter. It is likely that if in some future quarters our operating results fall below expectations of public market analysts and investors, the price of our common stock would likely decline.

Seasonality and concentration of revenues at the end of the quarter could cause our revenues to fall below the expectations of analysts and investors, resulting in a decline of our stock price.

The growth rate of our domestic and international sales has been and may continue to be slower in the summer months, when businesses often defer purchasing decisions. Also, as a result of customer buying patterns and the efforts of our sales force to meet or exceed quarterly and year-end quotas, historically we have earned a substantial portion of a quarter s revenue during its last month and more recently in the latter half of the last month. If expected revenues at the end of any quarter are delayed, our revenues for that quarter could fall below the expectations of the analysts and investors and result in a decline in our stock price.

If third party channel partners fail to perform, our ability to sell our products and services will be limited.

We expect to sell most of our products and services through our channel network partners and we expect our success to depend in large part on their performance. Some of our channel partners sell products and services that are competitive with ours, and may devote more resources to those competitive products than they devote to ours or may cease selling our products and services altogether. If our third party channel partners fail to perform, our ability to expand our business and increase sales will be limited.

We may need to decrease the price of our products, which may reduce our revenues and our ability to generate income.

Average selling prices of our products may decrease, which may reduce our gross margins. The average selling price for our products may decline as a result of competitive pricing pressures, promotional programs and customers who negotiate price reductions in exchange for long-term purchase commitments. The pricing of products depends on specific features and functions of the product, purchase volumes and the level of sales and services support. We expect competition to increase in the future. As we experience pricing pressure, we anticipate that the average selling prices and gross margins per product will decrease over product lifecycles. We cannot assure you that we will be successful in developing and introducing on a timely basis new products with enhanced features, or that these products,

if introduced, will enable us to maintain our average selling prices and gross margins at current levels. Our gross margins have been and will continue to be affected by a variety of factors including competition, the mix in average selling prices of products, new product introduction, enhancements and the cost of components and manufacturing labor. We must manage each of these factors competitively for our gross margins to remain at their current levels.

We rely primarily on a single manufacturer and assembly house. The loss of this relationship could result in our being unable to deliver products for an extended period of time.

We outsource all of our hardware manufacturing and assembly primarily to one third-party manufacturer and assembly house, Omni Tech Corporation, and we do not have a written contract with this company. We have only recently established arrangements with an alternative manufacturer and assembly house and we may not be able to meet the demands for our products if we were to lose our relationship with our primary manufacturer and assembly house. Our operations could be disrupted for an extended period of time if we have to switch to a replacement vendor. An interruption in our hardware supply could result in a loss of customer orders and revenue and diminish the reputation of our brands.

We may underestimate our required inventories, which may result in our inability to deliver products on a timely basis.

We provide forecasts of our demand to our primary contract manufacturer up to three months prior to scheduled delivery of product to our customers. If we underestimate our requirements, our primary contract manufacturer may have an inadequate component inventory, which could interrupt manufacturing of our products and result in delayed shipments and reduced revenues. In addition, lead times for materials and components that we order vary significantly and depend on the specific supplier, contract terms, and demand for each component at a given time and other factors. We may also experience shortages of components from time to time, which also could delay the manufacturing of our products.

We may need to raise additional capital to finance our operations or future growth, and this capital may not be available to us.

Our future revenue may be insufficient to support the expense of our operations and the expansion of our business. As a result, we may seek additional funding through:

- public or private equity financing;
- public or private debt financing; and/or
- capital lease transactions.

We believe that our cash on hand, cash equivalents and net working capital will be sufficient to meet our capital requirements for at least the next twelve months. However, our capital requirements will depend on several factors, including:

- the rate of market acceptance of our products and services;
- our ability to expand our customer base;
- the growth of our sales and marketing capabilities; and
- the cost of any acquisitions we may complete.

We may decide at any time to raise additional capital to take advantage of available strategic opportunities or attractive financing terms. If we issue equity securities, shareholders may experience dilution or the new equity securities may have rights, preferences or privileges senior to those of existing holders of common stock. If we cannot raise any required additional funds on acceptable terms, we may

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not be able to develop or enhance our products, take advantage of future opportunities or respond to competitive pressures or unanticipated requirements, which could have a material adverse effect on our ability to continue operating our business. If we are unable to meet our future capital requirements, our business would be harmed.

Because many potential customers remain unaware of the need for internet security or may perceive it as costly and difficult to implement, our products and services may not achieve market acceptance.

We believe that many potential customers are not fully aware of the need for internet security products and services. Historically, only enterprises having substantial resources have developed or purchased internet security solutions. Also, there is a perception that internet security is costly and difficult to implement. We will therefore not succeed unless the market understands the need for internet security and we can convince our potential customers of our ability to provide this security in a cost-effective manner. Although we have spent and will continue to spend considerable resources educating potential customers about the need for internet security and the benefits of our products and services, our efforts may be unsuccessful.

The market for internet security products and services is highly competitive and we may not have the resources to compete effectively.

The market for internet security products is intensely competitive and characterized by frequent technological change. We believe that competition in this market is likely to persist and intensify as demand for network security products continues to increase. In market segments requiring the highest levels of network security, we compete with Secure Computing Corporation, which also offers a firewall with a security-enhanced operating system. We also compete with security vendors such as Check Point Software Technologies Ltd., Cisco Systems, Inc., and NetScreen Technologies, Inc. These companies products may be considered to be alternatives to our products that could eventually compete with our firewall/VPN products.

Our failure to address strain on our resources caused by growth will result in our inability to effectively manage our business.

Our current systems, management and resources will be inadequate if we continue to grow at a significant rate. A rapid expansion of our business will place a significant strain on our administrative, operational and financial resources and will result in increasing responsibilities of our management personnel. We will be unable to effectively manage our business if we are unable to timely and successfully alleviate the strain on our business caused by rapid growth.

We may be unable to adequately expand our operational systems to accommodate growth, which can harm our ability to deliver our products and services.

Our operational systems have not been tested at customer volumes that may be required in the future. We may encounter performance difficulty when operating with a substantially greater number of customers. An inability to add additional operating systems and personnel to handle increased demands may cause unanticipated disruptions in our current processes, slower response times and poor customer service, including problems filling customer orders.

Rapid changes in technology and industry standards could render our products and services unmarketable or obsolete and we may be unable to introduce new products and services timely and successfully.

To succeed we must continually change and improve our products in response to rapid technological developments and changes in operating systems, internet access and communications, application and network software, computer and communication hardware, programming tools, computer language technology and hacker techniques. We may be unable to successfully and timely develop these

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new products and services or achieve and maintain market acceptance. The development of new, technologically advanced products and services is a complex and uncertain process requiring innovation and the ability to anticipate technological and market trends. Because internet security technology is complex it can require long development and testing periods. Releasing new products and services prematurely may result in quality problems, and releasing them late may result in loss of customer confidence and market share. In the past we have on occasion experienced delays in the scheduled introduction of new and enhanced products and services, and we may experience delays in the future. When we do introduce new or enhanced products and services, we may be unable to manage the transition from the older products and services to minimize disruptions to the customers ordering patterns, avoid excess inventory of older products and deliver enough products and services to meet customer demand.

We may be required to defend lawsuits or pay damages in connection with the alleged or actual failure of our products and services.

Because our products provide internet security and protect valuable information, we may face claims for product liability, tort or breach of warranty relating to our products and services. Anyone that circumvents our products security measures could misappropriate the confidential information or other property of end-users using our products and services or interrupt their operations. If that happens, affected end-users or channel partners may sue us. In addition, we may face breaches caused by faulty installations and implementations of our products by end-users or channel partners. Although we attempt to reduce the risk of loss from claims through contractual or warranty disclaimers and liability limitation provisions, these provisions may be unenforceable. Some courts, for example, have found contractual limitations of liability in standard software licenses to be unenforceable because the licensee does not sign them. Defending a suit regardless of its merit could be costly and could divert management s attention. Although we currently maintain business liability insurance, this coverage may be inadequate or be unavailable in the future on acceptable terms, if at all.

A breach in security could harm public perception of our products.

We will not succeed unless the marketplace is confident that we provide effective internet security protection. Even networks protected by our products may be vulnerable to electronic break-ins and computer viruses. If an actual or perceived breach of internet security occurs in an end-user system, regardless of whether the breach is attributable to us, the market perception of the efficiency and effectiveness of our products and services could be harmed. This could cause us or our channel partners to lose current and potential customers or cause us to lose potential channel partners. Because the technology used by computer hackers to access or sabotage networks changes frequently and generally is not recognized until launched against the target, we may be unable to anticipate these techniques.

If we are unable to prevent attacks on our internal network security system by computer hackers, public perception of our products and services will be harmed.

Because we provide internet security, we are a significant target of computer hackers. We have experienced attacks by computer hackers in the past and expect the attacks to continue. If attacks on our internal network systems are successful, public perception of our products and services will be harmed.

We may be unable to deliver our products and services if we cannot continue to license third party technology that is important for the functionality of our products.

Our success will depend in part on our continued ability to license technology that is important for the functionality of our products. We depend on our third party licenses to deliver reliable high quality products, develop new products on a timely and cost effective basis and respond to evolving technology and changes in industry standards. We also depend on the continued compatibility of third party software with future versions of our products. An interruption in the supply of third party technology could delay our development and sales until we can find, license and integrate equivalent technology. This could damage our brand and result in loss of current and potential customers. We have no written contracts to license third party technology in the future, however, we believe we can find other sources for the technology we need for our products. If the alternative technology is available, we cannot be assured that it will be on acceptable terms.

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We will be unable to deliver our products and services if component manufacturers fail to supply component parts with acceptable quality, quantity and cost.

We obtain the component parts for our hardware from a variety of manufacturers. While our component vendors have produced parts for us in acceptable quantities and with acceptable quality and cost in the past, they may be unable to do so in the future. Companies in the electronic industry regularly experience lower than required component allocations and this industry is subject to frequent component shortfalls. Although we believe we can find additional or replacement sources for our hardware components, our operations could be disrupted if we have to add or switch to a replacement vendor or if our components supply is interrupted. This could result in a loss of customer orders and revenue.

Declines in demand for our products and services would cause our revenues and profitability to decrease.

If overall market demand for computers, servers and other computing devices declines significantly, and consumer and corporate spending for such products declines, our revenue growth will be adversely affected. Additionally, our revenues would be unfavorably impacted if customers reduce their purchases of new software products or upgrades to existing products if such new offerings are not perceived to add significant new functionality or other value to prospective purchasers.

A reduction in the growth of internet usage and a softening demand for our products and services caused by the ongoing economic downturn may result in decreased revenue, earnings or growth rates and problems with our ability to manage inventory levels and realize customer receivables.

We depend on the government, telecommunications, financial services, computing and manufacturing industries for a significant portion of our revenues. Significant reduction in technology capital spending in these industries caused by recent adverse economic conditions may continue to result in decreased revenues and earnings. Our revenues are dependent on the level of technology capital spending in the United States and international economies. A number of companies announced significant reductions and deferrals in capital spending. Further delays or reductions in information technology spending could have a material adverse effect on demand for our products and services and consequently our results of operations, prospects and stock price.

Our failure to effectively develop new products could harm our ability to generate revenues in the future.

The development of software products is a complex and time-consuming process. New products and enhancements to existing products can require long development and testing periods. Significant delays in new product releases or significant problems in creating new products could negatively impact our ability to market and sell our products in the future.

If we do not retain our key employees, our ability to execute our business strategies and provide our products and services will be impaired.

Our future success will depend on the efforts and ability of our senior management and our key development, technical, operation, information systems, customer support, and sales and marketing personnel, and on our ability to retain them. These employees are not obligated to continue their employment with us and may leave us at any time. The loss of key employees would impair our ability to develop competitive products and provide appropriate levels of service to our customers.

If we do not expand our international operations, the growth of our business will be limited.

Our ability to grow depends in part on the expansion of our international sales and operations, which we expect to continue to account for a significant portion of our revenues. Sales to customers outside the United States accounted for approximately 51% of our revenues in fiscal year 2001, 58% in fiscal year 2002 and 50% in fiscal year 2003. The failure of our channel partners to sell our products internationally will limit our ability to increase our revenues.

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Our international operations result in export and currency risks, which may make our operations less profitable.

Our international sales are subject to the risks inherent in international business activity, including:

- cost of customizing products for foreign countries;
- export and import restrictions, including those affecting encryption commodities and software;
- difficulties in acquiring and authenticating customers information;
- reduced protection of intellectual property rights and increased liability exposure; and
- regional economic and political conditions.

Significant portions of our international sales currently are U.S. dollar denominated. As a result, an increase in the value of the U.S. dollar relative to foreign currencies may make our products less competitive in the international markets.

We may be unable to adequately protect our proprietary rights, which may limit our ability to compete effectively.

Despite our efforts to protect our proprietary rights, unauthorized parties may misappropriate or infringe on our trade secrets, copyrights, trademarks, service marks and similar proprietary rights. We face additional risk when conducting business in countries, which have poorly developed or inadequately enforced intellectual property laws. While we are unable to determine the extent to which piracy of our software products exists we expect piracy to be a continuing concern, particularly in international markets and as a result of the growing use of the internet.

Intellectual property claims and litigation could subject us to significant liabilities for damages and invalidation of our proprietary rights.

In the future we may have to resort to litigation to protect our intellectual property rights, to protect our trade secrets or to develop the validity and scope of proprietary rights with respect to intellectual property, which we have licensed from others. Any litigation, regardless of its success, would be costly and require significant time and attention of our key management and technical personnel. The litigation could also force us to:

- stop or delay selling, incorporating or using products that incorporate the challenged intellectual property;
- pay damages;

enter into licensing or royalty agreements, which may be unavailable under acceptable terms; or

redesign products and services that incorporate infringing technology.

We may face infringement claims from third parties in the future. The software industry has seen frequent litigation over intellectual property rights, and we expect that participants in the internet security industry will be increasingly subject to infringement claims as the number of products, services, and competitors grows and functionality of the products and services overlap. We cannot assure you that the

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steps taken by us will be adequate to deter misappropriation of our proprietary rights or that third parties will not independently develop substantially similar products, services and technology. Furthermore, there can be no assurance that our products will not infringe upon the intellectual property rights of third parties. We may not be able to avoid infringement of third party intellectual property rights and may have to obtain a license, defend an infringement action, or challenge the validity of the intellectual property rights in court. Failure to obtain or maintain intellectual property rights in our products, for any reason, could have a material adverse effect on us.

Undetected product errors or defects could result in loss of revenues or claims against us.

Our products and services may contain undetected errors or defects, especially when first released. Despite extensive testing, some errors are discovered only after a product has been installed and used by customers. Any errors discovered after commercial release could result in loss of revenue or claims against our channel partners or us.

We are subject to shareholder litigation claims that could result in large payments by us, which would reduce our earnings or increase our losses.

We are currently defending a class action lawsuit relating to a restatement of our financial results. We have entered into a Memorandum of Understanding relating to the settlement of this lawsuit, which resulted in our incurring a one-time charge of $3.9 million in the fourth quarter of our 2003 fiscal year. A portion of this amount will be payable in cash or in a combination of cash and stock, at our option. The terms of the settlement are subject to approval by the court, and there can be no assurance that the court will approve this proposed settlement of the lawsuit. If the court does not approve the settlement, there can be no assurance that we will ultimately be successful in defending the lawsuit, or that if we are unsuccessful, that there will be sufficient insurance coverage to cover any judgment rendered against us. We are unable to make any estimates regarding the potential liability related to this litigation if the court does not approve the proposed settlement.

Governmental controls over the export or import of encryption technology could cause us to lose sales.

Any additional governmental regulations of imports or exports, or failure to obtain required approval for our encryption technologies could adversely affect our international and domestic sales. The United States and various other countries have imposed controls, export license requirements and restrictions on the import or export of some technologies, especially encryption technology. In addition, from time to time governmental agencies have proposed additional regulation over encryption technology, including, for example, requiring the escrow and governmental recovery of private encryption keys. Additional regulation of encryption technology could delay or prevent the acceptance and use of encryption products in public networks for secure communications. This in turn could result in decreased demand for our products and services. In addition, some foreign competitors are subject to less stringent controls on exporting their encryption technologies. As a result, they may be able to compete more effectively than we can in the U.S. and international security markets.

One of our shareholders owns a significant percentage of our outstanding common stock and may be able to significantly effect the outcome of shareholder votes.

Richard L. Scott, a former member of our Board of Directors, beneficially owned as of June 30,, 2003, directly or indirectly, 8,203,647 shares of our common stock, or approximately 38.1% of our common stock outstanding as of that date. Accordingly, Mr. Scott may be able to significantly effect the outcome of certain shareholder votes, including votes concerning the election of directors, the adoption or amendment of provisions in our articles of incorporation, and the approval of mergers and other significant corporate transactions. This level of concentrated ownership by one person may have the effect of delaying or preventing a change in the management or voting control of us.

Our articles of incorporation and Florida law contain provisions that could discourage third parties from acquiring us or limit the price that they would be willing to pay for our stock.

Certain provisions of our articles of incorporation and bylaws, as well as the Florida Business Corporation Act, may have an anti-takeover effect and may discourage, delay, defer or prevent a tender

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offer or takeover attempt that a shareholder might consider to be in its best interest, including those attempts that might result in a premium over the market price for the shares held by the shareholders. Certain of such provisions allow our board of directors to authorize the issuance of preferred stock with rights superior to those of the common stock. These anti-takeover provisions could substantially impede the ability of shareholders to benefit from a change-in-control or to change our management and our board.

Our business will suffer if we fail to comply with recent federal regulations and future rules of the Securities and Exchange Commission relating to corporate governance reform.

As a public company, we are subject to certain federal regulations and the rules and regulations of the Securities and Exchange Commission. On July 30, 2002, President George W. Bush signed into law the Sarbanes-Oxley Act of 2002, effecting tighter accounting, corporate fraud and securities laws. With this legislation, the SEC has adopted new rules pertaining to, among other things, audit committee requirements and additional disclosure and reporting requirements. Our reputation and financial results could be materially harmed by any failure by us to comply with any current or future rules or regulations relating to the Sarbanes-Oxley Act or to any other federal corporate reform measures.

There is a limited public market for our common stock.

Our common stock is currently listed on the Nasdaq National Market. The market for our common stock has historically been characterized by limited trading volume and a limited number of holders. There can be no assurance that a more active trading market for our common stock will develop. See Price Range of Common Stock.

ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURE ABOUT MARKET RISK

Interest rate risk. We do not hold derivative financial instruments or derivative equity securities. Financial investments, which potentially subject the Company to a concentration of credit risk, principally consist of cash, cash equivalents and trade receivables. The Company holds any excess cash in short-term investments consisting of commercial paper. Concentration of credit risk with respect to receivables is limited due to the Company s customer base and historical collection rates.

Foreign currency risk. The majority of our sales and the majority of our expenses are currently denominated in US dollars. As a result, we have not experienced significant foreign exchange gains and losses except those disclosed on F9 in the accompanying audited consolidated financial statements. While we conducted some transactions in foreign currencies during 2002 and 2003 and expect to do so in the future, we do not anticipate the foreign currency gains or losses will be material to CyberGuard. Although we have not engaged in foreign currency hedging to date, we may do so in the future.

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

The following items are attached and incorporated into this Item 8.

Report of Independent Certified Public Accountants	F-1
Report of Management	F-2
Consolidated Balance Sheets as of June 30, 2003 and June 30, 2002	F-3
Consolidated Statements of Operations for years ended June 30, 2003, June 30, 2002, and June 30, 2001	F-4
Consolidated Statements of Cash Flows for years ended June 30, 2003, June 30, 2002, and June 30, 2001	F-5
Consolidated Statements of Changes in Shareholders Equity (Deficit) and Comprehensive Income for years ended June 30, 2003, June 30, 2002, and June 30, 2001	F-6
Notes to Consolidated Financial Statements	F-7

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ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURES

None

ITEM 9A. CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures

The Company maintains disclosure controls and procedures designed to ensure that information required to be disclosed in reports filed under the Securities Exchange Act of 1934, as amended, is recorded, processed, summarized and reported within the specified time periods. As of the end of the period covered by this report, the Company s Chief Executive Officer and Chief Financial Officer evaluated, with the participation of CyberGuard s management, the effectiveness of the Company s disclosure controls and procedures. Based on the evaluation, which disclosed no significant deficiencies or material weaknesses, the Company s Chief Executive Officer and Chief Financial Officer concluded that the Company s disclosure controls and procedures are effective. There were no changes in the Company s internal control over financial reporting that occurred during the Company s most recent fiscal quarter that have materially affected, or are reasonably likely to materially affect, the Company s internal control over financial reporting.

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 accounting principles generally accepted in the United States. 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 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. Over time, controls may become inadequate because of changes in conditions, or the degree of compliance with the policies or procedures may deteriorate. Because of the inherent limitations in a cost-effective control system, misstatements due to error or fraud may occur and not be detected.

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PART III

ITEM 10. DIRECTORS AND EXECUTIVE OFFICERS OF THE REGISTRANT

Director and Nominees for Director	Age	Director Since	Expiration of Term of Office
William D. Rubin (1)	50	2002	2003
Kenneth C. Jenne, II	56	2003	2003
John V. Tiberi, Jr. (1)(2)	60	2000	2003
Patrick J. Clawson	39	2003	2003
Scott J. Hammack	38	2001	2004
David L. Manning (1)(2)	53	1999	2004
William G. Scott (2)	52	1999	2005
Daniel J. Moen	51	2001	2005

(1) Member of Audit Committee

(2) Member of Compensation and Stock Option Committee

William D. Rubin has served as a Director of the Company since April 2002. Mr. Rubin is currently the President of The Rubin Group, a private lobbying and marketing company, with offices in Ft. Lauderdale and Tallahassee, Florida. Mr. Rubin has operated The Rubin Group since 1991. Prior to that time, Mr. Rubin had a career with the state of Florida, as Chief of Staff to the Florida Department of Insurance.

Kenneth C. Jenne, II has served as a Director of the Company since April 2003. Mr. Jenne is currently the Sheriff of Broward County, Florida, serving as the chief law enforcement, fire rescue and detention officer. Mr. Jenne was appointed to the Sheriff position in January 1998. In 1978, Mr. Jenne was elected to the Florida Senate where he served for 18 years while holding top committee chairmanships and also serving as Senate Democratic Leader. Mr. Jenne is a former prosecutor for the Broward County State Attorney s Office. After September 11, 2001, Mr. Jenne was appointed by the Florida governor as the Chair of the Southeast Florida Regional Domestic Security Task Force.

Patrick J. Clawson has served as a Director of the Company since October 2003. Mr. Clawson was appointed the Company s President in January 2001. Prior to that time, Mr. Clawson served as Senior Vice President of Business Development at Allscripts, Inc. from May 2000 to January 2001; Vice President of Sales and Marketing at MasterChart, Inc. from October 1998 to May 2000; Senior Director for the Southeastern U.S. region at Reynolds and Reynolds Healthcare Systems from January 1998 to October 1998; and in various positions at Lanier Worldwide, Inc. from 1986 to January 1998.

John V. Tiberi, Jr. has served as a Director of the Company since August 2000. Mr. Tiberi is currently President and Chief Executive Officer of Tech Highway, LLC, a venture catalyst company, and President of ETec Business Management Consultants, a partnership providing consulting services in the technology industry. From 1969 until 1998, Mr. Tiberi worked at Xerox Corporation in several senior executive positions. Mr. Tiberi currently serves on the board of directors of Zenographics, Inc. and Cycle 23, Inc. In the past, he served on the boards of directors of Spectra Diode Labs, Inc. and TracePoint Technologies, Inc.

Scott J. Hammack was appointed Chief Executive Officer of the Company in January 2001 and Chairman of the Company s Board of Directors in September 2001. In 1991, Mr. Hammack founded MasterChart, Inc., a private company that developed an electronic medical record product and other software products. Mr. Hammack served as the Chief Executive Officer of MasterChart, Inc. from 1991 until May 2000, when MasterChart, Inc. was sold to Allscripts, Inc. After the sale of MasterChart, Inc., Mr. Hammack worked on transitioning MasterChart within Allscripts from May 2000 to December 2000.

David L. Manning has served as a Director of the Company since September 1999. Mr. Manning was Commissioner of Finance and Administration for the State of Tennessee from 1987 to 1995 where he managed the State s finances and information technology services. In 1995, he joined Columbia/HCA Healthcare Corporation and became Senior Vice President during 1997 with responsibilities for healthcare data analysis and the company s relationships with state governments. After leaving that position in early 1998, Mr. Manning was a consultant in the healthcare industry. He currently serves as Director of Finance for the Metropolitan Government of Nashville and Davidson County. Mr. Manning was appointed to the Company s Board of Directors in September 1999 on the recommendation of Fernwood Partners II, LLC, upon completion of the Fernwood Financing.

William G. Scott has served as a Director of the Company since September 1999. Mr. Scott currently serves as Chief Financial Officer of CST Industries, Inc., a private company that manufactures steel bolted and welded tanks for dry and liquid storage. From December 1991 to April 1997, Mr. Scott was Chief Financial Officer and later President and member of the board of directors of Markay Plastics, Inc. From April 1997 to April 1999, Mr. Scott was Vice President of Strategic Resource Solutions, a division of Carolina Power and Light Corporation, and served as Chief Operating Officer of their Lighting Division. From May 1999 to March 2001, Mr. Scott, who is a C.P.A., was President of W.G. Scott & Associates, a consulting firm providing business and tax advice. Mr. Scott was appointed to the Company s Board of Directors in September 1999 on the recommendation of Fernwood Partners II, LLC, upon completion of the Fernwood Financing (as defined below).

*Daniel J. Moen*has served as a Director of the Company since December 2001. Mr. Moen is currently Chief Executive Officer of Quorum Health Resources, LLC, where he has served since October 1, 2001 and Executive Vice President of Development for Triad Hospitals, Inc. of Dallas, TX, where he has served since April 2002. From January 2001 to September 2001, Mr. Moen served as Director of HIP Health Plan of Florida, a privately-held health maintenance organization. From January 2000 to December 2000, Mr. Moen was Chairman and Chief Executive Officer of Healthline Management, Inc., a privately-held physician outsourcing company. From August 1998 to December 1999, Mr. Moen was a healthcare consultant. From 1991 to July 1998, Mr. Moen served as President of various divisions within Columbia/HCA Healthcare Corporation.

Executive Officers

Name	Age	Position
Scott J. Hammack(1)	38	Chief Executive Officer and Chairman of the Board of Directors
Patrick J. Clawson(1)	39	President
Michael Matte	44	Chief Financial Officer and Vice President Finance
Michael G. Wittig	39	Vice President Development and Chief Technology Officer
Adriana Kovalovska	34	Vice President Legal Affairs, Corporate Counsel and Secretary

(1) For biographical information on Mr. Hammack and Mr. Clawson, see above.

Michael Matte. Prior to joining the Company in February 2001, Mr. Matte served as Chief Financial Officer of Amerijet International, Inc. from June 1998 to February 2001; Chief Financial Officer of Intime Systems International from October 1994 to June 1998; and Chief Financial Officer of Torwest, Inc. from October 1992 to October 1994. Mr. Matte, a certified public accountant, began his career at PricewaterhouseCoopers, where he worked for 11 years.

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Michael G. Wittig. Mr. Wittig was appointed the Company s Vice President of Development in February 1998. In February 1999, Mr. Wittig was also appointed the Company s Chief Technology Officer. Since joining the Company in 1992, Mr. Wittig has served as Director of Software Development, as Manager of Software Development, and in various other software development positions.

Adriana Kovalovska. Ms. Kovalovska, an attorney, was appointed the Company s Vice President of Legal Affairs in July 2000. Since joining the Company in January 1998, she has served as Associate Counsel and from February 2000 as the Company s Corporate Counsel and Secretary. Ms. Kovalovska is responsible for administering legal, regulatory and compliance activities for the Company. In 1996, Ms. Kovalovska completed an internship with the U.S. Securities and Exchange Commission, Division of Enforcement.

SECTION 16(a) BENEFICIAL OWNERSHIP REPORTING COMPLIANCE

Under federal securities laws, the Company s directors, certain officers, and persons holding more than 10% of the Common Stock of the Company are required to report, within specified due dates, their initial ownership and all subsequent acquisitions, dispositions or other transfers of interest in Common Stock, if and to the extent reportable events occur which require reporting of such due dates. The Company is required to describe in this Proxy Statement whether it has knowledge that any person required to file such report failed to do so in a timely manner. To the Company s knowledge, all such filings were made in a timely manner during the fiscal year ended June 30, 2003, with the following exceptions: one Form 4 filing was filed late by Mr. Michael Wittig relating to an April 28, 2003 trade, and all Form 4 filings relating to automatic stock option awards to the Company s non-employee directors under a pre-approved compensation plan (which was previously disclosed in the Director Compensation section of the Company s Proxy Statements) for awards made on September 30, 2002, December 31, 2002, March 31, 2003 and June 30, 2003, which stock option grants were inadvertently reported on Forms 5 filed on their behalf by the Company because of inadvertent oversight and advice from the Company s outside counsel during the transition to the new Sarbanes-Oxley filing rules. The foregoing is based upon reports furnished to the Company and other information provided to the Company by the persons required to make such filings.

CODE OF ETHICS

The policy of the Company is to comply strictly with all laws governing its operations and to conduct its affairs in keeping with the highest moral, legal and ethical standards. Senior executive and financial officers hold an important and elevated role in maintaining a commitment to (i) honest and ethical conduct, (ii) full, fair, accurate, timely and understandable disclosure in the Company s public communications, and (iii) compliance with applicable governmental rules and regulations. Accordingly, the Company has adopted this Code of Ethics for its principal executive officer, principal financial officer and principal accounting officer and controller and any other senior executive or financial officers performing similar functions and so designated from time to time by the Chief Executive Officer (Senior Executive and Financial Officers). The Company posted the Code of Ethics on the Company s website at: http://www.cyberguard.com/pdf/cyberguard_code_of_ethics_financial_officers.pdf.

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ITEM 11. EXECUTIVE COMPENSATION

Summary Compensation Table

The following table sets forth certain information with respect to the annual and long-term compensation of the Company s Chief Executive Officer and certain of the Company s other executive officers (collectively, the named executive officers) for the fiscal years ended June 30, 2003, June 30, 2002, and June 30, 2001.

					Long Term Compensation	
		Annual Compensation			*Awards(3)*	*All other Compensation ($)(4)*
Name and Principal Position	***Fiscal Year***	***Salary ($)***	***Bonus ($)(1)***	***Other Annual Compen-sation ($)(2)***	***Securities Underlying Options (#)***	
Scott J. Hammack						
Chairman and Chief						5,921
Executive Officer (Became	2003	129,199	212,000		350,000	104
	2002	76,923	18,750		461,539	
CEO on January 2, 2001)	2001	99,231	56,250	69,877	500,000	3,735
Patrick J. Clawson	2003	162,727	175,900		250,000	
	2002	140,760	33,125			
President (Became	2001	67,500	42,188	39,588	34,650	1,175
				11,270		
President on January 18,					250,000	6,181
2001)						
Michael Matte	2003	158,028	169,600		250,000	11,409
	2002	137,846	30,000			
Chief Financial Officer and	2001	61,538	45,000		83,077	7,461
Vice President Finance					100,000	3,411
(Became CFO on February						
14, 2001)						
Michael G. Wittig(5)	2003	155,943	174,900		250,000	16,723
	2002	143,462	30,938			
Vice President	2001	165,000	47,953		80,769	6,606

Development & Chief				50,000	13,387
Technology Officer					
Adriana Kovalovska	2003	122,510	66,251	150,000	5,963
	2002	113,923	11,719		
Vice President Legal	2001	109,231	27,844	34,615	7,051
Affairs (Became VP Legal				40,000	4,983
Affairs on July 14, 2000)					

(1) The following amounts of bonuses for the fiscal year ended June 30, 2003 were accrued during such period but were paid during the subsequent fiscal year: Mr. Hammack $55,250; Mr. Clawson $45,581; Mr. Matte $44,200; Mr. Wittig $45,581; and Ms. Kovalovska $17, 266. The following amounts of bonuses for the fiscal year ended June 30, 2001 were accrued during such period but were paid during the subsequent fiscal year: Mr. Hammack $6,250; Mr. Clawson $4,688; Mr. Matte $45,000; Mr. Wittig $2,578; and Ms. Kovalovska $1,719.

(2) The amounts represent relocation expenses paid by the Company. During the fiscal year ended June 30, 2002, the relocation expenses paid to Mr. Clawson included the following: $9,932 for house closing costs and $26,435 for moving and storage of personal property. The amounts do not include the value of securities purchased by Mr. Hammack from the Company during fiscal year 2001 in connection with a non-compensation-related investment in the Company.

(3) Includes options to purchase the Company s Common Stock that were granted to Messrs. Hammack, Clawson, Matte and Wittig and Ms. Kovalovska during fiscal year ended June 30, 2002 in connection with the Salary Reduction Program described below.

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(4) Amounts reported represent contributions to the Company s Retirement Plan and term life insurance premiums paid by the Company.

(5) The amount under Awards does not include the securities or the value of the securities issued to Mr. Wittig upon conversion during fiscal year ended June 30, 2001 of promissory note held by him in connection with a non-compensation-related financing of the Company.

Option Grants in the Fiscal Year Ended June 30, 2003

The following table shows all grants during the fiscal year ended June 30, 2003 of stock options under the Company s stock option plans to the named executive officers.

Individual Grants

Name	*Number of Securities Underlying Option Granted (#)(1)*	*Percent of Total Options Granted to Employees in Fiscal Year (%)(2)*	*Exercise or Base Price ($Sh)*	*Expiration Date*	*Potential Realizable Value At Assumed Annual Rates of Stock Price Appreciation for Option Term(3) 5%($)*	*10%($)*
Scott J. Hammack	350,000	16.43%	2.45	7/4/07	$ 236,911	$ 523,512
Patrick J. Clawson	250,000	11.74%	2.45	7/4/07	$ 169,222	$ 373,937
Michael Matte	250,000	11.74%	2.45	7/4/07	$ 169,222	$ 373,937
Michael G. Wittig	250,000	11.74%	2.45	7/4/07	$ 169,222	$ 373,937
Adriana Kovalovska	150,000	7.04%	2.45	7/4/07	$ 101,533	$ 224,362

(1) The options expire 5 years from the date of grant, July 5, 2002, and vest in 3 annual increments as follows: Mr. Hammack 35,000 shares on January 1, 2003, 105,000 shares on January 1, 2004 and 210,000 shares on January 1, 2005; Messrs. Clawson, Matte and Wittig 25,000 shares on January 1, 2003, 75,000 shares on January 1, 2004 and 150,000 shares on January 1, 2005; Ms. Kovalovska 25,000 shares on January 1, 2003, 50,000 shares on January 1, 2004 and 75,000 shares on January 1, 2005).

(2) The amount of total options granted to employees during the fiscal year ended June 30, 2003 (2,129,981 shares) includes options issued to the members of the Company s Board of Directors.

(3) The potential realizable values set forth under these columns result from calculations assuming 5% and 10% annualized stock price growth rates from grant dates to expiration dates as set by the Securities and Exchange Commission and are not intended to forecast future price appreciation of the Company s Common Stock based upon growth at these prescribed rates. The Company is not aware of any formula that will determine with reasonable accuracy a present value based on future unknown factors. Actual gains, if any, on stock option exercises are dependent on the future performance of the Company. There can be no assurance that the amounts reflected in this table will be achieved.

Aggregated Option Exercises in the Fiscal Year Ended June 30, 2003 and Fiscal Year-End Option Values

The following table provides information as to the number and value of unexercised options to purchase the Company s Common Stock held by the named executive officers at June 30, 2003, based on a closing sale price of $7.10 on June 30, 2003.

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Name	Shares Acquired On Exercise (#)	Value Realized ($)	Number of Securities Underlying Unexercised Options at Fiscal Year-End (#) Exercisable/ Unexercisable	Value of Unexercised In-the-Money Options at Fiscal Year-End ($) Exercisable/ Unexercisable(1)
Scott J. Hammack	0	0	863,205/448,334	4,889,339/2,210,087
Patrick Clawson	0	0	242,983/291,667	1,343,885/1,419,585
Michael Matte	0	0	174,743/258,334	818,094/1,156,252
Michael G. Wittig	45,000	222,215	239,702/241,667	1,206,610/1,139,585
Adriana Kovalovska	20,000	89,325	126,281/138,334	503,681/647,585

(1) Based on the difference between the closing price of the Company s common stock on June 30, 2003 ($7.10) and the exercise price of the options.

Compensation Plans

Executive Employment Arrangements. The Company and Mr. Hammack entered into an agreement effective as of January 2, 2001 (the Hammack Employment Agreement). The Hammack Employment Agreement provides for the employment of Mr. Hammack as Chief Executive Officer of the Company at an annual base salary of $200,000; however, the Hammack Employment Agreement was amended on October 1, 2001 to reduce his salary to $0 for the period from November 3, 2001 to November 2, 2002 in connection with the Salary Reduction Program described below. The Hammack Employment Agreement, as amended, provides for Mr. Hammack to receive a target bonus equal to 100% of his annual base salary upon the achievement of certain performance objectives established by the Company.

The Company may terminate the Hammack Employment Agreement for cause. The Hammack Employment Agreement defines cause as acts of willful misconduct or gross negligence by Mr. Hammack in performance of his material duties or obligations to the Company, or conviction of Mr. Hammack of a felony involving moral turpitude, or a material act of dishonesty or breach of trust by Mr. Hammack, intended to enrich Mr. Hammack at the expense of the Company. If the Hammack Employment Agreement is terminated by the Company other than for cause or the death, disability or normal retirement of Mr. Hammack or by Mr. Hammack for good reason, Mr. Hammack will receive severance pay equal to his annual base salary as in effect immediately prior to termination, and all of Mr. Hammack s stock options and stock appreciation rights will be exercisable at termination. If Mr. Hammack s employment with the Company is terminated within one year following a change in control of the Company (other than as consequence of death, disability or normal retirement of Mr. Hammack) by the Company for any reason whatsoever or by Mr. Hammack for good reason, Mr. Hammack will receive severance equal to his annual base salary as in effect immediately prior to termination and all of Mr. Hammack s stock options and stock appreciation rights will become exercisable at termination. If Mr. Hammack s employment is terminated at any time by the Company or by Mr. Hammack, other than within one year of a change in control, the Company may, at its sole discretion and upon certain conditions, prohibit Mr. Hammack from engaging in any business competitive with the business of the Company for a six-month period following the effective date of termination.

In addition to the Hammack Employment Agreement, the Company has employment agreements with Mr. Clawson, Mr. Matte, Mr. Wittig and Ms. Kovalovska. Such employment agreements, other than the Hammack Employment Agreement, are referred to herein as the Executive Employment Agreements. Under such Executive Employment Agreements, for fiscal year 2003 the annual base salaries were $150,000 for Mr. Clawson (Mr. Clawson s annual base salary was increased from $150,000 to $165,000 on September 11, 2002); $160,000 for Mr. Matte, $165,000 for Mr. Wittig and $125,000 for Ms. Kovalovska; and the target bonuses were 100% for Mr. Clawson, Mr. Matte and Mr. Wittig, and 50% for Ms. Kovalovska of annual base salary, based on achievement of certain performance targets under the Company s bonus program. The annual base salaries were reduced for the period from November 3, 2001 to November 2, 2002 in connection with the Salary Reduction Program as follows: $134,985 Mr. Clawson; $124,000 Mr. Matte; $130,000 Mr. Wittig and $110,000 Ms. Kovalovska.

The Executive Employment Agreements may be terminated by either the Company or the respective executive officer at any time. In the event the executive officer resigns without good reason or is terminated for cause, compensation under the employment agreements will end. In the event any such employment agreement is terminated by the Company without cause or the executive officer resigns for good reason, the terminated executive officer will receive, among other things, severance compensation equal to a specified multiple of such employee s monthly base salary and target bonus under the Company s bonus program. In addition, upon termination of employment the non-statutory options and stock appreciation rights of such executive officers that are exercisable within a specified number of months after the date of termination will be immediately exercisable and certain other awards previously made under any of the Company s compensation plans or programs and previously not paid will immediately vest on the date of such termination.

The Executive Employment Agreements contain severance provisions that apply if the executive officer s employment is terminated within one year after the occurrence of a change of control. In the event that the employee is terminated within one year following the occurrence of a change in control by the Company for any reason or by the employee for good reason , the employee will be entitled to receive on the date of the termination an amount equal to, among other things, a specific multiple of the employee s base salary, target bonus under the Company s bonus program, and any performance award payable under the Stock Incentive Plan (the Stock Incentive Plan), the Stock Option Plan or similar plan, as well as any other benefits which the employee would be entitled to where termination was without cause or with good reason by employee.

In addition to the information stated above, each of the Executive Employment Agreements provides for the executive to receive options to acquire shares of the Company s Common Stock and/or to participate in the Company s stock option plans. The amounts and certain terms of the options are described elsewhere in this Proxy Statement. In general, the options become immediately exercisable upon a change in control of the Company.

Salary Reduction Program. In October 2001, the Company offered a salary reduction program to all employees (Salary Reduction Program) through which an employee could reduce his or her salary and receive in exchange an option to purchase the Company s Common Stock. For any amount from 0.01%-10.00% of reduction in base salary, the employee would receive an option to purchase a number of shares equal to double the dollar amount of base salary reduction divided by the exercise price per share on the grant date. For any amount from 10.01%-100% reduction in base salary, the employee would receive an option to purchase a number of shares equal to triple the dollar amount of base salary reduction divided by the exercise price per share on the grant date. The options vest during a period of one year at intervals of 1/12 per month, beginning on December 2, 2001 and ending on November 2, 2002. The options expire in ten years from October 1, 2001, the grant date.

The named executive officers participated in the Salary Reduction Program and in exchange for the reductions of their annual base salaries received options to purchase the Company s Common Stock in the following amounts: Scott Hammack 461,539 shares, Patrick Clawson 34,659 shares, Michael Matte 83,077, Michael Wittig 80,769, and Adriana Kovalovska 34,615 shares.

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Stock Incentive Plan. All salaried employees and non-employee directors of the Company are eligible to participate in the Stock Incentive Plan. An eligible employee may receive an award under the Plan, however, only if selected by the Compensation Committee or Board of Directors. The maximum number of shares of Common Stock that may be issued under the Stock Incentive Plan is 2,400,000.

Stock Option Plan. All employees, consultants and directors of the Company are eligible to participate in the Stock Option Plan. An eligible participant may receive an award under the Stock Option Plan, however, only if selected by the Compensation Committee or Board of Directors. The Company s Board of Directors initially adopted the Stock Option Plan on September 4, 1998. The maximum number of shares of Common Stock that may be issued under the Stock Option Plan is 7,000,000.

The criteria for award selection under the Stock Incentive Plan and Stock Option Plan commonly used by the Compensation Committee and/or the Board of Directors include: the capacity to contribute materially to the continued growth and successful performance of the Company, the individual s achievements and contributions, incentives and other motivational factors. The Compensation Committee or the Board of Directors may set additional criteria when reviewing individual s compensation. In addition, the Board of Directors set up a matrix for the Company s issuance of a certain number of shares of stock options to new employees under the Plans, according to the employee position. The stock options granted under both plans generally vest in three equal increments over a period of three years, however, the Compensation Committee or the Board of Directors may set different vesting terms.

Employee Stock Purchase Plan. All salaried employees are eligible to participate in the Company s Employee Stock Purchase Plan under which salaried employees can purchase the Company s Common Stock at 85% of the fair market value through payroll deductions of up to 10 percent of the employee s base salary. The Company s Board of Directors adopted the Employee Stock Purchase Plan on December 8, 1999 and the Company s shareholders approved the Employee Stock Purchase Plan on December 6, 2000. The maximum number of shares of Common Stock that may be issued under the Employee Stock Purchase Plan is 2,500,000.

Director Compensation

Upon joining the Board of Directors, all non-employee directors receive options to purchase 10,000 shares of Common Stock of the Company.

During the fiscal year ended June 30, 2003, the annual compensation of non-employee directors was as follows: each non-employee director serving on the Board of Directors received options to purchase, in the aggregate, 13,000 shares of Company s common stock per year and each non-employee director serving on any committee of the Board of Directors received options to purchase, in the aggregate, 1,000 shares of Company s common stock per year per committee service; all such options were issued quarterly in equal installments. The options were non-statutory stock options, immediately exercisable, and priced at 100% of the fair market value on the date of grant.

Directors are also reimbursed for travel and lodging expenses in connection with Board of Directors and committee meetings.

Compensation and Stock Option Committee

The Compensation and Stock Option Committee is responsible for setting and approving the salaries, bonuses and other compensation for the Company s executive officers, establishing compensation programs, and determining the amounts and conditions of grants of awards under the Company s Stock Incentive Plan and Stock Option Plan. The Company s Compensation and Stock Option Committee generally consists of non-employee directors who are not executive officers of the Company. During the fiscal year ended June 30, 2003, the Compensation and Stock Option Committee of the Company s Board of Directors consisted of David L. Manning, William G. Scott, David T. Vandewater, Richard L. Scott, and John V. Tiberi, Jr., none of whom was an executive officer or employee of the Company during the fiscal year ended June 30, 2003 (Mr. Vandewater resigned from the Compensation

Committee on August 6, 2002 and Mr. Richard Scott was appointed to the Compensation Committee on August 23, 2002 and resigned from the Compensation Committee on March 4, 2003). No executive officer of the Company served during the fiscal year ended June 30, 2003 or serves as a member of the board of directors or compensation committee of any entity that has one or more executive officers serving on the Company s Board of Directors or Compensation Committee. During the fiscal year ended June 30, 2003, the Compensation and Stock Option Committee met 3 times and acted 3 times by unanimous written consent.

Compensation Committee Report on Executive Compensation

The Compensation and Stock Option Committee Objectives. The Company s compensation programs are designed by the Compensation and Stock Option Committee to achieve four fundamental objectives: (1) to provide competitive salary levels and compensation incentives that attract and retain qualified executives; (2) to motivate executives to achieve specific strategic short-term and long-term objectives of the Company; (3) to recognize individual performances and achievements as well as the performance of the Company relative to its peers; and (4) to link the interests of senior management with the long-term interest of the Company s shareholders through compensation opportunities in the form of stock ownership. At present, these objectives are met through a program composed of salary, cash bonus, and long-term incentive opportunities in the form of stock options.

Chief Executive Officer Compensation. During the fiscal year ended June 30, 2003, the Company s Chief Executive Officer was Mr. Scott Hammack. Mr. Hammack s annual base salary for fiscal year 2001 was set at $200,000 and was not adjusted for fiscal year 2002 or for fiscal year 2003**.** In setting Mr. Hammack s salary for fiscal year 2001 and reviewing Mr. Hammack s salary for fiscal years 2002 and 2003, the Compensation Committee s deliberations regarding Mr. Hammack s compensation were based upon competitive factors, Mr. Hammack s prior experience and consideration of the bonus and stock option portions of his compensation.

In reviewing the CEO s compensation for fiscal year 2003, the Compensation Committee used the following factors and criteria: Mr. Hammack s work experience, management style and length of employment at the Company, compensation of other CEOs in comparable companies, the composition of Mr. Hammack s overall compensation (salary, bonus and stock options), the Company s financial results since he joined the Company and the Company s overall financial position. The goal of the Compensation Committee was to tie a significant portion of the CEO s compensation to the financial performance of the Company and the performance of the Company s common stock, primarily by option grants and by bonus opportunity being based on the Company s revenues and net income.

As part of the Salary Reduction Program described above, Mr. Hammack voluntarily reduced his salary to $0 for the period from November 3, 2001 to November 2, 2002. In exchange for such reduction in salary, and as part of the Salary Reduction Program, Mr. Hammack received an option to purchase 461,539 shares of Common Stock at $1.30, which was the fair market value on the date of grant. During fiscal year 2003, Mr. Hammack s received $129,199 in base salary. Mr. Hammack was paid a bonus in the total amount of $212,000 during fiscal year 2003 in accordance with the attainment of the set goals and objectives of the bonus plan. On July 5, 2002, the Compensation Committee granted to Mr. Hammack an option to purchase 350,000 shares of the Company s Common Stock at $2.45 per share with three year vesting as follows: 35,000 shares vesting on January 1, 2003, 105,000 shares vesting on January 1, 2004 and 210,000 shares vesting on January 1, 2005.

Other Executive Salaries. Base salaries for management employees are determined initially by evaluating the responsibilities of the position, the experience of the individual, internal comparability considerations, as appropriate, the competition in the marketplace for management talent, and the compensation practices among industry competitors and for public companies of the size of the Company. Salary adjustments are determined and normally made at 12-month intervals.

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Bonuses. The Company offers a bonus program for executives designed to provide incentive bonuses to executives who contributed materially to the Company s success during the most recently completed fiscal year. The bonus program is intended to enable the Company executives to participate in the Company s success as well as to provide incentives for future performance. In determining the amounts to be awarded as bonuses, the Compensation and Stock Option Committee determines bonus payout based on the Company s gross revenue and net income.

Long Term Incentives. Under the Company s stock plans, the Compensation and Stock Option Committee may grant to certain employees of the Company a variety of long-term incentives, including non-qualified stock options, incentive stock options, stock appreciation rights, grants of stock or performance awards. In granting these incentives to executives, the Committee considers those factors described above in this Committee Report regarding compensation decisions.

This report has been executed by each person who served as a member of the Company s Compensation and Stock Option Committee at the time of filing the Annual Report.

Compensation and Stock Option Committee:

William G. Scott

David L. Manning

John V. Tiberi, Jr.

Compensation Committee Interlocks and Insider Participation

Messrs. William G. Scott, David L. Manning, David T. Vandewater, Richard L. Scott and John V. Tiberi, Jr. served on the Compensation Committee during the fiscal year ended June 30, 2003. No member of the Compensation Committee was at any time during the fiscal year ended June 30, 2003 an officer or employee of the Company. No executive officer of the Company served during the fiscal year ended June 30, 2003 or serves as a member of the board of directors or compensation committee of any entity that has one or more executive officers serving on the Company s Board of Directors or Compensation Committee. William G. Scott and David T. Vandewater participated in the Fernwood Financing (as defined below in Related Transactions.

PERFORMANCE GRAPH

The following graph shows the Company s cumulative total return to shareholders, based on an initial investment of $100, compared to Standard & Poor s 500 Index and the Peer Group (defined below) over the period from June 30, 1998 and the end of the fiscal year ended June 30, 2003. Total shareholder return assumes dividend reinvestment. The stock performance shown on the following graph is not indicative of future price performance.

The Old Peer Group is composed of Secure Computing Corporation, WatchGuard Technologies, Inc. and Netscreen Technologies, Inc. These companies shares were first publicly traded as follows: Secure Computing Corporation on November 17, 1995; WatchGuard Technologies, Inc. on July 30, 1999; and Netscreen Technologies, Inc. on December 12, 2001.

The New Peer Group is composed of Secure Computing Corporation, Netscreen Technologies, Inc. and Check Point Software Technologies Ltd. These companies shares were first publicly traded as follows: Secure Computing Corporation on November 17, 1995; Netscreen Technologies, Inc. on December 12, 2001; and Check Point Software Technologies Ltd. on June 28, 1996.

The Company s shares were first traded publicly on October 14, 1994.

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The Company changed its peer group this year, because the Company believes that the New Peer Group more accurately represents the Company s current peers, specifically, the New Peer Group represents those companies that the Company competes with in the high-end enterprise space.

COMPARISON OF 5 YEAR CUMULATIVE TOTAL RETURN*

AMONG CYBERGUARD CORPORATION, THE S & P 500 INDEX AND A NEW PEER GROUP AND AN OLD PEER GROUP

* $100 invested on 6/30/98 in stock or index-including reinvestment of dividends. Fiscal year ending June 30.

CYBERGUARD CORPORATION	Cumulative Total Return					
	6/98	6/99	6/00	6/01	6/02	6/03
CYBERGUARD CORPORATION	100.00	21.75	56.50	24.42	28.57	73.77
S & P 500	100.00	122.76	131.66	112.13	91.96	92.19
OLD PEER GROUP	100.00	24.68	190.51	68.91	33.67	64.81
NEW PEER GROUP	100.00	146.05	1152.82	829.92	228.99	364.27

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ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS

The following table sets forth certain information with respect to the beneficial ownership of the Company s Common Stock as of October 14, 2003 by: (i) each person known by the Company to beneficially own more than 5% of the outstanding shares of the Company s Common Stock; (ii) each current director of the Company; (iii) each of the Company s named executive officers; and (iv) all directors and executive officers as a group. The calculation of the percentage of outstanding shares is based on 21,767,641 shares outstanding on October 14, 2003. Unless otherwise indicated, each of the shareholders named in this table: (a) has sole voting and investment power with respect to all shares of Common Stock beneficially owned and (b) has the same address as the Company.

Name/Address	Number of Shares Beneficially Owned	Percent of Class
Scott J. Hammack(1)	1,214,226	5.33
Patrick J. Clawson(3)	227,632	1.03
Michael Matte(3)	156,547	*
Michael G. Wittig(3)	305,772	1.39
Adriana Kovalovska(3)	17,257	*
David L. Manning(3)	81,607	*
Daniel J. Moen(3)	33,668	*
William D. Rubin(3)	30,000	*
William G. Scott(3)	219,575	1.00
Kenneth C. Jenne, II(3)	15,714	*
John V. Tiberi, Jr.(3)	51,250	*
Richard L. Scott(2) 100 First Stamford Place, Suite 625, Stamford, Connecticut 06902	8,206,097	35.19
F. Stephen Allen 2540 E. 30th Street Tulsa, OK 74114	1,152,530	5.24
William D. Witter, Inc. One Citicorp Center 153 East 53rd Street New York, NY 10022-4611	1,169,400	5.10
All directors and executive officers as a group (11 persons)	2,353,248	9.99

* Less than 1%

(1) Includes: (a) 863,205 shares in options that are currently exercisable by Mr. Hammack to purchase Common Stock; (b) 205,357 shares of restricted Common Stock and 142,857 shares of Common Stock for warrant issued by the Company as a result of an investment transaction in January 2001; and (c) 2,807 shares of Common Stock owned by Mr. Hammack under the Company s 401(k) plan.

(2) Includes: (a) 1,562,904 shares of Common Stock beneficially owned by Richard L. Scott Revocable Trust; (b) 3,531,222 shares of Common Stock owned by spouse s trust, Frances A. Scott Revocable Trust; (c) 1,562,904 shares of Common Stock beneficially owned by Richard L. & F. Annette Scott Family Partnership Ltd.; (d) warrants to purchase 379,094 shares of Common Stock beneficially owned by Richard L. Scott Revocable Trust; (e) warrants to purchase 755,405 shares of Common Stock beneficially owned by Frances A. Scott

Revocable Trust; (f) 379,094 shares of Common Stock beneficially owned by Richard L. & F. Annette Scott Family Partnership Ltd; and (g) 35,474 shares in options that are currently exercisable by Mr. Richard L. Scott to purchase Common Stock.

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(3) Includes (a) options that are currently exercisable to purchase Common Stock in the following amounts: Mr. Clawson 217,983; Mr. Matte 149,743; Mr. Wittig 158,757; Ms. Kovalovska 10,000; Mr. Tiberi 51,250; Mr. Manning 60,500; Mr. William Scott 58,500; Mr. Moen 33,668; Mr. Rubin 30,000; and Mr. Jenne 15,714; (b) shares of Common Stock for warrants issued by the Company in connection with the Fernwood Financing in August 1999 in the following amounts: Mr. Wittig 37,000; and Mr. William Scott 100,000; (c) shares of restricted Common Stock as a result of the conversion of the promissory note and exercise of warrants issued by the Company in connection with the Fernwood Financing in August 1999: Mr. Manning 21,107; (d) shares of restricted Common Stock as a result of the conversion of the promissory notes issued in connection with the Fernwood Financing in August 1999: Mr. Wittig 41,567; Mr. William Scott 61,075; (e) shares of Common Stock under the Company s 401(k) plan: Mr. Clawson 1,649; Mr. Matte 6,804; Mr. Wittig 15,939; Ms. Kovalovska 7,257; (f) shares of Common Stock: Mr. Clawson 8,000; Mr. Wittig 50,000; and (g) shares of Common Stock under the Company s Employee Stock Purchase Plan: Mr. Wittig 2,509.

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ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS

In August 1999, the Company entered into a financing transaction with Fernwood Partners II, LLC (Fernwood) and certain present and former officers, directors and employees of the Company, through which the Company obtained a total amount of $4,313,484 (the Fernwood Financing). In the Fernwood Financing, Fernwood provided $3,699,484, William G. Scott provided $100,000. The remaining $514,000 was provided by certain other directors, executive officers and employees of the Company. All of the financing consisted of promissory notes convertible into the Company s Common Stock at $1 per share and warrants to purchase an equivalent number of shares of the Company s Common Stock at $2.00 per share. The Fernwood Financing, bearing interest at a rate of 11.5% per annum, was secured by a lien on all of the Company s assets. The officers, directors and employees of the Company participating in the Fernwood Financing have granted to Fernwood the right to act as their agent for purposes of enforcing their rights in the event that the Company should default on its obligations. Part of the proceeds from this financing was used to repay a $1,125,000 loan and accrued interest to Fernwood Partners, LLC, a limited liability company that provided financing to the Company in December 1998.

In December 2000, the Company completed an additional $1,000,000 financing transaction with Fernwood, which was constructed as an add-on to the earlier Fernwood Financing, consisting of a promissory note convertible into shares of Company s common stock at $1.51 per share and a warrant to purchase an additional 333,877 shares of the Company s common stock at $2.51 per share.

In January 2001, Fernwood and certain directors elected to convert their promissory notes into shares of common stock. In addition, certain directors elected to exercise their warrants and Fernwood exercised a warrant to purchase 2,292,000 shares of common stock. In May 2001, the majority of all officers and employees who participated in the Fernwood Financing converted their promissory notes into shares of common stock. As of June 30, 2002, all promissory notes were either converted or paid off in full.

The promissory notes issued under the Fernwood Financing were either paid off in full or converted into common stock as of June 30, 2002. Thus, the Fernwood Financing was completely repaid by June 30, 2002 and the lien on the Company s assets was released in August 2002.

In March 2003, Fernwood Partners II, LLC was dissolved and all the Company s common stock and warrants held by Fernwood were distributed in-kind to its members. Mr. Richard L. Scott, with his wife, was a major equity holder of Fernwood. Mr. Richard L. Scott was also a major equity holder of Fernwood Partners, LLC and a former member of the Company s Board of Directors where he served until March 4, 2003. Mr. Richard L. Scott is the brother of Mr. William G. Scott, a member of the Company s Board of Directors. Mr. F. Stephen Allen, a five percent owner of the Company s Common Stock, is a former member of Fernwood Partners II, LLC.

In January 2000, Mr. Scott J. Hammack invested $500,000 to purchase 142,857 shares of the Company s common stock at $1.75 share and 62,500 shares of the Company s common stock at $4.00 per share. In conjunction with the purchase of the 142,857 shares of common stock, Mr. Hammack was granted a warrant to purchase 142,857 shares of the Company s common stock at $1.75 per share. The warrant is exercisable any time prior to December 25, 2005.

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ITEM 14. PRINCIPAL ACCOUNTANT FEES AND SERVICES

Audit Fees. The aggregate fees billed by Grant Thornton LLP for professional services rendered for the audit of the Company s annual financial statements for the fiscal year ended June 30, 2003 and fiscal year ended June 30, 2002 and for the review of the financial statements included in the Company s Quarterly Reports on Form 10Q for the first three quarters of the fiscal year 2003 and fiscal year 2002 or the services that are normally provided by the accountant in connection with statutory and regulatory filings or engagements for those fiscal years were $124,439 and $128,727, respectively.

Audit-Related Fees. The aggregate fees billed by Grant Thornton LLP for assurance and related services by the principal accountant that are reasonably related to the performance of the audit or review of the Company s financial statements and are not reported the fiscal year 2003 and fiscal year 2002 were $29,036 and $3,080, respectively. These fees were primarily for assurance services .

Tax Fees. The aggregate fees billed by Grant Thornton LLP for professional services rendered by the principal accountant for tax compliance, tax advice and tax planning for the fiscal year ended June 30, 2003 and fiscal year ended June 30, 2002 were $34,010 and $26,800, respectively. These fees were primarily for tax returns preparation.

All Other Fees. The aggregate fees billed by Grant Thornton LLP for products and services provided by the principal accountant, other than the services described above under Audit Fees , Audit-Related Fees and Tax Fees for the fiscal year ended June 30, 2003 and fiscal year ended June 30, 2002 were $0 and $0, respectively.

The Audit Committee of the Company s Board of Directors considered whether the provision of non-audit services by the independent public accountants is compatible with maintaining the accountants independence.

The Audit Committee of the Company s Board of Directors has not put in place a pre-approval policy but considers each engagement of the independent auditor on a case-by-case basis.

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PART IV

ITEM 15. EXHIBITS, FINANCIAL STATEMENT SCHEDULES AND REPORTS ON FORM 8-K

(a) **Financial Statements**. The Financial Statements filed as part of this Report are listed separately in the Index to Financial Statements beginning on page F-1 of this Report.

(b) **Reports on Form 8-K.** During the fourth quarter of the fiscal year 2003 the Company filed the following reports on Form 8-K: (1) on April 24, 2003 Items 7 and 9; (2) on April 25, 2003 Item 9, and (3) on May 12, 2003 an amended Current report on Form 8-K/A Item 7.

(c) **Exhibits**. The following exhibits are included in this Report:

Exhibit No.	Exhibit Description
2.01	Asset Purchase Agreement dated January 22, 2003 by and between NetOctave, Inc. and CyberGuard Corporation(16)
3.01	Articles of Incorporation of the Company, as amended June 26, 1996(8)
3.02	Articles of Amendment to the Amended and Restated Articles of Incorporation of the Company (13)
3.03	Restated Bylaws of the Company(3)
4.01	Form of Common Stock Certificate(4)
4.02	Form of Stockholder Rights Plan(2)
10.01	Employee Stock Incentive Plan(6)
10.02	Amendment to Employee Stock Incentive Plan(7)
10.03	Amendment to Employee Stock Incentive Plan dated March 20, 1998(15)
10.04	Second Amended and Restated Employee Stock Option Plan dated September 4, 1998, as amended through October 16, 2001(14)
10.05	Forms of Stock Option Agreements(15)
10.06	Retirement Savings Plan, as amended and restated on July 1, 2002(5)
10.07	Employment Agreement Amendment dated October 1, 2001 between the Company and Scott Hammack(12)
10.08	Employment Agreement Amendment dated October 1, 2001 between the Company and Patrick Clawson(12)
10.09	Employment Agreement Amendment dated October 1, 2001 between the Company and Michael Matte(12)
10.10	Employment Agreement Amendment dated October 1, 2001 between the Company and Michael Wittig(12)
10.11	Employment Agreement Amendment dated October 1, 2001 between the Company and Adriana Kovalovska(12)
10.12	Employment Agreement dated April 18, 2001 between the Company and Adriana Kovalovska(9)
10.13	Employment Agreement dated September 30, 1998 between the Company and Michael Wittig(15)
10.14	Amendment to Employment Agreement between the Company and Mike Wittig, dated December 13, 2000(11)
10.15	Agreement between the Company and Scott J. Hammack, dated December 26, 2000(11)
10.16	Employment Agreement between the Company and Scott J. Hammack, dated January 2, 2001(11)

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10.17	Agreement between the Company and Scott J. Hammack, dated January 17, 2001(11)
10.18	Employment Agreement between the Company and Patrick J. Clawson, dated January 18, 2001(11)
10.19	Employment Agreement dated February 13, 2001 between the Company and Michael Matte(10)
10.20	Loan Documents dated December 17, 1998 between the Company and Fernwood Partners, LLC(15)
10.21	Loan Agreements dated August 26, 1999, between (i) the Company and Fernwood Partners II, LLC; (ii) the Company and certain officers, directors and employees of the Company; and (iii) the Company and David R. Proctor(3)
10.22	Amendment No. 1 to Loan Agreement, dated December 29, 2000 between the Company and Fernwood Partners II, LLC(11)
10.23	Agreements dated January 24, 2001 relating to the conversion of promissory notes and exercise of warrants issued under (i) the Loan Agreement, as amended, between the Company and Fernwood Partners II, LLC, and (ii) the Loan Agreement between the Company and certain officers, directors and employees of the Company(11)
21.01	List of subsidiaries of the Company(9)
23.01	Consent of Grant Thornton LLP, Independent Certified Public Accountants
31.01	Certification by Scott Hammack, Chief Executive Officer, pursuant to Exchange Act Rules 13a-14 and 15d-15.
31.02	Certification by Michael D. Matte, Chief Financial Officer, pursuant to Exchange Act Rules 13a-14 and 15d-15.
32.01	Certification by Scott 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(1)
32.02	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(1)

(1) This exhibit shall be treated as accompanying this Annual Report on Form 10-K and shall not be deemed as filed as part of this Report.
(2) Incorporated herein by reference to Post-Effective Amendment No. 1 to the Company s Registration Statement on Form 10, dated September 29, 1994, File No. 0-24544.
(3) Incorporated herein by reference to the Company s Quarterly Report on Form 10-Q filed on November 12, 1999.
(4) Incorporated herein by reference to the Company s Registration Statement on Form S-3 dated May 23, 1996 (File No. 333-04407).
(5) Incorporated herein by reference to the Company s Registration Statement on Form S-8 (Commission File Number 333-58262), filed on July 19, 2002.
(6) Incorporated herein by reference from Exhibit 4.1 to the Company s Registration Statement on Form S-8 (Commission File Number 33-88448) filed on January 13, 1995.
(7) Incorporated herein by reference to Annex E of the Registrant s Definitive Proxy Statement as filed on May 24, 1996.
(8) Incorporated herein by reference to the Company s Annual Report on Form 10-K for fiscal year ended June 30, 1996.
(9) Incorporated herein by reference to the Company s Annual Report on 10-K for fiscal year ended June 30, 2001.
(10) Incorporated herein by reference to the Company s Quarterly Report on Form 10-Q filed on May 14, 2001.
(11) Incorporated herein by reference to the Company s Quarterly Report on Form 10-Q filed on February 14, 2001.
(12) Incorporated herein by reference to the Company s Quarterly Report on Form 10-Q filed on February 5, 2002.
(13) Incorporated herein by reference to the Company s Annual Report on 10-K for fiscal year ended June 30, 2000.

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(14) Incorporated herein by reference to the Company s Registration Statement on Form S-8 (Commission File Number 333-73852), filed on November 21, 2001.
(15) Incorporated herein by reference to the Company s Annual Report on 10-K for fiscal year ended June 30, 1999.
(16) 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 Section 13 or 15(d) 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.

October 23, 2003	CYBERGUARD CORPORATION		
	By:	/s/	SCOTT J. HAMMACK
			Scott Hammack Chairman and Chief Executive Officer

KNOW ALL MEN BY THESE PRESENTS, that each person whose signature appears below constitutes and appoints Scott J. Hammack and Michael D. Matte and each of them, his true and lawful attorney-in-fact and agent, with full power of substitution and revocation, for him and in his name, place and stead, in any and all capacities, to sign any and all amendments (including post-effective amendments) to this report on Form 10-K, and to file the same with all exhibits thereto, and other documents in connection therewith, with the Securities and Exchange Commission, granting unto said attorney-in-fact and agent full power and authority to do and perform each and every act and thing requisite and necessary to be done as fully to all intents and purposes as he might or could do in person, hereby ratifying and confirming all that said attorney-in-fact and agent, or his substitute or substitutes, may lawfully do or cause to be done by virtue hereof.

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

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SIGNATURE	TITLE	DATE
/s/ SCOTT J. HAMMACK Scott Hammack	Chairman and Chief Executive Officer (Principal Executive Officer)	October 23, 2003
/s/ MICHAEL D. MATTE Michael D. Matte	Chief Financial Officer (Principal Financial and Principal Accounting Officer)	October 23, 2003
/s/ PATRICK CLAWSON Patrick Clawson	President (Principal Executive Officer)	October 23, 2003
/s/ DANIEL J. MOEN Daniel J. Moen	Director	October 23, 2003
/s/ DAVID L. MANNING David L. Manning	Director	October 23, 2003
/s/ WILLIAM G. SCOTT William G. Scott	Director	October 23, 2003
/s/ JOHN V. TIBERI, JR. John V. Tiberi, Jr.	Director	October 23, 2003
/s/ WILLIAM D. RUBIN William D. Rubin	Director	October 23, 2003
/s/ KENNETH C. JENNE, II Kenneth C. Jenne, II	Director	October 23, 2003

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REPORT OF INDEPENDENT CERTIFIED PUBLIC ACCOUNTANTS

The Board of Directors and Shareholders of

CyberGuard Corporation and Subsidiaries

We have audited the accompanying consolidated balance sheets of CyberGuard Corporation and Subsidiaries as of June 30, 2003 and 2002, and the related consolidated statements of operations, stockholders equity and comprehensive income, and cash flows for each of the three years in the period ended June 30, 2003. These financial statements are the responsibility of the Company s management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As more fully described in Note 7 of the consolidated financial statements, subsequent to the issuance of the Company s 2001 consolidated financial statements and our report thereon dated August 16, 2001 containing an unqualified opinion, management decided to restate the 2001 consolidated financial statements to reflect a revision in the accounting for a beneficial conversion feature for convertible debt issued in August 1999 and December 2000.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of CyberGuard Corporation and Subsidiaries as of June 30, 2003 and 2002, and the consolidated results of their operations and their consolidated cash flows for each of the three years in the period ended June 30, 2003 in conformity with accounting principles generally accepted in the United States of America.

We have also audited Schedule II for each of the three years in the period ended June 30, 2003. In our opinion, this Schedule, when considered in relation to the basic consolidated financial statements taken as a whole, presents fairly, in all material respects, the information therein.

Grant Thornton LLP

/s/ GRANT THORNTON LLP

Ft. Lauderdale, Florida

July 31, 2003

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Report of Management

To our shareholders:

The management of CyberGuard Corporation is responsible for the preparation, integrity and objectivity of the consolidated financial statements and related financial information contained in CyberGuard s Annual Report on Form 10-K. The consolidated financial statements have been prepared by the Company in accordance with accounting principles generally accepted in the United States and, in the judgment of management, present fairly and consistently the Company s financial position and results of operations. The financial statement s and other financial information in this report includes amounts that are based on management s best estimates and judgments and give due consideration to materiality.

The Company maintains an effective 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 s in accordance with generally accepted accounting principles. The design, monitoring and revisions of the system of internal accounting controls involve, among other things, management s judgment with respect to the relative cost and expected benefits of specific control measures.

The Audit Committee of the Board of Directors is responsible for recommending to the Board the independent certified public accounting firm to be retained each year. The Audit Committee meets periodically with the independent accountants and management to review their performance and confirm that they are properly discharging their responsibilities. The independent accountants have direct access to the Audit Committee to discuss the scope and results of their work, the adequacy of internal accounting controls and the quality of financial reporting.

/s/ SCOTT HAMMACK	/s/ MICHAEL MATTE
Scott Hammack	Michael Matte
Chief Executive Officer	Chief Financial Officer

October 23, 2003

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CYBERGUARD CORPORATION AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

(Amounts in thousands, except per share data)

	June 30, 2003	June 30, 2002
ASSETS		
Cash and cash equivalents	$ 12,095	$ 6,166
Restricted cash	379	44
Accounts receivable, less allowance for uncollectible accounts of $707 at June 30, 2003 and $109 at June 30, 2002	7,608	5,152
Inventory	359	442
Other current assets	967	801
Receivable from insurance company	6,500	
Total current assets	27,908	12,605
Property and equipment at cost, less accumulated depreciation of $3,373 at June 30, 2003 and $2,335 at June 30, 2002	1,762	1,212
Capitalized software, less accumulated amortization of $1,988 at June 30, 2003 and $1,748 at June 30, 2002	158	219
Intangibles, less accumulated amortization of $304 at June 30, 2003	799	
Other assets	283	94
Deferred tax asset, net	4,249	
Total assets	$ 35,159	$ 14,130
LIABILITIES AND SHAREHOLDERS EQUITY		
Note payable		140
Accounts payable	1,215	778
Deferred revenue	5,697	3,951
Litigation payable	10,400	
Accrued expenses and other liabilities	3,176	2,305
Total liabilities	$ 20,488	$ 7,174
Commitments and contingencies		
Shareholders equity		
Preferred stock par value $0.01; authorized 5,000 shares; none issued		
Common stock par value $0.01; authorized 50,000 shares; issued and outstanding 20,953 at June 30, 2003 and 19,100 at June 30, 2002	210	191
Additional paid-in capital	94,924	91,211
Accumulated deficit	(80,542)	(84,613)
Accumulated other comprehensive income	79	167
Total shareholders equity	14,671	6,956
Total liabilities and shareholders equity	$ 35,159	$ 14,130

The accompanying notes are an integral part of these consolidated financial statements.

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CYBERGUARD CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF OPERATIONS

(Amounts in thousands, except per share data)

	Year Ended		
	June 30, 2003	June 30, 2002	June 30, 2001
			As Restated
Revenues:			
Products	$ 22,632	$ 15,215	$ 18,685
Services	10,348	7,125	5,721
Total revenues	32,980	22,340	24,406
Cost of revenues:			
Products	5,884	5,143	5,690
Services	2,687	2,020	2,287
Total cost of revenues	8,571	7,163	7,977
Gross profit	24,409	15,177	16,429
Operating expenses:			
Research and development	5,941	4,705	5,450
Selling, general and administrative	14,947	11,313	13,919
Class action settlement	3,900		
Total operating expenses	24,788	16,018	19,369
Operating loss	(379)	(841)	(2,940)
Other income (expense)			
Interest income/(expense), net	111	58	(830)
Loss on sale of assets	(33)	(18)	(106)
Other income (expense)	205	193	(90)
Total other income (expense)	283	233	(1,026)
Net loss before income tax and cumulative effect of change in accounting principle	(96)	(608)	(3,966)
Income tax benefit	4167		
Net income (loss) before cumulative effect of change in accounting principle	4,071	(608)	(3,966)
Cumulative effect of change in accounting principle			(431)
Net income / (loss)	$ 4,071	$ (608)	$ (4,397)

Basic earnings / (loss) per common share:			
Before cumulative effect of change in accounting principle	$ 0.21	$ (0.03)	$ (0.30)
Cumulative effect of change in accounting principle	$	$	$ (0.03)
Basic earnings / (loss) per common share	$ 0.21	$ (0.03)	$ (0.33)
Weighted average number of common shares outstanding	19,856	18,779	13,188
Diluted earnings / (loss) per common share:			
Before cumulative effect of change in accounting principle	$ 0.16	$ (0.03)	$ (0.30)
Cumulative effect of change in accounting principle	$	$	$ (0.03)
Diluted earnings / (loss) per common share	$ 0.16	$ (0.03)	$ (0.33)
Weighted average number of common shares outstanding	24,893	18,779	13,188

The accompanying notes are an integral part of these consolidated financial statements.

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CYBERGUARD CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

(Amounts in thousands, except share data)

	Year Ended		
	June 30, 2003	**June 30, 2002**	**June 30, 2001**
			As Restated
Cash flows from operating activities:			
Net income/ (loss)	$ 4,071	$ (608)	$ (4,397)
Adjustments to reconcile net income/(loss) to net cash provided by/(used in) operating activities:			
Depreciation	1,048	817	670
Amortization	544	694	1,101
Loss on disposal of property & equipment	33	18	134
Interest expense related to convertible debt			613
Deferred tax benefit	(4,249)		
Provision for uncollectible accounts receivable	598	73	(15)
Provision for inventory reserve		(68)	(5)
Compensation expense related to stock options	81	156	195
Non cash expense for company 401(k) match	362	259	
Cumulative effect of change in accounting principle			431
Translation adjustment	(91)	(33)	89
Changes in assets and liabilities (excluding the effect of acquisition):			
(Increase)/Decrease in restricted cash	(335)	736	20
(Increase) in accounts receivable	(3,053)	(1,078)	(517)
(Increase)/Decrease in other current assets	(122)	264	130
(Increase) in inventories	(439)	(113)	(130)
(Increase)/Decrease in other, net	(189)	(4)	74
Increase/(Decrease) in accounts payable	437	(189)	(457)
Increase/(Decrease) in accrued expenses and other liabilities	334	(65)	428
Increase/(Decrease) in deferred revenue	1,746	1,643	(604)
(Increase) in receivable from insurance company	(6,500)		
Increase in litigation payable	10,400		
Net cash provided by (used in) operating activities	4,676	2,503	(2,240)
Cash flows used in investing activities			
Capitalized software costs	(179)	(172)	(360)
Purchase of property & equipment	(666)	(805)	(930)
Proceeds from the sale of property & equipment		2	
Acquisition of certain assets of NetOctave	(300)		
Net cash used in investing activities	(1,145)	(975)	(1,290)
Cash flows provided by (used in) financing activities:			
Issuance of convertible debt			1,000
Retirement of convertible debt		(37)	
Proceeds from exercise of warrants			4,804

Borrowings under notes payable			310
Repayment of notes payable	(140)	(16)	(413)
Net repayment under revolving line of credit		(763)	(1,203)
Proceeds from stock options exercised	2,442	523	532
Proceeds from private placement of common stock			500
Proceeds from issuance of common stock in stock purchase plan	96	160	274
Net cash provided by (used in) financing activities	2,398	(133)	5,804
Net increase (decrease) in cash	5,929	1,395	2,274
Cash and cash equivalents at beginning of period	6,166	4,771	2,497
Cash and cash equivalents at end of period	$ 12,095	$ 6,166	$ 4,771
Supplemental disclosure of cash flow information			
Cash paid for interest	7	62	511
Cash paid for income taxes	112		

Supplemental disclosure of non-cash information

In connection with the Netoctave acquisition as explaned in note 3, the Company issued 107 shares as part of the purchase consideration.

During fiscal years 2003 and 2002, the Company s CEO, Scott Hammack, participated in a special option program which required the Company to record compensation expense of $59 in 2003 and $91 in 2002.

During fiscal year 2002, approximately $25 in convertible debt and interest on the debt was converted into approximately 25 shares of the Company s common stock.

During fiscal year 2001, the expiration dates of approximately 141 options to purchase shares of the Company s common stock were extended, which required the Company to record $141 in compensation expense. In addition, 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 $22 in compensation expense during fiscal year 2003, $65 in 2002 and $54 in fiscal year 2001.

During fiscal year 2001, the Company recorded $431 as a cumulative effect of a change in accounting principle associated with the recognition of the effective conversion price related to the convertible debt issued in August 1999.

During fiscal year 2001, approximately $5,892 in convertible debt and interest on the debt was converted into approximately 5,492 shares of the Company s common stock.

During fiscal year 2001, the Company issued a $1,000 convertible debenture and issued 334 warrants valued at $40.

The accompanying notes are an integral part of these consolidated financial statements.

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CYBERGUARD CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS EQUITY (DEFICIT)

AND COMPREHENSIVE INCOME

(Amounts in thousands, except share data)

	Common Stock Shares	Common Stock Par Value	Additional Paid in Capital	Accumulated Deficit	Accumulated Other Comprehensive Income	Total
Balance June 30, 2000, as restated	9,799,321	$ 98	$ 77,447	$ (79,608)	$ 111	$ (1,952)
Net loss, as restated				(4,397)		(4,397)
Translation adjustment					89	89
Issuance related to debt conversion			152			152
Adjustment for stock option activity			195			195
Cumulative change in accounting principle			431			431
Issuance of common stock related to debt conversion	5,506,905	55	5,791			5,846
Issuance of common stock related to exercise of warrants	2,402,000	24	4,780			4,804
Issuance of common stock related to the exercise of options	385,938	4	528			532
Issuance of common stock	334,408	3	772			775
Balance June 30, 2001	18,428,572	$ 184	$ 90,096	$ (84,005)	$ 200	$ 6,475
Net loss				(608)		(608)
Translation adjustment					(33)	(33)
Adjustment for stock option activity			156			156
Issuance of common stock related to debt conversion	24,835	0	25			25
Issuance of common stock related to the exercise of options	418,400	4	519			523
Issuance of common stock	227,875	3	415			418
Balance June 30, 2002	19,099,682	191	91,211	(84,613)	167	6,956
Net income				4,071		4,071
Translation adjustment					(88)	(88)
Adjustment for stock option activity			81			82
Issuance of common stock related to NetOctave acquisition	107,419	1	749			750
Issuance of common stock related to the exercise of options	1,598,976	16	2,426			2,442
Issuance of common stock	146,428	2	456			458
Balance June 30, 2003	20,952,505	210	94,924	(80,542)	79	14,671

The accompanying notes are an integral part of these consolidated financial statements.

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CYBERGUARD CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Amounts in thousands, except share and per share data)

(1) DESCRIPTION OF BUSINESS

CyberGuard Corporation (CyberGuard or the Company) is a leading provider of network security solutions designed to protect enterprises that use the Internet for electronic commerce and secure communication (customers include Global 2000 companies, major financial institutions, and government agencies worldwide). The Company s CyberGuard® appliance, which includes firewall and VPN (Virtual Private Network), provides a level of security, features and availability that the Company believes is not matched in the industry. Through a combination of proprietary and third party technology, the Company provides a full suite of products and services that are designed to protect the integrity of electronic data and customer applications from unauthorized individuals and digital thieves.

The appliance is sold to end-users directly and indirectly by direct sales and resellers worldwide in over thirty countries.

(2) SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Consolidation. The consolidated financial statements of CyberGuard Corporation and its subsidiaries (CyberGuard Europe Ltd. and CYBG Consultant, Inc. (the Company)) include the accounts of the Company and its subsidiaries over which it maintains control. All significant inter-company balances and transactions have been eliminated.

Use of Estimates. 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 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.

The Company s operations and ability to grow may be affected by numerous factors, including changes in customer requirements, new laws and governmental regulations and policies, technological advances, entry of new competitors and changes in the willingness of financial institutions and other lenders to finance acquisitions and operations. The Company cannot predict which, if any, of these or other factors might have a significant impact on the Company s industry in the future, nor can it predict what impact, if any, the occurrence of these or other events might have on the Company s operations.

Cash Equivalents and Restricted Cash. The Company considers all investments purchased with an original maturity of three months or less at the time of purchase to be cash equivalents. Restricted cash is unavailable to the Company until certain contractual terms and conditions are met.

At June 30, 2003, the Company has $455 of cash in a UK bank and an overdraft facility with a UK bank of $250.

Restricted cash as of June 30, 2003 consists of the following:

	2003	2002
Cash held on behalf of employees for purchase of company stock	$ 100	$ 33
Cash held on behalf of employees for flexible reimbursement plan	32	11
Certificate of deposit as collateral for a UK Customs and Excise bond	247	0
	$ 379	$ 44

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CYBERGUARD CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Amounts in thousands, except share and per share data)

Inventories. 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 determine the lower of cost on 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. Evaluation inventory older than six month old is transferred to fixed assets and depreciated over 12 months.

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.

Property and Equipment. Property and equipment are stated at cost, less accumulated depreciation. Depreciation is computed by the straight-line method using the estimated useful lives of the assets, which range from 2 to 5 years. Maintenance and repairs are charged to expense as incurred. Expenditures for renewals and improvement that significantly add to the useful life are capitalized. Upon sale, retirement or other disposition of these assets, the cost and the related accumulated depreciation are removed from the respective accounts and any gain or loss on the disposition is included in the consolidated statement of operations.

Long Lived Assets. Long lived assets are reviewed for potential impairment at such time when events or changes in circumstances indicate that the carrying amount of an asset might not be recoverable. Any impairment loss would be recognized when the sum of the expected, undiscounted net cash flows is less than the carrying amount of the asset. If an asset is impaired, the asset is written down to its estimated fair value.

Software Development Costs. The Company capitalizes costs 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 two years and is the greater of the two amounts calculated using the methods noted in SFAS 86.

During fiscal year 2003, the Company capitalized software development costs of $179 and associated amortization of $240. During 2002, the Company capitalized software development costs of $172 and associated amortization of $694. During 2001, the Company capitalized software development costs of $360 and associated amortization of $761.

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, 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 the product because of non-payment for a three-month period. For the year ended June 30, 2003, the revenue

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CYBERGUARD CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Amounts in thousands, except share and per share data)

recognition for 8 resellers in North America, 1 reseller in Asia and 4 resellers in Europe, was 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 contract 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 priced.

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.

Deferred Revenue. Deferred revenue represents amounts billed or payments received in advance of maintenance services to be rendered over a certain period of time, and are recognized ratably over the service term.

Reclassifications. Certain prior period amounts have been reclassified to conform to the current year presentation.

Advertising Expense. The Company expenses advertising and promotional costs as incurred. Advertising expense for the years ended June 30, 2003, 2002 and 2001 was $1,412, $872 and $1,475, respectively.

Income Taxes. The provision for income taxes and corresponding balance sheet accounts are determined in accordance with Statement of Financial Accounting Standards No. 109, Accounting for Income Taxes (SFAS No. 109). Under SFAS No. 109, deferred tax assets and liabilities are determined based on the temporary differences between the bases of certain assets and liabilities for income tax and financial reporting purposes. The deferred tax assets and liabilities are classified according to the financial statement classification of the assets and liabilities generating the differences. The Company provides a valuation allowance for that portion of deferred tax assets, which it cannot determine is more likely than not to be recognized due to the Company s cumulative losses and the uncertainty as to future recoverability. The Company recorded an income tax benefit of $4,167 as of June 30, 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 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. 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 carry forwards as planned, changes in the industry, our product life-cycle, profitability trends, and tax law changes.

Foreign Currency Translation. The Company s foreign operations utilize the local foreign currency as the functional currency. The results of operations and cash flows for the foreign operations are translated at an average exchange rate for the period, and the assets and liabilities of the foreign operations are translated at the exchange rate at the end of the period. Translation adjustments are included in stockholders equity (deficit). Transaction gains or losses are included in determining net income / (loss) for the period and are recorded as

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CYBERGUARD CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Amounts in thousands, except share and per share data)

other income/expense. During fiscal year 2003, 2002, and 2001, the Company recognized a transaction gain of $173, a transaction gain of $203, and a transaction loss of $159, respectively.

Stock Based Compensation. 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 the 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 25 and related interpretations in accounting for stock based compensation. For the years ended June 30, 2003, 2002 and 2001 there was approximately $81, $156 and $195 of stock based compensation reflected 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.

The Black-Scholes option valuation model was developed for use in estimating the fair value of traded options, which have no vesting restrictions and are fully transferable. In addition, option valuation models require the input of highly subjective assumptions including the expected stock volatility. Because the Company s employee stock options have characteristics significantly different from those of traded options, and because changes in subjective input assumptions can materially affect the fair value estimate, in management s opinion, the existing models do not necessarily provide a reliable single measure of the fair value of its employee stock options.

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 2003, 2002, and 2001, respectively: risk-free interest rates were 2.94%, 5.31%, and 6.0%, an expected dividend yield of 0%, the volatility factors of the expected market price of the Company s common stock were 94%, 105%, and 115%, and a weighted average expected life of the option of 3 years for each period.

	Year ended June 30,		
	2003	**2002**	**2001**
			As restated
Net income / (loss), as reported	$ 4,071	$ (608)	$ (4,397)
Add: Stock-based employee compensation expense included in net income, net of related tax effects	81	156	195
Deduct: Total stock-based employee compensation expense determined under fair value based methods for all awards	(2,928)	(2,506)	(2,560)
Pro forma net income / (loss)	$ 1,224	$ (2,958)	$ (6,762)
Earnings / (loss) per share:			

Basic-as reported	$ 0.21	$ (0.03)	$ (0.33)
Basic-pro forma	$ 0.06	$ (0.16)	$ (0.51)
Diluted-as reported	$ 0.16	$ (0.03)	$ (0.33)
Diluted-pro forma	$ 0.05	$ (0.16)	$ (0.51)

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Net Income/(loss) Per Share. Basic earnings (loss) per share excludes dilution and 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 reflects the potential dilution that could occur, assuming stock options, warrants or other contracts to issue common stock were exercised, using the treasury stock 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.

	Year Ended June 30,		
	2003	**2002**	**2001**
			As restated
Net Income/(loss)	$ 4,071	($ 608)	($ 4,397)
Weighted average number of common shares outstanding	19,856	18,779	13,188
Dilutive effect of:			
Employee stock options	3,634		
Warrants	1,403		
Weighted average number of common shares outstanding	24,893	18,779	13,188
Earnings/(loss) per share			
Basic	0.21	(0.03)	(0.33)
Diluted	0.16	(0.03)	(0.33)

(3) ACQUISITION

During the third quarter, the Company acquired certain assets of NetOctave, Inc., which 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 NetOctave product, purchased from NetOctave suppliers, and sold to third party customers. The net impact 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 (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 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

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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.

Current Assets	$ 203
Property and Equipment	282
Intangible Assets	1,103
Total Assets Acquired	$ 1,588

The following values were assigned to intangible assets:

	June 30, 2003		
	Gross Carrying Amount	Accumulated Amortization	Net Book Value
Amortized intangible assets:			
Developed Technology	843	(232)	611
Customer Base	260	(72)	188
Total	1,103	(304)	799

Estimated amortization expense for succeeding fiscal years is as follows:

2004	(736)
2005	(63)

The intangible assets acquired have a useful life of approximately 18 months.

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 June 30, 2003 and June 30, 2002. The amounts are shown as if the acquisition had occurred at the beginning of each period presented:

	Year Ended June 30,	
	2003	2002
Proforma revenues	$ 33,270	$ 22,440
Net Income / (Loss)	564	(9,984)
Earnings/(loss) per share-basic-proforma	$ 0.03	$ (0.53)
Earnings/(loss) per share-diluted-proforma	$ 0.02	$ (0.53)

Proforma results are not necessarily indicative of the results that would have occurred if the acquisition had actually been completed at the beginning of each period presented, nor are they necessarily indicative of future consolidated results

(4) PROPERTY AND EQUIPMENT

Property and equipment consists of the following:

	June 30, 2003	June 30, 2002
Property and equipment	$ 4,397	$ 3,126
Purchased software for internal use	697	387
Leasehold improvement	42	34
Subtotal	5,136	3,547
Less: accumulated depreciation	(3,374)	(2,335)
Property and equipment, net	$ 1,762	$ 1,212

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(5) ACCRUED EXPENSES AND OTHER LIABILITIES

Accrued expenses and other liabilities consists of the following:

	June 30, 2003	June 30, 2002
Salaries, wages and other compensation	$ 1,910	$ 1,355
Other payables	1,266	950
	$ 3,176	$ 2,305

(6) NOTE PAYABLE

The Company had entered into an insurance premium financing agreement. At June 30, 2002 the total amount outstanding was $140 and the interest rate was 5.26%. There was no such agreement in place at June 30, 2003.

(7) CONVERTIBLE DEBENTURE

On December 17, 1998, the Company executed an agreement to issue $1,125 of Convertible Debt (Debt) with an investment company. The Debt was interest bearing at a rate of prime plus 2% and was payable quarterly. The Debt was convertible into 750,000 shares of common stock at a conversion price equal to $1.50 per share. The Debt was convertible, at the debt holders   option, after February 1, 2000. In addition, the Company issued the debt holders warrants to purchase 500,000 shares of the Company s common stock at $2.00 per share. The warrants were exercisable at any time before June 2001. The terms of the Debt agreement that permitted the conversion of the Debt to common stock at a discount to market, was considered a beneficial conversion feature. The beneficial conversion feature at the date of issuance of the Debt was recognized as interest expense over the shortest possible conversion period. The convertible debt was secured by a second lien on the Company s assets and properties and was subordinated to the Company s senior debt.

On August 26, 1999, the Company increased the convertible debt to approximately $4,300 including repaying the December 1998 issuance. This increased amount was principally with the same debt holders as the December 1998 transaction, with certain company officers, directors and employees also participating**.** The debt was interest bearing at a rate of 11.5% per annum with a maturity of June 30, 2002. Interest was payable quarterly, except for interest accruing from the date of issuance through July 1, 2000, which was added to the principal amount of the note. The number of shares of common stock into which the debt may be converted was equal to the principal amount of the note, plus the accrued interest, divided by the conversion price of $1.00 per share. In addition, the warrants from the December 17, 1998 transaction were cancelled, and the Company issued approximately 4,300,000 warrants to purchase the Company s common stock at $2.00 per share that have a term of five years. The warrants were valued at $431 and this amount was recognized as interest expense over the debt maturity period. In fiscal 2002 certain debt holders, holding $25 in convertible debt, elected to convert the debt into 24,835 shares of common stock and holders of the remaining $38 convertible debt were repaid.

As of September 30, 1999, the Company had recorded a beneficial conversion feature attributable to the convertible debt of $1,078. This feature was being amortized over the term of the debt. A report subsequently issued by a national valuation firm indicated the fair value of the Company s common stock was below the conversion price at the date of the transaction and therefore, no such beneficial conversion feature existed. The Company reversed the charge of $317 in the fourth quarter of fiscal year 2000 that had been charged as interest expense. The effect on the prior quarterly results was immaterial.

On December 29, 2000, the Company completed an additional $1 million financing transaction as an add-on to the August 1999 financing agreement. The additional note was convertible into the Company s common stock at

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$1.51 per share and carried a warrant to purchase an additional 333,877 shares of the Company s common stock at $2.51 per share.

At the November 2000 meeting, The Emerging Issues Task Force (EITF) reached a consensus opinion on Issue 00-27 regarding the Application of EITF Issue 98-5, Convertible Securities with Beneficial Conversion Features or Contingently Adjustable Conversion Ratios, to Certain Convertible Instruments . The consensus opinion required the Company to use an effective conversion price to determine a convertible instrument s beneficial conversion feature. The change was effective retroactively to transactions for which a commitment date occurred prior to November 16, 2000. As a result, in December 2000, the Company recognized approximately $129 as a cumulative effect of a change in accounting principle associated with the convertible debt issued in August 1999. During December 2000, the Company also recognized $33 in interest expense associated with the convertible debt issued in December 2000.

During fiscal year 2003, the Company re-evaluated the calculation of the beneficial conversion feature for the convertible debt that was issued in August 1999 and December 2000. The Company had originally retained a National valuation firm to determine the fair market value of the Company s common stock for the purposes of determining the existence and the amount of any beneficial conversion feature. The Company, instead of using the independent valuation, has now recalculated the beneficial conversion feature for the convertible debt issued in 1999 and 2000 using the then quoted market price of the stock, as quoted in the pink sheets at the time of the transactions. As a result of the revised beneficial conversion feature calculation, the Company has recorded additional interest expense in fiscal 2001 and 2000 in the amounts of $79 and $2,157, respectively with a corresponding increase in Additional Paid in Capital. In addition, the charge for the cumulative effect of the change in accounting principle in the fiscal year 2001 has increased by $302 to $431 with a corresponding increase to Additional Paid in Capital. The restatement did not affect cash or the amount of the Company s operating losses.

On January 24, 2001, approximately $5,700 of convertible debt and the interest accrued on that debt was converted into approximately 5,300,000 shares of common stock at prices between $1.00 and $1.51 per share, by the investment company, current directors and certain former officers. Approximately $130 of the debt discount related to the warrants associated with this debt conversion was amortized into interest expense.

During January 2001, warrants for the purchase of approximately 2,400,000 shares of the Company s common stock was exercised at $2.00 per share for a total of approximately $4,800 in cash. The debt discount related to the warrants decreased by $127 as a result of this exercise. On May 31, 2001, approximately $192 of convertible debt and the interest accrued on that debt was converted into approximately 192,000 shares of common stock at $1.00 per share. Approximately $7 of the debt discount related to the warrants associated with this debt conversion was amortized into interest expense.

The number of warrants outstanding on the convertible debt as of June 30, 2003 and June 30, 2002 was 2,255,361 and are exercisable at prices ranging from $2.00 to $2.50, and expire in August 2004. The unamortized debt discount related to the warrants as of June 30, 2002 and 2001 was $0. During 2003 and 2002, $0 and $2 of the debt discount related to the warrants was amortized to interest expense. As of June 30, 2002 all convertible debt has either been repaid or converted into common stock of the Company.

(8) INCOME TAXES

Significant components of the provision for income taxes / (benefit) are as follows:

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	June 30, 2003
Current:	
Federal	$ 76
State	6
	82
Deferred:	
Federal and State	(4,249)
	($ 4,249)
Total income tax (benefit)	($ 4,167)

There was no provision for income taxes at June 30, 2002 and 2001 due to the Company s net operating losses.

The significant components of the Company s net deferred income tax assets (liabilities) are as follows:

Deferred tax assets

	June 30, 2003	June 30, 2002	June 30, 2001
Accrued expenses	$ 496	$ 443	$ 339
Depreciation and amortization	561	545	313
Net operating loss carry forwards	24,965	25,029	24,210
Capital loss carry forwards	158	2,855	2,024
AMT credit carry forward	76		
Other deferred tax assets	163	39	517
Settlement charges	1,332		
Less: Valuation allowance	(23,502)	(28,911)	(27,403)
	4,249		

The valuation allowance for deferred tax assets was $23,502 and $28,911 as of June 30, 2003 and June 30, 2002, respectively. During fiscal year 2003, the Company recorded an income tax benefit of $4,167 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 $4,167 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 in excess of $11.5 million in US taxable income from normal and recurring operations through the end of fiscal year 2005. This projection of is the minimum amount of future US taxable income that would have to be generated to realize the $4,167 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 Company 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 upon 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. 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 net tax operating loss carryforwards as planned, changes in the industry, our product life-cycle, profitability trends, and tax law changes.

As of June 30, 2003, the Company had U.S. net operating loss carryforwards for federal income tax purposes of approximately $64,011. The Company s net operating loss carry forwards begin to expire in 2010. Under the Tax Reform Act of 1986, the amounts of, and the benefits from, net operating loss carryforwards may be impaired or limited due to a change of ownership control as defined by the Internal Revenue Code. The Company also has U.S. net capital loss carry forwards of approximately $427. The Company may utilize the U.S. capital loss carry forwards only to the extent it generates future capital gains. As of June 30, 2003 the Company had U.K. net operating loss carry forwards of approximately $3,462, which do not expire under U.K. tax laws.

A reconciliation of the effective income tax benefit rate and the statutory United States income tax rate follows:

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	Years ending		
	June 30, 2003	**June 30, 2002**	**June 30, 2001**
	%	%	%
Income taxes at statutory rates	(34.00)	(34.00)	(34.00)
State and local taxes, net of benefit	(3.00)	(3.00)	(3.00)
Foreign operating results with no benefit provided	(518.21)	(123.76)	11.65
Deferred compensation	(796.74)	(51.36)	0.00
Interest on convertible debt	2.67	0.42	6.19
Permanent differences, net	37.61	(37.97)	(24.14)
Change in valuation allowance	5652.30	249.67	43.30
	4340.63%	0.00%	0.00%

(9) SHAREHOLDERS EQUITY

Common Stock The Company has authorized 50,000,000 shares of CyberGuard common stock, each share having a par value of $0.01 per share.

Preferred Stock The Company has authorized 5,000,000 shares of CyberGuard preferred stock, each share having a par value of $0.01 per share. No preferred shares are outstanding.

Stockholder Protection Rights Agreement- In September 1994, the Company approved a Stockholder Protection Rights Agreement. The agreement states that each share of the Company s common stock has attached to it one right. Each right entitles its registered holder to purchase from the Company after the Separation Time , as hereinafter defined, one-hundredth of a share of Participating Preferred Stock, par value $0.01 per share, for an amount calculated in accordance with the Preferred Stock Agreement. The rights will not trade separately from the common stock unless and until the Separation Time. The Separation Time is defined as the earlier of the tenth business day after the date on which any person commences a tender or exchange offer which, if consummated, would result in an acquisition, and the first date of public announcement by the Company of such offering. In the event of any voluntary or involuntary liquidation of the Company, the holders of the Preferred Stock shall be paid an amount as calculated in accordance with the Preferred Stock Agreement.

Stock Option Plans Effective October 8, 1994, the Company adopted an Incentive Stock Option Plan. On February 4, 1996, the Board of Directors approved an amendment to the plan to reserve 2,025,000 shares of common stock for grant, and effective October 28, 1997 increased the reserve to 2,400,000 shares. Effective September 4, 1998, the Company adopted an Employee Stock Option Plan. The Board of Directors approved an initial reserve of 1,400,000 shares of common stock for grant, and effective August 10, 1999 increased the reserve to 2,500,000 shares. On March 9, 2001, the Company registered an additional 2,000,000 shares and on November 21, 2001, an additional 2,500,000 shares, totaling 7,000,000 shares under the 1998 plan. The options vest over a three-year period and have a term of five years.

Both plans permit the issuance of stock options; stock appreciation rights, performance awards, restricted stock and/or other stock based awards to directors and salaried employees. The option price shall be determined by the Board of Directors effective on the Grant Date unless approved by the Board of Directors. The option price shall not be less than 100% of the Fair Market Value of a share of common stock on the Grant Date. If Incentive Stock Options are granted to a participant who on the Grant Date is a ten-percent holder, such price shall not be less than one hundred and ten percent of the Fair Market Value of a share of common stock on the Grant Date. Vesting of these options occurs based on years of service. Generally it begins at 33% after one year, 66% after

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two years, and 100% after the third year of service. All options become immediately exercisable upon the occurrence of a Change in Control of the Company.

During October 2001, certain officers and employees elected to participate in a special stock option program offered by the Company through a Stock Option Plan. Officers could elect a base salary reduction ranging from 10.01% to 100% and employees could elect a base salary reduction ranging from .01% to 100%. This base salary reduction entitled them to receive a specified number of stock options, as defined in the program agreement, to purchase shares of the Company s common stock at the then current market price of $1.30 per share. Approximately 1,751,000 stock options, with a one-year vesting period that will expire in 10 years from the grant date were issued related to this program. The Company s CEO participated in this special option program where he elected to accept options in lieu of salary for a twelve months period. The company was required to record compensation expense of $59 and $91 during the year ended June 30, 2003 and 2002 respectively. This amount is included in the modification of stock option balance on the Consolidated Statements of Changes in Shareholders Equity.

Information relating to the Company s stock option plans is as follows:

	Number of Shares	Weighted Average Exercise Price
Options at July 1, 2000	2,977,000	$ 2.70
Granted	1,929,000	$ 1.98
Exercised	(386,000)	$ 1.38
Forfeited	(654,000)	$ 4.66
Shares under option at June 30, 2001	3,866,000	$ 2.20
Option shares exercisable at June 30, 2001	1,993,000	$ 1.83
Options at June 30, 2001	3,866,000	$ 2.20
Granted	2,025,000	$ 1.47
Exercised	(418,000)	$ 1.25
Forfeited	(330,000)	$ 2.77
Shares under option at June 30, 2002	5,143,000	$ 1.91
Option shares exercisable at June 30, 2002	3,327,000	$ 1.84
Options at July 1, 2002	5,143,000	$ 1.91
Granted	2,211,000	$ 3.14
Exercised	(1,617,000)	$ 1.53
Forfeited	(302,000)	$ 2.73
Shares under option at June 30, 2003	5,435,000	$ 2.46

Option shares exercisable at June 30, 2003	3,157,000	$ 2.16

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The following information applies to options outstanding as of June 30, 2003:

	Options Outstanding			Options Exercisable	
Actual Range of Exercise Prices Increment	**Number Outstanding**	**Weighted-Average Remaining Contractual Life**	**Weighted-Average Exercise Price**	**Number Exercisable**	**Weighted-Average Exercise Price**
$1.00-1.50	2,135,000	6.2	$1.36	1,937,000	$1.34
$1.51-2.15	621,000	2.7	$1.59	391,000	$1.57
$2.30-3.40	1,817,000	4.2	$2.56	326,000	$2.71
$3.60-5.30	373,000	4.2	$4.02	220,000	$4.02
$5.56-7.64	489,000	6.4	$6.77	283,000	$6.52
$1.00-7.64	5,435,000	5.0	$2.46	3,157,000	$2.16

In November 2000, the Company extended the expiration dates of approximately 129,000 options to purchase shares of the Company s common stock. As a result of this modification, the Company recorded approximately $68 in compensation expense.

In January 2001, the Company resolved that the former Chief Financial Officer s (CFO) stock options would vest in full upon his retirement date, and the options would remain exercisable through June 30, 2003 or the options expiration date, whichever comes first. As a result of this modification, the Company recorded approximately $73 in compensation expense.

During the third quarter of 2001, under market priced options were issued to the Company s President, which resulted in compensation expense of $43. The Company also issued under market priced options to two employees, which resulted in compensation expense of $65 in fiscal 2002 and $11 in fiscal 2001.

On October 24, 2001, the Board of Directors of the Company resolved that upon Mr. David Proctor s resignation as Chairman of the Board effective November 15, 2001, additional vesting of 16,667 options to purchase the Company s common stock granted on April 26, 2000, with the options remaining exercisable through May 15, 2002. There was no accounting effect as a result of this resolution.

On July 19, 2002, the Company filed an amendment to its Registration Statement on Form S-8 with the Securities and Exchange Commission to reflect the amendment and restatement of the Harris Computer Systems Corporation Employee Savings Plan as the CyberGuard Corporation Retirement Savings Plan.

Related Party Equity Transactions- During January 2001, the Company s CEO invested $500 to purchase at the market value approximately 143,000 shares of common stock at $1.75 share and approximately 62,000 shares of common stock at $4.00 per share. In conjunction with the purchase of the approximately 143,000 shares of common stock, the CEO was granted an equal number of warrants to purchase the Company s common stock at $1.75 per share. The warrants are exercisable any time before December 25, 2005.

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(10) COMMITMENTS AND CONTINGENCIES

Employment Agreements. The Company has entered into employment agreements with certain key employees. These agreements provided for severance and other benefits if the Company for any reason other than cause terminates these employees.

Lease Commitments. Rent expense was approximately $709 for the year ended June 30, 2003, $643 for the year ended June 30, 2002, and approximately $631 for the year ended June 30, 2001.

Total future minimum rental commitments under non-cancelable operating leases, primarily for buildings and equipment, for the years following June 30, 2003 are as follows:

YEAR	AMOUNT
2004	$ 636
2005	$ 110
2006	$ 11
Total	$ 757

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 (Exchange Act) and SEC Rule 10b-5 promulgated there under 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 there under. 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

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damaged by the purchase of such stock. The trial is scheduled for March 2004.

In June 2003, the company received an offer to settle the outstanding class action lawsuit for $10,000. After consulting with the company s insurer, the company accepted the offer to settle. $6,500 of the settlement amount will be proceeds from the company s insurance policy and the company will pay the balance. The company will pay $500 in cash and have the following options for the payment of the balance of the settlement: (1) $3,000 in cash; (2) 468,750 shares of CyberGuard s common stock or (3) 312, 500 shares of CyberGuard s common stock and warrant to purchase shares of CyberGuard common stock with a net present value (as of May 30, 2003) of $1,000. The results of operations for the year ended June 30, 2003 include a charge of $3,900, representing the settlement discussed above and the legal fees incurred through June 30, 2003. The company has recorded a receivable at June 30, 2003 for $6,500, which is the amount the insurance company has agreed to pay. The company received the payment from the insurance company in July and placed the cash in escrow pending approval of the settlement by the court. The terms of the settlement are subject to approval by the court, and there can be no assurance that the court will approve this proposed settlement of the lawsuit.

If the court does not approve the settlement, there can be no assurance that the Company will ultimately be successful in defending the lawsuit, or that if the Company is unsuccessful, that there will be sufficient insurance coverage to cover any expense of the lawsuit and/or any judgment rendered against the Company. 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 initially notified its insurance carrier of the existence of the lawsuit, and the carrier has sent the Company a reservation of rights letter. If the settlement is not approved by the court, 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. In the event the court does not approve the settlement and the action goes to court, 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 assuming the court does not approve the settlement.

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 has 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 various 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.

(11) FINANCIAL INSTRUMENTS AND CONCENTRATIONS OF CREDIT RISK

Financial instruments, which potentially subject the Company to a concentration of credit risk principally, consist of cash, cash equivalents and trade receivables. The carrying value of these financial instruments approximates fair value.

The Company does not require collateral or other security on its trade receivables. During 2003, no customer represented more than 10% of consolidated revenues. During 2002, one customer represented 11% of

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(Amounts in thousands, except share and per share data)

consolidated revenues. This customer represented 3% of consolidated revenues in 2003. During 2001, one customer represented 16% and one distributor represented 12% of consolidated revenues. During 2003, 2002 and 2001, one supplier who is our hardware manufacturer and assembly provider, represented 25%, 21% and 20% respectively of consolidated purchases. At June 30, 2003, 2002 and 2001, this supplier represented 44%, 39% and 43% respectively of consolidated accounts payable.

(12) EMPLOYEE BENEFIT PLANS

The Company has a 401(k) Savings Plan (the Plan) which covers the eligible employees of the Company. An employee is eligible to participate in the Plan on the date of hire. The amount of profit-sharing contributions made by the Company into the Plan is discretionary. Each participant may contribute up to 19% of compensation into the Plan. The Company makes a matching contribution on behalf of each participant for the first 6% of their individual contribution. These contributions are currently made in the form of common stock of the Company. Participants profit sharing and matching contribution vests over a three-year period. For the years ended June 30, 2003, 2002, and 2001, the Company recorded compensation expense of $408, 259, and $222 respectively, for the Company matches to the Plan.

The Company has an Employee Stock Purchase Plan (ESPP), which covers the eligible employees of the Company. The ESPP allows an employee to purchase common stock of the Company at a 15% discount on the lower of the beginning or ending offering date. An employee is eligible to participate in the ESPP beginning on the offering date (defined as January 1 and July 1) following their hire date. Each participant may contribute the lesser of 10% of eligible compensation or $25,000 per calendar year. During 2003 and 2002, 51,000 and 114,000 shares respectively, were issued in connection with this plan.

(13) GEOGRAPHIC INFORMATION

A summary of the Company s revenues* by geographic area is summarized below:

	YEAR ENDED JUNE 30,		
	2003	2002	2001
North America	$ 16,406	$ 9,339	$ 12,080
Europe (EMEA)	10,469	7,761	8,553
Asia / Latin America	6,105	5,240	3,773
	$ 32,980	$ 22,340	$ 24,406

*Revenues are attributed to countries based on location of customer.

A summary of the Company s long-lived assets is summarized below:

	YEAR ENDED JUNE 30,		
	2003	2002	2001
United States	$ 1,626	$ 1,121	$ 1,190
Europe	136	91	54
Asia			
	$ 1,762	$ 1,212	$ 1,244

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(14) NEW ACCOUNTING PRONOUNCEMENTS

In December 2002, the FASB issued SFAS No. 148, *Accounting for Stock-Based Compensation Transition and Disclosure, an amendment of FASB Statement No. 123*. SFAS No. 148 amends FASB SFAS No. 123, *Accounting for Stock-Based Compensation*, to provide alternative methods of transition for an entity that voluntarily changes to the fair value based method of accounting for stock-based employee compensation and to require prominent disclosures about the effects on reported net income of an entity s accounting policy decisions with respect to stock-based employee compensation. SFAS No. 148 also amends APB Opinion No. 28, *Interim Financial Reporting*, to require disclosures about those effects in interim financial information. We currently accounts for its stock-based compensation awards to employees and directors under the accounting prescribed by Accounting Principles Board Opinion No. 25 and provides the disclosures required by SFAS No. 123. We currently intend to continue to account for our stock-based compensation awards to employees and directors under the accounting prescribed by Accounting Principles Board Opinion No. 25 and will adopt the additional disclosure provisions of SFAS No. 148.

In November 2002, the FASB issued Interpretation 45 (FIN 45), *Guarantor s Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others.* For a guarantee subject to FIN 45, a guarantor is required to:

- measure and recognize the fair value of the guarantee at inception (for many guarantees, fair value will be determined using a present value method); and

- provide new disclosures regarding the nature of any guarantees, the maximum potential amount of future guarantee payments, the current carrying amount of the guarantee liability, and the nature of any recourse provisions or assets held as collateral that could be liquidated and allow the guarantor to recover all or a portion of its payments in the event guarantee payments are required.

FIN 45 is effective for financial statements for fiscal years ending after December 15, 2002. We are currently in compliance with the provisions of the new pronouncement.

In January 2003, the FASB issued FASB Interpretation 46 (FIN 46), *Consolidation of Variable Interest Entities*. FIN 46 clarifies the application of Accounting Research Bulletin 51, *Consolidated Financial Statements*, for certain entities that do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support from other parties or in which equity investors do not have the characteristics of a controlling financial interest (variable interest entities). Variable interest entities within the scope of FIN 46 will be required to be consolidated by their primary beneficiary. The primary beneficiary of a variable interest entity is determined to be the party that absorbs a majority of the entity s expected losses, receives a majority of its expected returns, or both. FIN 46 applies immediately to variable interest entities created after January 31, 2003, and to variable interest entities in which an enterprise obtains an interest after that date. It applies in the first fiscal year or interim period beginning after June 15, 2003, to variable interest entities in which an enterprise holds a variable interest that it acquired before February 1, 2003. At June 30, 2003 we were not a party to transactions contemplated under FIN 46.

In November 2002, the Emerging Issues Task Force reached a consensus opinion on EITF 00-21, *Revenue Arrangements with Multiple Deliverables*. The consensus provides that revenue arrangements with multiple deliverables should be divided into separate units of accounting if certain criteria are met. The consideration for the arrangement should be allocated to the separate units of accounting based on their relative fair values, with different provisions if the fair value of all deliverables is not known or if the fair value is contingent on delivery of specified items or performance conditions. Applicable revenue recognition criteria should be considered separately for each separate unit of accounting. EITF 00-21 is effective for revenue arrangements entered into in fiscal periods beginning after June 15, 2003. Entities may elect to report the change as a cumulative effect adjustment in accordance with APB Opinion 20, Accounting Changes.

In November 2002 the Emerging Issues Task Force reached a consensus opinion on EITF 02-16, *Accounting by a Customer (including a reseller) for Certain Consideration Received from a Vendor*. EITF 02-16 requires that cash payments, credits, or equity instruments received, as consideration by a customer from a vendor should be presumed to be a reduction of cost of sales when recognized by the customer in the income statement. In certain situations, the presumption could be

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overcome and the consideration recognized either as revenue or a reduction of a specific cost incurred. The consensus should be applied prospectively to new or modified arrangements entered into after December 31, 2002. At June 30, 2003, we were not a party to transactions contemplated by EITF 02-16.

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*. In general, the SFAS No. 149 is effective for contracts entered into or modified after June 30, 2003 and for hedging relationships designated after June 30, 2003. The adoption of SFAS No. 149 did not have a material impact on our financial condition or results of operations.

On May 15, 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. It requires that an issuer classify a financial instrument that is within its scope as a liability (or an asset in some circumstances). SFAS No. 150 affects the issuer s accounting for three types of freestanding financial instruments:

- mandatory redeemable shares, which the issuing company is obligated to buy back in exchange for cash or other assets;
- instruments that do or may require the issuer to buy back some of its shares in exchange for cash or other assets; includes put options and forward purchase contracts; and
- obligations that can be settled with shares, the monetary value of which is fixed, tied solely or predominantly to a variable such as a market index, or varies inversely with the value of the issuers shares.

SFAS No. 150 does not apply to features embedded in a financial instrument that is not a derivative in its entirety. Most of the guidance in SFAS No. 150 is effective for all financial instruments entered into or modified after May 31, 2003, and otherwise is effective at the beginning of the first interim period beginning after June 15, 2003. We have not yet completed our analysis of SFAS No. 150; however, we believe that we are currently substantially in compliance with the requirements of SFAS No. 150.

(15) QUARTERLY FINANCIAL INFORMATION (UNAUDITED)

Selected unaudited quarterly results for the fiscal year ended June 30, 2003 and 2002 were as follows:

Fiscal Year 2003

	Total	Jun 30, 2003 (1)	Mar 31, 2003	Dec 31, 2002	Sep 30, 2002
Revenues	$ 32,980	$ 9,004	$ 8,643	$ 8,233	$ 7,100
Gross profit	24,409	6,591	6,532	6,028	5,258
Operating (loss) / income	(379)	(3,671)	973	1,364	955
Net (loss) / income	$ 4,071	($ 3,516)	$ 5,148	$ 1,508	$ 931
Basic (loss) / income per share	$ 0.21	($ 0.17)	$ 0.26	$ 0.08	$ 0.05
Diluted (loss) / income per share	$ 0.16	($ 0.17)	$ 0.20	$ 0.06	$ 0.04

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(Amounts in thousands, except share and per share data)

Fiscal Year 2002

	Total	Jun 30, 2002	Mar 31, 2002	Dec 31, 2001	Sep 30, 2001
Revenues	$ 22,340	$ 5,720	$ 6,291	$ 5,753	$ 4,576
Gross profit	15,177	3,809	4,230	3,946	3,192
Operating (loss) / income	(841)	(131)	85	141	(936)
Net (loss) / income	$ (608)	$ 109	$ 81	$ 110	$ (908)
Basic and diluted (loss) / income per share	$ (0.03)	$ 0.00	$ 0.00	$ 0.01	$ (0.05)

(1) The quarter ended June 30,2003 includes a $3.9 million class action settlement charge as explained in note 16.

(16) SUBSEQUENT EVENTS

In June 2003, the company received an offer to settle an outstanding class action lawsuit for $10,000,000. After consulting with our insurer, we accepted the offer. A total of $6.5 million of the settlement amount will be funded by proceeds from our insurance policy and has been included as a receivable as of June 30, 2003. On July 18, 2003 the company received the funds from the insurance company and subsequently forwarded these funds to the escrow agent on July 31, 2003. The results of operations for the fiscal year ended June 30, 2003 included a charge of $3.9 million representing our portion of the settlement and the associated legal fees incurred through June 30, 2003. The terms of the settlement are subject to approval by the court, and there can be no assurance that the court will approve this proposed settlement.

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SCHEDULE II

CyberGuard Corporation

VALUATION AND QUALIFYING ACCOUNTS

(In Thousands)

Description	Balance at Beginning of Period	Charged to Costs and Expenses	Charged to Other Accounts	Deductions	Balance at End of Period
Year ended June 30, 2003					
Reserves deducted from assets to which they apply:					
Allowance for doubtful accounts	$ 109	$ 598	$	$	$ 707
Deferred tax valuation allowance	$ 28,911	$	$	$ (5,409)	$ 23,502
Year ended June 30, 2002					
Reserve deducted from assets to which they apply:					
Allowance for doubtful accounts	$ 36	$ 97	$	$ (24)	$ 109
Deferred tax valuation allowance	$ 27,403	$	$ 1,508	$	$ 28,911
Year ended June 30, 2001					
Reserve deducted from assets to which they apply:					
Allowance for doubtful accounts	$ 52	$ 10	$	$ (26)	$ 36
Deferred tax valuation allowance	$ 25,342	$	$ 2,061	$	$ 27,403

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EXHIBIT INDEX

Exhibit No.	Description
23.01	Consent of Grant Thornton LLP, Independent Certified Public Accountants
31.01	Certification by Scott Hammack, Chief Executive Officer, pursuant to Exchange Act Rules 13a-14 and 15d-15.
31.02	Certification by Michael D. Matte, Chief Financial Officer, pursuant to Exchange Act Rules 13a-14 and 15d-15.
32.01	Certification by Scott 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(1)
32.02	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(1)