VERITAS SOFTWARE CORP /DE/
Form 10-Q
August 09, 2004

UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-Q

(Mark One)

þ	**QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
	For the quarterly period ended June 30, 2004
	or
o	**TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
	For the transition period from to .

Commission file number: 000-26247

VERITAS Software Corporation

(Exact name of Registrant as Specified in Its Charter)

Delaware	**77-0507675**
(State or Other Jurisdiction of Incorporation or Organization)	*(I.R.S. Employer Identification No.)*

350 Ellis Street

Mountain View, California 94043
(650) 527-8000
(Address, including Zip Code, of Registrant s Principal Executive Offices and Registrant s Telephone Number, including Area Code)

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 þ No o

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

The number of shares of the registrant s common stock outstanding as of July 30, 2004 was 432,828,668 shares.

VERITAS SOFTWARE CORPORATION

INDEX

Table of Contents

PART I: FINANCIAL INFORMATION

Item 1. ***Condensed Consolidated Financial Statements***

VERITAS SOFTWARE CORPORATION

CONDENSED CONSOLIDATED BALANCE SHEETS

	June 30, 2004	December 31, 2003
	(Unaudited)	
	(In thousands)	
ASSETS		
Current assets:		
Cash and cash equivalents	$ 1,048,618	$ 823,171
Short-term investments	1,701,487	1,679,844
Accounts receivable, net of allowance for doubtful accounts of $5,865 and $7,479, respectively	171,498	250,098
Other current assets	66,841	60,254
Deferred income taxes	36,333	30,302
Total current assets	3,024,777	2,843,669
Property and equipment, net	569,264	572,977
Other intangibles, net	86,139	81,344
Goodwill	1,809,309	1,755,591
Other non-current assets	23,707	25,385
Deferred income taxes	83,201	69,500
	$ 5,596,397	$ 5,348,466
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 39,098	$ 38,289
Accrued compensation and benefits	110,797	124,655
Accrued acquisition and restructuring costs	22,789	25,051
Other accrued liabilities	67,412	83,184
Current portion of long-term debt	186,373	
Income taxes payable	159,058	141,623
Deferred revenue	422,584	398,772
Total current liabilities	1,008,111	811,574
Convertible subordinated notes	520,000	520,000
Long-term debt	194,257	380,630
Accrued acquisition and restructuring costs	60,080	69,019
Other long-term liabilities	24,881	23,649
Total liabilities	1,807,329	1,804,872
Stockholders equity:		
Common stock	461	458
Additional paid-in capital	7,013,156	6,941,798

Accumulated deficit	(1,191,558)	(1,378,076)
Deferred stock-based compensation	(12,183)	(8,455)
Accumulated other comprehensive income (loss)	(2,505)	6,172
Treasury stock, at cost; 28,609 shares at June 30, 2004 and December 31, 2003	(2,018,303)	(2,018,303)
Total stockholders equity	3,789,068	3,543,594
	$ 5,596,397	$ 5,348,466

See accompanying notes to condensed consolidated financial statements.

Table of Contents

VERITAS SOFTWARE CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

	Three Months Ended June 30,		Six Months Ended June 30,	
	2004	**2003**	**2004**	**2003**
	(Unaudited) (In thousands, except per share amounts)			
Net revenue:				
User license fees	$269,916	$252,801	$572,325	$500,256
Services	215,118	155,567	398,456	298,248
Total net revenue	485,034	408,368	970,781	798,504
Cost of revenue:				
User license fees	8,878	11,716	18,397	23,633
Services(1)	66,812	54,807	132,655	107,109
Amortization of developed technology	4,055	10,554	7,879	25,336
Total cost of revenue	79,745	77,077	158,931	156,078
Gross profit	405,289	331,291	811,850	642,426
Operating expenses:				
Selling and marketing(1)	151,580	121,843	294,618	237,141
Research and development(1)	83,580	71,468	163,504	142,056
General and administrative(1)	46,389	39,638	94,138	77,817
Amortization of other intangibles	2,409	12,250	4,803	30,441
In-process research and development		15,300	400	19,400
Total operating expenses	283,958	260,499	557,463	506,855
Income from operations	121,331	70,792	254,387	135,571
Interest and other income, net	10,438	13,891	21,764	24,903
Interest expense	(6,000)	(7,798)	(11,702)	(15,536)
Gain (loss) on strategic investments			7,496	(3,518)
Income before income taxes	125,769	76,885	271,945	141,420
Provision for income taxes	39,299	31,251	85,427	52,682
Net income	$ 86,470	$ 45,634	$186,518	$ 88,738
Net income per share basic	$ 0.20	$ 0.11	$ 0.43	$ 0.21
Number of shares used in computing per share amounts basic	431,943	415,621	431,329	414,270
Net income per share diluted	$ 0.20	$ 0.11	$ 0.42	$ 0.21
Number of shares used in computing per share amounts diluted	442,361	427,939	443,622	424,275

(1) Amortization of stock-based compensation consists of:

Services	$ 66	$	$ 303	$
Selling and marketing	981		3,862	
Research and development	614	416	1,836	730
General and administrative	24		768	
Total amortization of stock-based compensation	$1,685	$416	$6,769	$730

See accompanying notes to condensed consolidated financial statements.

Table of Contents

VERITAS SOFTWARE CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

	Six Months Ended June 30, 2004	Six Months Ended June 30, 2003
	(Unaudited) (In thousands)	
Cash flows from operating activities:		
Net income	$ 186,518	$ 88,738
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	59,731	61,899
Amortization of developed technology	7,879	25,336
Amortization of other intangibles	4,803	30,441
In-process research and development	400	19,400
Provision for (recovery of) allowance for doubtful accounts	(836)	1,475
Stock-based compensation	6,769	730
Tax benefits from stock plans	8,618	11,065
(Gain) loss on strategic investments	(7,496)	3,518
(Gain) loss on sale and disposal of assets	909	(428)
Deferred income taxes	(18,923)	(23,359)
Changes in operating assets and liabilities, net of effects of business acquisitions:		
Accounts receivable	77,729	52,712
Other assets	(8,053)	6,200
Accounts payable	863	(929)
Accrued compensation and benefits	(13,911)	(14,398)
Accrued acquisition and restructuring costs	(12,888)	(10,193)
Other liabilities	(10,268)	(6,133)
Income taxes payable	17,517	50,164
Deferred revenue	21,633	25,656
Net cash provided by operating activities	320,994	321,894
Cash flows from investing activities:		
Purchases of investments	(1,651,284)	(930,935)
Sales and maturities of investments	1,624,392	1,160,013
Purchases of property and equipment	(53,005)	(34,998)
Purchase of businesses and technology, net of cash acquired	(68,987)	(333,739)
Payments made for prior year business and technology acquisitions		(4,152)
Net cash used for investing activities	(148,884)	(143,811)
Cash flows from financing activities:		
Additional issuance costs for convertible subordinated debt	(170)	
Proceeds from issuance of common stock	52,249	58,984
Net cash provided by financing activities	52,079	58,984
Effect of exchange rate changes on cash and cash equivalents	1,258	15,889
Net increase in cash and cash equivalents	225,447	252,956
Cash and cash equivalents at beginning of period	823,171	764,062
Cash and cash equivalents at end of period	$ 1,048,618	$ 1,017,018

Supplemental disclosures:		
Cash paid for interest	$ 8,855	$ 5,992
Cash paid for income taxes	$ 88,674	$ 15,808

See accompanying notes to condensed consolidated financial statements.

Table of Contents

VERITAS SOFTWARE CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

1. Basis of Presentation

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with generally accepted accounting principles in the United States of America for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for annual financial statements. In the opinion of management, all adjustments, consisting only of normal recurring adjustments, considered necessary for a fair presentation have been included. The results for the interim periods presented are not necessarily indicative of the results that may be expected for any future period. The following information should be read in conjunction with the consolidated financial statements and accompanying notes included in VERITAS Software Corporation s Annual Report on Form 10-K for the year ended December 31, 2003.

2. Use of Estimates

The preparation of financial statements in conformity with generally accepted accounting principles in the United States of America requires management to make estimates and assumptions that affect the amounts reported in the condensed consolidated financial statements and accompanying notes. Actual results could differ from those estimates.

3. Accounting for Stock-Based Compensation

The Company accounts for employee stock-based compensation in accordance with Accounting Principles Board (APB) Opinion No. 25, *Accounting for Stock Issued to Employees*, and related interpretations, and the disclosure requirements of Statement of Financial Accounting Standards (SFAS) No. 148, *Accounting for Stock-Based Compensation Transition and Disclosure an Amendment of FASB Statement No. 123*. Since the exercise price of options granted under the Company s stock option plans is equal to the market value on the date of grant, no compensation cost has been recognized for grants under such plans. In accordance with APB Opinion No. 25, the Company does not recognize compensation cost related to its employee stock purchase plan. The following table illustrates the effect on net income (loss) and net income (loss) per share if the Company had accounted for its stock option and stock purchase plans under the fair value method of accounting under SFAS No. 123, *Accounting for Stock-Based Compensation*:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2004	2003	2004	2003
	(In thousands, except per share amounts)			
Net income (loss):				
As reported	$ 86,470	$ 45,634	$ 186,518	$ 88,738
Add:				
Stock-based compensation expense included in net income, net of tax	1,112	279	4,468	489
Less:				
Total stock-based compensation expense determined under the fair value method for all awards, net of tax	(76,313)	(76,513)	(147,429)	(152,047)
Pro forma	$ 11,269	$ (30,600)	$ 43,557	$ (62,820)

Table of Contents

VERITAS SOFTWARE CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2004	2003	2004	2003
	(In thousands, except per share amounts)			
Basic income (loss) per share:				
As reported	$0.20	$ 0.11	$0.43	$ 0.21
Pro forma	$0.03	$(0.07)	$0.10	$(0.15)
Diluted income (loss) per share:				
As reported	$0.20	$ 0.11	$0.42	$ 0.21
Pro forma	$0.03	$(0.07)	$0.10	$(0.15)

For purposes of the pro forma disclosures, the expected volatility assumptions the Company used prior to the fourth quarter of fiscal 2003 were based solely on the historical volatility of the Company s common stock over the most recent period commensurate with the estimated expected life of the Company s stock options. Beginning with the fourth quarter of fiscal 2003, the Company modified its approach and expected volatility by considering other relevant factors in accordance with SFAS No. 123. The Company considered implied volatility in market-traded options on the Company s common stock as well as historical volatility. The Company will continue to monitor these and other relevant factors used to measure expected volatility for future option grants.

Also, beginning with the third quarter of fiscal 2003, the Company decreased its estimate of the expected life of new options granted to its employees from 5 years to 4 years. The Company bases its expected life assumption on historical experience as well as the terms and vesting periods of the options granted. The reduction in the estimated expected life was a result of an analysis of the Company s historical experience.

For the pro forma amounts determined under SFAS No. 123, as set forth above, the fair value of each stock option grant under the stock option plans is estimated on the date of grant using the Black-Scholes option-pricing model with the following weighted-average assumptions used for grants:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2004	2003	2004	2003
Risk-free interest rate	3.36%	2.57%	2.74%	2.74%
Dividend yield	0%	0%	0%	0%
Weighted average expected life	4.0 years	5.0 years	4.0 years	5.0 years
Volatility of common stock	52%	90%	54%	90%

The fair value of the employees purchase rights under the employee stock purchase plan is estimated on the date of grant using the Black-Scholes option-pricing model. There were no grants under the employee stock purchase plan for the three months ended June 30, 2004 and 2003.

As a result of the Company s restatement of its financial statements for 2002 and 2001 and the delay in filing its Form 10-K for the year ended December 31, 2003, the Company suspended option-holders ability to use the Company s registration statements for its stock option plans (the Plans). As a result, option-holders were unable to exercise options under the Plans until such time as the Company filed its Form 10-K for the year ended December 31, 2003 and lifted the suspension on the use of the registration statements. Pursuant to the terms of the Plans, options held by certain former employees of the Company were scheduled to expire during the suspension period. On March 15, 2004, the Company extended the expiration date of such options for a period of 15 days from the date of filing the Form 10-K, which was considered a modification of such

VERITAS SOFTWARE CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

options. For the six months ended June 30, 2004, $4.3 million was expensed in the statement of operations as a result of this modification.

4. Net Income per Share

The following table sets forth the computation of basic and diluted net income per share:

	Three Months Ended June 30,		Three Months Ended June 30,	
	2004	2003	2004	2003
	(In thousands, except per share amounts)			
Numerator:				
Net income	$ 86,470	$ 45,634	$ 186,518	$ 88,738
Denominator:				
Denominator for basic net income per share weighted-average shares outstanding	431,943	415,621	431,329	414,270
Potential common shares	10,418	12,318	12,293	10,005
Denominator for diluted net income per share	442,361	427,939	443,622	424,275
Basic net income per share	$ 0.20	$ 0.11	$ 0.43	$ 0.21
Diluted net income per share	$ 0.20	$ 0.11	$ 0.42	$ 0.21

For the three and six months ended June 30, 2004 and 2003, potential common shares consist of employee stock options using the treasury stock method. The following table sets forth the potential common shares that were excluded from the net income per share computations:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2004	2003	2004	2003
	(In thousands)			
Employee stock options outstanding(1)	39,961	34,572	31,726	38,363
5.25% convertible subordinated notes(2)		6,695		6,695
1.856% convertible subordinated notes(2)		12,981		12,981
0.25% convertible subordinated notes(3)	11,274		11,274	

(1) These employee stock options were excluded from the computation of diluted net income per share because the exercise price was greater than the average market price of the Company s common stock during the period, and therefore the effect is antidilutive.

(2)

Potential common shares issuable upon the conversion of the Company s 5.25% and 1.856% convertible subordinated notes were excluded from the computation of diluted net income per share because the impact of adding back after tax interest expense associated with the convertible subordinated notes, and including the potential common shares, would be antidilutive.

(3) Potential common shares related to the Company s 0.25% convertible subordinated notes were excluded from the computation of diluted net income per share because the specified circumstances under which the 0.25% notes are convertible prior to maturity have not been met (see Note 9).

The weighted average exercise prices of employee stock options with exercise prices exceeding the average fair value of the Company s common stock was $56.70 and $61.92 per share for the three months ended June 30, 2004 and 2003, respectively and $63.93 and $58.45 per share for the six months ended June 30, 2004 and 2003, respectively.

VERITAS SOFTWARE CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

5. Business Combinations

Ejasent, Inc.

On January 20, 2004, the Company acquired all of the outstanding capital stock of Ejasent, Inc. (Ejasent), a privately held provider of application virtualization technology for utility computing. The Company acquired Ejasent to add important application migration technology, which allows IT personnel to move an application from one server to another without disrupting or terminating the application, to the Company s growing utility computing portfolio. The Ejasent acquisition was accounted for using the purchase method of accounting for total purchase consideration of $61.4 million, which included $47.8 million in cash and $13.6 million of acquisition-related costs. The purchase price was allocated to goodwill of $53.7 million, developed technology of $10.2 million, other intangibles of $1.9 million, in-process research and development (IPR&D) of $0.4 million, net deferred tax liabilities of $4.6 million and net tangible liabilities of $0.2 million. The weighted average amortization period for all purchased intangible assets is 4.4 years. Acquisition-related costs consist of $11.5 million of change in control bonuses and direct transaction costs of $2.1 million for legal and other professional fees. Total cash outlays for acquisition-related costs were $13.3 million through June 30, 2004. The results of operations of Ejasent were included in the Company s consolidated financial statements from the date of acquisition. The pro forma impact of the acquisition on the Company s results of operations is not significant.

Precise Software Solutions Ltd.

On June 30, 2003, the Company acquired all of the outstanding common stock of Precise Software Solutions Ltd. (Precise), a provider of application performance management products. The Company acquired Precise in order to expand its product and service offerings across storage, databases and application management. The Precise acquisition was accounted for using the purchase method of accounting for total purchase consideration of $715.1 million, which included 7.3 million shares of common stock valued at $210.6 million, $397.8 million of cash, $94.0 million relating to the assumption of Precise s outstanding vested and unvested stock options for 4.4 million shares of the Company s common stock and $12.7 million of acquisition-related costs. The purchase price was allocated to goodwill of $509.7 million, developed technology of $27.6 million, other intangibles of $34.3 million, IPR&D of $15.3 million, net deferred tax liabilities of $21.4 million, deferred stock-based compensation of $7.3 million and net tangible assets of $142.3 million. The weighted average amortization period for all purchased intangible assets is 3.7 years. The acquired IPR&D of $15.3 million was written off and the related charge was expensed in the statement of operations in the second quarter of 2003. Acquisition-related costs of $12.7 million consist of $9.0 million associated with investment banking and other professional fees, $3.3 million for terminating and satisfying existing lease commitments and $0.4 million for severance-related costs. Total cash outlays for acquisition-related costs were approximately $8.8 million for investment banking and other professional fees, $0.4 million for severance and $0.5 million for leases through June 30, 2004.

The results of operations of Precise are included in the Company s consolidated financial statements from the date of acquisition. The following table presents pro forma results of operations and gives effect to the acquisition of Precise as if the acquisition was consummated at the beginning of fiscal year 2003. The unaudited pro forma results of operations are not necessarily indicative of what would have occurred had the acquisition been made as of the beginning of the period or of the results that may occur in the future. Net income excludes the write-off of acquired IPR&D of $15.3 million and includes amortization of intangible

VERITAS SOFTWARE CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

assets related to the acquisition of $4.7 million per quarter and amortization of deferred compensation of $0.5 million per quarter. The unaudited pro forma information is as follows:

	Three Months Ended June 30, 2003	Six Months Ended June 30, 2003
	(In thousands, except per share amounts)	
Total net revenue	$418,055	$830,346
Net income	$ 32,113	$ 72,235
Net income per share basic	$ 0.08	$ 0.17
Net income per share diluted	$ 0.07	$ 0.17

Jareva Technologies, Inc.

On January 27, 2003, the Company acquired all of the outstanding capital stock of Jareva Technologies, Inc. (Jareva), a privately held provider of automated server provisioning products that enable businesses to automatically deploy additional servers without manual intervention. The Company acquired Jareva to integrate Jareva s technology into the Company s software products to enable the Company s customers to optimize their investments in server hardware by deploying new server resources on demand. The Jareva acquisition was accounted for using the purchase method of accounting for total purchase consideration of $68.7 million, which included $58.7 million of cash, $6.8 million relating to the assumption of options exercisable for 426,766 shares of the Company s common stock and $3.2 million of acquisition-related costs. The purchase price was allocated to goodwill of $51.3 million, developed technology of $9.1 million, other intangibles of $1.9 million, IPR&D of $4.1 million, net deferred tax liabilities of $6.1 million, deferred stock-based compensation of $4.6 million and net tangible assets of $3.8 million. The weighted average amortization period for all purchased intangible assets is 3.3 years. The acquired IPR&D of $4.1 million was written off and the related charge was expensed in the statement of operations in the first quarter of 2003. Acquisition-related costs of $3.2 million consist of $2.7 million associated with terminating and satisfying remaining lease commitments, partially offset by sublease income net of related sublease costs, and direct transaction costs of $0.5 million for legal and other professional fees. Total cash outlays for acquisition-related costs were $1.8 million through June 30, 2004. The results of operations of Jareva are included in the Company s consolidated financial statements from the date of acquisition. The pro forma impact on the Company s results of operations is not significant.

6. Goodwill and Other Intangible Assets

On January 1, 2002, the Company adopted SFAS No. 142, *Goodwill and Other Intangible Assets*. As a result, the Company no longer amortizes goodwill but will test it for impairment annually or whenever events or changes in circumstances suggest that the carrying amount may not be recoverable.

The following table sets forth the carrying amount of goodwill. Goodwill also includes amounts originally allocated to assembled workforce:

	June 30, 2004	December 31, 2003
	(In thousands)	
Goodwill:		
Gross carrying amount	$ 3,895,936	$ 3,842,218
Less accumulated amortization	(2,086,627)	(2,086,627)
Net carrying amount of goodwill	$ 1,809,309	$ 1,755,591

During the first quarter of 2004, the Company acquired Ejasent (see Note 5), which increased goodwill by $53.7 million.

VERITAS SOFTWARE CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The following tables set forth the carrying amount of other intangible assets that will continue to be amortized:

	June 30, 2004		
	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
		(In thousands)	
Developed technology	$299,749	$245,677	$54,072
Distribution channels	234,800	234,800	
Trademarks	26,650	25,500	1,150
Other intangible assets	60,612	38,502	22,110
Intangibles related to acquisitions	621,811	544,479	77,332
Convertible subordinated notes issuance costs	12,571	3,764	8,807
Total other intangibles	$634,382	$548,243	$86,139

	December 31, 2003		
	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
		(In thousands)	
Developed technology	$287,949	$237,043	$50,906
Distribution channels	234,800	234,800	
Trademarks	26,650	24,925	1,725
Other intangible assets	51,734	33,714	18,020
Intangibles related to business acquisitions	601,133	530,482	70,651
Convertible subordinated notes issuance costs	12,401	1,708	10,693
Total other intangibles	$613,534	$532,190	$81,344

Total amortization expense of intangible assets related to acquisitions is set forth in the table below:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2004	2003	2004	2003
		(In thousands)		
Developed technology	$4,433	$10,887	$ 8,634	$25,985
Distribution channels		9,783		24,458

Trademarks	288	1,015	575	2,537
Other intangible assets	2,519	1,612	4,788	3,668
Total amortization expense	$7,240	$23,297	$13,997	$56,648

Total amortization expense for developed technology and other intangibles includes approximately $0.8 million and $0.5 million, respectively, for the three months ended June 30, 2004 and 2003 and approximately $1.3 million and $0.9 million, respectively, for the six months ended June 30, 2004 and 2003 that is included in cost of user license fees.

VERITAS SOFTWARE CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The total expected future annual amortization of intangible assets related to acquisitions is set forth in the table below:

	Future Amortization
	(In thousands)
2004	$13,346
2005	25,942
2006	23,910
2007	12,077
2008	1,912
2009	145
Total	$77,332

7. Strategic Investments

The Company holds investments in capital stock of several privately-held companies. The total carrying amount of these strategic investments was $2.7 million at June 30, 2004 and $5.4 million at December 31, 2003. These strategic investments are included in other non-current assets. For the six months ended June 30, 2004, the Company realized a gain of $7.5 million on the sale of a strategic investment. The Company recorded no impairment losses on strategic investments for the three and six months ended June 30, 2004 and for the three months ended June 30, 2003. The Company recorded $3.5 million of impairment losses for the six months ended June 30, 2003. The losses realized represent other-than-temporary declines in the fair value of the investment and were determined based on the value of the investee s stock, its inability to obtain additional private financing, its cash position and current cash burn rate, the status and competitive position of the investee s products and the uncertainty of its financial condition, among other factors.

8. Accrued Restructuring Costs

In the fourth quarter of 2002, the Company s board of directors approved a facility restructuring plan to exit and consolidate certain of its facilities located in 17 metropolitan areas worldwide. The facility restructuring plan was adopted to address overcapacity in the Company s facilities as a result of lower than planned headcount growth in these metropolitan areas. In connection with this facility restructuring plan, the Company recorded a net restructuring charge to operating expenses of $96.1 million in the fourth quarter of 2002. This restructuring charge is comprised of $86.9 million associated with terminating and satisfying remaining lease commitments, partially offset by sublease income net of related sublease costs, and $9.2 million for net asset write-offs. Total cash outlays under this restructuring plan are expected to be approximately $86.9 million.

Restructuring costs will generally be paid over the remaining lease terms, ending at various dates through 2021, or over a shorter period as the Company may negotiate with its lessors. The Company expects the majority of costs will be paid by the year ending December 31, 2008.

The Company began vacating facilities during the fourth quarter of 2002 and completed vacating facilities as of January 31, 2004.

The Company is in the process of seeking suitable subtenants for these facilities. The Company s estimates of the facility restructure charge may vary significantly, depending in part on factors that are beyond the Company s control, including the commercial real estate market in the applicable metropolitan areas, the Company s ability to obtain subleases related to these facilities and the time period to do so, the sublease rental market rates and the outcome of negotiations with lessors regarding terminations of some of the leases.

VERITAS SOFTWARE CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Adjustments to the accrued restructuring costs will be made if actual lease exit costs or sublease income differ from amounts currently expected. As a portion of the accrued restructuring costs relate to international locations, the accrual will be affected by exchange rate fluctuations. The impact of exchange rate fluctuations is recorded in accumulated other comprehensive income on the balance sheet.

The portion of the accrual expected to be utilized through June 30, 2005 of $16.7 million has been classified in the current portion of accrued acquisition and restructuring costs. The portion of the accrual expected to be utilized in periods subsequent to June 30, 2005 of $56.3 million has been classified in the non-current portion of accrued acquisition and restructuring costs. The components of the accrued restructuring costs and movements within these components through June 30, 2004 were as follows:

	Facilities Related Costs	Asset Write-offs	Total
		(In millions)	
Balance at December 31, 2003	$79.8	$ 2.1	$81.9
Cash payments	(3.8)		(3.8)
Asset write-offs		(2.1)	(2.1)
Impact of exchange rates	0.6		0.6
Balance at March 31, 2004	76.6		76.6
Cash payments	(3.8)		(3.8)
Impact of exchange rates	0.2		0.2
Balance at June 30, 2004	$73.0	$	$73.0

Included in total accrued acquisition and restructuring costs of $82.9 million as of June 30, 2004 are the $73.0 million balance related to the facility restructuring plan discussed above, the remaining acquisition costs to be paid in connection with the Company s acquisitions (see Note 5) and the remaining restructuring costs to be paid for other restructuring plans.

9. Convertible Subordinated Notes

In August 2003, the Company issued $520.0 million of 0.25% convertible subordinated notes due August 1, 2013 (the 0.25% Notes), to several initial purchasers in a private offering, for which the Company received net proceeds of approximately $508.2 million. The 0.25% Notes were issued at their face value and provide for semi-annual interest payments of $0.7 million each February 1 and August 1, beginning February 1, 2004. Effective as of January 28, 2004, the 0.25% Notes began accruing additional interest at a rate of 0.25% as a result of the Company s registration statement having not been declared effective by the SEC on or before the 180th day following the original issuance of the 0.25% Notes and the 0.25% Notes continued to accrue such additional interest until April 27, 2004, the 90th day following such registration default. As of April 27, 2004, the 0.25% Notes began to accrue additional interest at a rate of 0.50% and will accrue such additional interest until the registration statement is declared effective or until the Company is no longer required to maintain the effectiveness of the registration statement. The 0.25% Notes are convertible, under specified circumstances, into shares of the Company s common stock at a conversion rate of 21.6802 shares per $1,000 principal amount of notes, which is equivalent to a conversion price of approximately $46.13 per share.

10. Long-Term Debt

In 1999 and 2000, the Company entered into three build-to-suit lease agreements for office buildings in Mountain View, California, Roseville, Minnesota and Milpitas, California. The Company began occupying the Roseville and Mountain View facilities in May and June 2001, respectively, and began occupying the Milpitas

Table of Contents

VERITAS SOFTWARE CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

facility in April 2003. The Mountain View facility includes 425,000 square feet and serves as the Company s corporate headquarters and for research and development functions. The Milpitas facility includes 466,000 square feet and is primarily used for technical support, sales and general corporate functions. The Roseville facility includes 204,000 square feet and provides space for technical support and research and development functions. A syndicate of financial institutions financed the acquisition and development of these properties. Prior to July 1, 2003, the Company accounted for these properties as operating leases in accordance with SFAS No. 13, *Accounting for Leases*, as amended. On July 1, 2003, the Company adopted Financial Accounting Standards Board, or FASB, Interpretation Number (FIN) 46. Under FIN 46, the lessors of the facilities are considered variable interest entities, and the Company is considered the primary beneficiary. Accordingly, the Company began consolidating these variable interest entities on July 1, 2003 and has included the property and equipment and long-term debt on its balance sheet at June 30, 2004 and December 31, 2003 and the results of their operations in its consolidated statement of operations for the three and six months ended June 30, 2004. As of June 30, 2004, approximately $186.4 million of debt has been classified as current as the lease terms for Mountain View and Roseville facilities expire in March 2005.

Interest only payments under the debt agreements relating to the facilities are generally paid quarterly and are equal to the termination value of the outstanding debt obligations multiplied by the Company s cost of funds, which is based on London Inter Bank Offered Rate (LIBOR) using 30-day to 180-day LIBOR contracts and adjusted for the Company s credit spread. The termination values of the debt agreements are approximately $145.2 million, $41.2 million and $194.2 million for the Mountain View, Roseville and Milpitas leases, respectively. The terms of these debt agreements are five years with an option to extend the lease terms for two successive periods of one year each, if agreed to by the financial institutions that financed the facilities. The terms of these debt agreements began March 2000 for the Mountain View and Roseville facilities and July 2000 for the Milpitas facility. The Company has the option to purchase the three facilities for the aggregate termination value of $380.6 million or, at the end of the term, to arrange for the sale of the properties to third parties while the Company retains an obligation to the financial institutions that financed the facilities in an amount equal to the difference between the sales price and the guaranteed residual value up to an aggregate $344.6 million if the sales price is less than this amount, subject to the specific terms of the debt agreements. In addition, the Company is entitled to any proceeds from a sale of the facilities in excess of the termination values.

In January 2002, the Company entered into two three-year pay fixed, receive floating, interest rate swaps for the purpose of hedging the cash payments related to the Mountain View, California and Roseville, Minnesota agreements (see Note 12). Under the terms of these interest rate swaps, the Company makes payments based on the fixed rate and will receive interest payments based on the 3-month LIBOR rate. For the three months ended June 30, 2004 and 2003, the aggregate payments, including the net payments on the interest rate swaps, were $4.0 million and $4.1 million, respectively and for the six months ended June 30, 2004 and 2003, the aggregate payments, including the net payments on the interest rate swaps, were $8.0 million and $8.2 million, respectively. The payments for the three and six months ended June 30, 2004 were included in interest expense in the consolidated statement of operations in accordance with FIN 46. The payments made for the three and six months ended June 30, 2003 were classified as rent expense and included in cost of revenue and operating expenses, in accordance with SFAS No. 13.

The agreements for the facilities described above require that the Company maintain specified financial covenants, all of which the Company was in compliance with as of June 30, 2004. The specified financial covenants as of June 30, 2004 require the Company to maintain a minimum rolling four quarters earning before interest, taxes, depreciation and amortization (EBITDA) of $400.0 million, a minimum ratio of cash and cash equivalents and accounts receivable to current liabilities plus the debt consolidated under the build-to-suit lease agreements of 1.2 to 1, and a leverage ratio of total funded indebtedness to rolling four quarter EBITDA of not more than 2 to 1. For purposes of these financial covenants, EBITDA represents the Company s net income for the applicable period, plus interest expense, taxes, depreciation and amortization

VERITAS SOFTWARE CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

and all non-cash restructuring charges, less software development expenses classified as capital expenditures. In order to secure the obligation under each agreement, each of the facilities is subject to a deed of trust in favor of the financial institutions that financed the development and acquisition of the respective facility. Bank of America, N.A. was the agent for the syndicate of banks that funded the development of the Mountain View, California and Roseville, Minnesota facilities, and ABN AMRO Bank, N.V. was the agent for the syndicate of banks that funded the development of the Milpitas, California facility.

11. Comprehensive Income

The following are the components of comprehensive income:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2004	2003	2004	2003
	(In thousands)			
Net income	$ 86,470	$45,634	$186,518	$ 88,738
Other comprehensive income (loss), net of tax:				
Foreign currency translation adjustments	23	10,729	(2,105)	14,639
Derivative financial instrument adjustments	2,423	323	3,343	(248)
Unrealized gain (loss) on marketable securities	(11,210)	82	(9,915)	(114)
Comprehensive income	$ 77,706	$56,768	$177,841	$103,015

The components of accumulated other comprehensive income (loss) are:

	June 30, 2004	December 31, 2003
	(In thousands)	
Foreign currency translation adjustments	$11,351	$13,456
Derivative financial instrument adjustments	(4,439)	(7,782)
Unrealized gain (loss) on marketable securities	(9,417)	498
Accumulated other comprehensive income (loss)	$ (2,505)	$ 6,172

12. Derivative Financial Instruments

In September 2000, the Company entered into a three-year cross currency cash flow hedge against foreign exchange fluctuations on foreign currency denominated cash flows under an intercompany loan receivable. Under the terms of this derivative financial instrument, Euro denominated fixed principal and interest payments to be received under the intercompany loan were swapped for U.S. dollar-fixed principal and interest payments. In September 2003, the intercompany loan was paid in full and the derivative financial instrument was settled.

In January 2002, the Company entered into two three-year pay fixed, receive floating, interest rate swaps for the purpose of hedging cash flows on variable interest rate debt related to Mountain View, California and Roseville, Minnesota build-to-suit lease agreements. Under the terms of these interest rate swaps, the Company makes payments based on the fixed rate and will receive interest payments based on the 3-month LIBOR. The Company s payments on its build-to-suit lease agreements are based upon a 3-month LIBOR plus a credit spread. If critical terms of the interest rate swap or the hedged item do not change, the interest rate swap will be considered to be highly effective with all changes in the fair value included in other comprehensive income. If critical terms of the interest rate swap or the hedged item change, the hedge may become partially or fully ineffective, which could result in all or a portion of the changes in fair value of the

VERITAS SOFTWARE CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

derivative recorded in the statement of operations. The interest rate swaps settle the first day of January, April, July and October until expiration. As of June 30, 2004, the fair value of the interest rate swaps was $(4.4) million and was recorded in other long-term liabilities. As a result of entering into the interest rate swaps, the Company has mitigated its exposure to variable cash flows associated with interest rate fluctuations. Because the rental payments on the leases are based on the 3-month LIBOR and the Company receives 3-month LIBOR from the interest rate swap counter-party, the Company has eliminated any impact to raising interest rates related to its rent payments under the build-to-suit lease agreements. On July 1, 2003, the Company began accounting for its variable interest rate debt in accordance with FIN 46 (see Note 10). In accordance with SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*, the Company had designated the interest rate swap as a cash flow hedge of the variability embedded in the rent expense as it was based on a 3-month LIBOR. However, with the adoption of FIN 46, the Company redesignated the interest rate swap as a cash flow hedge of variability in interest expense and it remains highly effective with all changes in the fair value included in other comprehensive income.

As of June 30, 2004, the total gross notional amount of the Company s forward contracts was approximately $101.9 million, all hedging intercompany accounts of certain of its international subsidiaries. The forward contracts had terms of 32 days or less and settled on July 30, 2004. All foreign currency transactions and all outstanding forward contracts are marked-to-market at the end of the period with unrealized gains and losses included in other income. The unrealized gain (loss) and fair market value of the outstanding forward contracts at June 30, 2004 were not material to the Company s consolidated financial statements.

13. Segment Information

The Company operates in one segment, storage and infrastructure software solutions. The Company s products and services are sold throughout the world, both directly to end-users and through a variety of indirect sales channels. The Company s chief operating decision maker, the chief executive officer, evaluates the performance of the Company based upon stand-alone revenue of product channels and the geographic regions of the segment and does not receive discrete financial information about asset allocation, expense allocation or profitability from the Company s storage products or services.

Geographic Information

	Three Months Ended June 30,		Six Months Ended June 30,	
	2004	**2003**	**2004**	**2003**
		(In thousands)		
User license fees(1):				
United States	$142,751	$152,377	$315,261	$310,268
Europe(2)	89,545	68,024	179,244	126,288
Other(3)	37,620	32,400	77,820	63,700
Total user license fees	269,916	252,801	572,325	500,256
Services(1):				
United States	146,006	112,702	271,745	213,655
Europe(2)	50,833	29,265	91,833	59,193
Other(3)	18,279	13,600	34,878	25,400
Total services	215,118	155,567	398,456	298,248
Total net revenue	$485,034	$408,368	$970,781	$798,504

15

Table of Contents

VERITAS SOFTWARE CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

	June 30, 2004	December 31, 2003
	(In thousands)	
Long-lived assets(4):		
United States	$1,960,425	$1,902,181
Europe(2)	484,906	483,315
Other(3)	10,574	13,723
Total	2,455,905	2,399,219
Other assets, including current	3,140,492	2,949,247
Total consolidated assets	$5,596,397	$5,348,466

(1) License and services revenues are attributed to geographic regions based on location of customers.

(2) Europe includes the Middle East and Africa.

(3) Other includes Canada, Latin America, Japan and the Asia Pacific region.

(4) Long-lived assets include all long-term assets except those specifically excluded under SFAS No. 131, such as deferred income taxes.

For the three and six months ended June 30, 2004, no customer represented 10% or more of the Company s net revenue. For the three and six months ended June 30, 2003, a distributor that sells the Company s products and services through resellers, accounted for 10% of the Company s net revenue.

User License Fees Information

The Company markets and distributes its software products both as stand-alone software products and as integrated product suites, also referenced as application solutions. The Company derives its user license fees from the licensing of its technology, segregated into three product areas: Data Protection, which include its NetBackup and Backup Exec product families; Storage Management, which includes its Storage Foundation Suites, which includes File Systems, Volume Manager, replication, Database Editions and storage resource management product families; and Utility Computing Infrastructure, which includes its clustering, high-availability offerings, application performance management, OpForce and CommandCentral Service product families. User license fees by product area were as follows:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2004	2003	2004	2003
	(In millions, except percentages)			
User license fees:				
Data protection	$151.3	$147.2	$313.1	$286.5
Storage management	74.3	64.1	158.2	125.3
Utility computing infrastructure	44.3	41.5	101.0	88.5
Total user license fees	$269.9	$252.8	$572.3	$500.3

14. Credit Facility

During 2002, the Company s Japanese subsidiary entered into a short-term credit facility with a multinational Japanese bank in the amount of 1.0 billion Japanese yen ($9.3 million USD). At June 30, 2004, no amount was outstanding. The short-term credit facility was renewed in March 2004 and is due to expire in March 2005. Borrowings under the short-term credit facility bear interest at Tokyo Inter Bank Offered Rate

VERITAS SOFTWARE CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

plus 0.5%. There are no covenants on the short-term credit facility and the loan has been guaranteed by VERITAS Software Global LLC, a wholly-owned subsidiary of the Company.

15. Commitments and Contingencies

Acquired Technology

On October 1, 2002, the Company acquired volume replicator software technology for $6.0 million and contingent payments of up to another $6.0 million based on future revenues generated by the acquired technology. The contingent payments will be paid quarterly over 40 quarters, in amounts between $150,000 and $300,000. The Company issued a promissory note payable in the principal amount of $5.0 million, representing the present value of the Company s minimum payment obligations under the purchase agreement for the acquired technology, which are payable quarterly commencing in the first quarter of 2003 and ending in the fourth quarter of 2012. The contingent payments in excess of the quarterly minimum obligations will be paid as they may become due. The outstanding balance of the note payable was $4.5 million as of June 30, 2004 and $4.6 million as of December 31, 2003 and is included in other long-term liabilities.

SEC Related Matters

SEC Investigation. As previously disclosed, since the third quarter of 2002, the Company has received subpoenas issued by the Securities Exchange Commission in the investigation entitled *In the Matter of AOL/ Time Warner.* The SEC has requested information concerning the facts and circumstances surrounding the Company s transactions with AOL Time Warner (AOL), and related accounting and disclosure matters. The Company s transactions with AOL, entered into in September 2000, involved a software and services purchase by AOL at a stated value of $50.0 million and the purchase by the Company of advertising services from AOL at a stated value of $20.0 million. In March 2003, the Company restated its financial statements for 2001 and 2000 to reflect a reduction in revenues and expenses of $20.0 million. The restatement included an additional reduction in revenues and expenses of $1.0 million related to two other contemporaneous transactions with other parties entered into in 2000 that involved software licenses and the purchase of on-line advertising services.

In March 2004, the Company announced its intention to restate its financial statements for 2002 and 2001. The decision resulted from the findings of an investigation into past accounting practices that concluded on March 12, 2004. The investigation resulted from concerns raised by an employee in late 2003, which led to a detailed review of the matter in accordance with the Company s corporate governance processes, including the reporting of the matter to the audit committee of the Company s board of directors, and to KPMG LLP, the Company s independent registered public accounting firm. The audit committee retained independent counsel to investigate issues relating to these past accounting practices, and the audit committee s counsel retained independent accountants to assist with the investigation. In the first quarter of 2004, the Company voluntarily disclosed to the staff of the SEC past accounting practices applicable to its 2002 and 2001 financial statements that were not in compliance with GAAP. For more information regarding the audit committee s investigation and the restatement of the Company s financial statements for 2002 and 2001, including the corresponding interim periods for 2002 and 2001 and the interim periods ended March, June and September 2003, see Management s Discussion and Analysis of Financial Condition and Results of Operations Restatement of Consolidated Financial Statements, Financial Statements and Supplementary Data Selected Quarterly Results of Operations, Controls and Procedures and Note 2 of the Notes to Consolidated Financial Statements of the Company s annual report on Form 10-K for the year ended December 31, 2003.

The Company and its audit committee continue to cooperate with the SEC in its review of these matters. At this time, the Company cannot predict the outcome of the SEC s review.

Table of Contents

VERITAS SOFTWARE CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Litigation

After the Company announced in January 2003 that it would restate its financial results as a result of transactions entered into with AOL in September 2000, numerous separate complaints purporting to be class actions were filed in the United States District Court for the Northern District of California alleging that the Company and some of its officers and directors violated provisions of the Securities Exchange Act of 1934. The complaints contain varying allegations, including that the Company made materially false and misleading statements with respect to its 2000, 2001 and 2002 financial results included in its filings with the SEC, press releases and other public disclosures. On May 2, 2003, a lead plaintiff and lead counsel were appointed. A consolidated complaint entitled *In Re VERITAS Software Corporation Securities Litigation* was filed by the lead plaintiff on July 18, 2003. On December 10, 2003, the District Court granted the defendants motion to dismiss the consolidated complaint, with leave to amend. On May 19, 2004, the District Court granted the defendants motion to dismiss the plaintiffs first amended complaint, with leave to amend. On June 30, 2004, an amended complaint was filed with the Court in this matter. In 2003 several complaints purporting to be derivative actions were filed in California state court against some of the Company s directors and officers. These complaints are based on the same facts and circumstances as the class actions and generally allege that the named directors and officers breached their fiduciary duties by failing to oversee adequately the Company s financial reporting. The state court complaints have been consolidated into the action *In Re VERITAS Software Corporation Derivative Litigation*, which was filed on May 8, 2003 in the Superior Court of Santa Clara County and is currently pending. All of the complaints generally seek an unspecified amount of damages. The cases are still in the preliminary stages, and it is not possible for the Company to quantify the extent of its potential liability, if any.

On July 7, 2004, a purported class action complaint entitled *Paul Kuck, et al. v. VERITAS Software Corporation, et al.* was filed in the United States District Court for the District of Delaware. The lawsuit alleges violations of federal securities laws in connection with the Company s announcement on July 6, 2004 that it expected its results of operations for the fiscal quarter ended June 30, 2004 to fall below estimates that were earlier provided by the Company. The complaint generally seeks an unspecified amount of damages. Subsequently, additional purported class action complaints have been filed in Delaware federal court against the same defendants named in the Kuck lawsuit. These complaints are based on the same facts and circumstances as the Kuck lawsuit. These cases are still in the preliminary stages, and it is not possible for the Company to quantify the extent of its potential liability, if any.

On October 23, 2001, Storage Computer Corporation sued VERITAS in the United States District Court for the Northern District of Texas for alleged patent infringement. VERITAS denied such claims of infringement and countersued for, among other things, infringement of certain of its patents. On March 12, 2004, the Court granted VERITAS dispositive motions for summary judgment of non-infringement under the patents asserted by Storage Computer Corporation. Storage Computer Corporation subsequently filed a notice of appeal. On June 18, 2004, the Court dismissed Storage Computer Corporation s notice of appeal. As of August 4, 2004, the parties have reached a settlement of all claims and have moved for a dismissal of the matter with prejudice.

In addition to the legal proceedings listed above, the Company is also party to various other legal proceedings that have arisen in the ordinary course of business. While the Company currently believes that the ultimate outcome of these proceedings, individually and in the aggregate, will not have a material adverse effect on its financial position or overall trends in results of operations, litigation is subject to inherent uncertainties. Were an unfavorable ruling to occur, there exists the possibility of a material adverse impact on the Company s results of operations and cash flows for the period in which the ruling occurs. The estimate of the potential impact on the Company s financial position or overall results of operations for the above discussed legal proceedings could change in the future.

VERITAS SOFTWARE CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

For each of the matters noted, the Company does not believe that it is probable that a liability has been incurred nor does it believe that the amount of any loss can be reasonably estimated. Accordingly, no liability has been accrued for these matters.

16. Subsequent Events

In July 2004, the Company acquired all of the outstanding capital stock of Invio Software, Inc. (Invio), a privately held supplier of information technology (IT) process automation technology. The Company acquired Invio to extend the capability of software products that enable utility computing by offering customers a tool for standardizing and automating IT service delivery in key areas such as storage provisioning, server provisioning and data protection. The Invio acquisition will be accounted for using the purchase method of accounting for cash consideration of approximately $35 million.

In July 2004, the Company s board of directors authorized a program by which the Company may repurchase up to $500.0 million of the Company s common stock over the next 12 to 18 months.

Table of Contents

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

This quarterly report on Form 10-Q contains forward-looking statements within the meaning of the Securities Exchange Act of 1934 and the Securities Act of 1933 that involve risks and uncertainties. These forward-looking statements include statements about our revenue, revenue mix, gross margin, operating expense levels, financial outlook, commitments under existing leases, research and development initiatives, sales and marketing initiatives and competition. In some cases, forward-looking statements are identified by words such as believe, anticipate, expect, intend, plan, will, may and similar expressions. You should not place undue reliance on these forward-looking statements, which speak only as of the date of this quarterly report on Form 10-Q. All of these forward-looking statements are based on information available to us at this time, and we assume no obligation to update any of these statements. Actual results could differ from those projected in these forward-looking statements as a result of many factors, including those identified in the section captioned Factors That May Affect Future Results below, and elsewhere in this quarterly report. We urge you to review and consider the various disclosures made by us in this report, and those detailed from time to time in our filings with the Securities and Exchange Commission, that attempt to advise you of the risks and factors that may affect our future results.

The following discussion should be read in conjunction with our financial statements and accompanying notes, which appear elsewhere in this quarterly report on Form 10-Q. Unless expressly stated or the context otherwise requires, the terms we , our , us and VERITAS refer to VERITAS Software Corporation and its subsidiaries.

Overview

The following Management s Discussion and Analysis of Financial Condition and Results of Operations, or MD&A, is intended to help the reader understand our company. MD&A is provided as a supplement to and should be read in conjunction with our condensed consolidated financial statements and the accompanying notes.

Our Business

VERITAS Software Corporation is a leading independent supplier of storage and infrastructure software products and services. Our software products operate across a variety of computing environments, from PCs and workgroup servers to enterprise servers and networking platforms in corporate data centers. Our products protect, archive and recover business-critical data, provide high levels of application availability, enhance and tune system and application performance and enable recovery from disasters. Our solutions enable businesses to reduce costs by efficiently and effectively managing their information technology, or IT, infrastructure as they seek to maximize value from their IT investments.

We generate revenues, income and cash flows by licensing software products and selling related services to our customers, which include many leading global corporations and small and medium-sized enterprises around the world operating in a wide variety of industries. We market our products and related services both directly and through a variety of indirect sales channels, which include value added resellers, or VARs, distributors, system integrators, or SIs, and original equipment manufacturers, or OEMs. Specifically, the channel mix for the three and six months ended June 30, 2004 was 55% and 57%, respectively, from sales to end-users and through VARs, and 45% and 43%, respectively, from other indirect sales channels, which includes 13% and 11%, respectively, from our OEM partners.

We invest significantly in research and development activities and for the three and six months ended June 30, 2004, we spent $83.6 million and $163.5 million, respectively, on research and development. Our research and development efforts have been directed toward developing new products for UNIX, Linux and Windows, developing new features and functionality for existing products, integrating products across our existing product lines, porting new and existing products to different operating systems and expanding our product portfolio into new markets such as application performance management, server provisioning and centralized service level management.

In the fourth quarter of 2003, we revised our revenue reporting categories to more closely align with how we manage our business. Historically, we categorized our revenue between Core and Emerging technologies. We believe the new revenue categories will provide investors with better insight into our results. These new categories are Data Protection, Storage Management and Utility Computing Infrastructure. Our revenue performance in these categories is described in the User License Fees section of MD&A.

Our Strategy

Our strategy is to continue to compete in our current markets while expanding and integrating our product portfolio in the area of utility computing infrastructure, to continue to expand our product offering across key operating system platforms, including UNIX, Linux and Windows, and to continue to invest for growth in international markets.

We expect to continue to grow the company organically and through acquisitions. In 2003, we completed two acquisitions that provided us with essential components of our utility computing infrastructure product strategy, including application performance management software and server provisioning technology. In January 2004, we completed the acquisition of Ejasent, Inc., which added application migration technology and in July 2004, we completed the acquisition of Invio Software, Inc., which added IT process automation technology to our utility computing infrastructure portfolio. We will continue to evaluate new strategic acquisitions in the future.

Our revenue from international sales continues to increase primarily as a result of our increased investment in our international geographies, market strength in the emerging market areas in Europe and Asia and a favorable impact of changes in foreign currency exchange rates related to the weaker U.S. dollar. For the three and six months ended June 30, 2004, revenue from international sales, consisting of sales of licenses and services to customers located outside the U.S., increased 37% and 40% from the three and six months ended June 30, 2003, respectively, and represented 40% of our total revenue for the three and six months ended June 30, 2004.

Our Financial Position

In the second quarter of 2004, our operating results were affected by several factors, including IT spending trends, lower than expected demand for our products in the U.S. enterprise portion of our business, the growing need of enterprises to effectively manage storage and computing infrastructure, the strength of our product offerings and the contribution of our recent acquisitions. In the first half of 2004, we experienced stronger IT spending in our customer base, resulting in stronger demand for our products and growth in our user license fees compared to the same period last year, especially in our international regions. The acquisition of Precise and the integration of the acquired products into our product offerings contributed to our growth, as did our increased sales penetration in international markets and the favorable impact of changes in foreign currency exchange rates. Additionally, our services revenue grew significantly due to new service contracts associated with user license fees as well as our success in increasing support contract renewals within our customer base.

For the three months ended June 30, 2004, total revenue from sales in the U.S., consisting of sales of licenses and services to customers located in the U.S., increased 9% from the three months ended June 30, 2003. License revenue decreased by 6% from $152.4 million for the three months ended June 30, 2003 to $142.8 million for the three months ended June 30, 2004 as we saw customer buying patterns in enterprise accounts become more cautious leading to longer sales cycles and a smaller average deal size. U.S. services revenue increased by 30% from $112.7 million for the three months ended June 30, 2003 to $146.0 million for the three months ended June 30, 2004 primarily as a result of strong maintenance renewal rates and $7.0 million of U.S. retroactive maintenance revenue from one of our OEM partners.

For the six months ended June 30, 2004, total revenue from sales in the U.S. increased 12% from the six months ended June 30, 2003 and represented approximately 60% of our total revenue for the first half of 2004.

For the three and six months ended June 30, 2004, net revenue was $485.0 million and $970.8 million, respectively, an increase of 19% and 22%, respectively, from the three and six months ended June 30, 2003. Revenue from user license fees for the three and six months ended June 30, 2004 was $269.9 million and $572.3 million, respectively, an increase of 7% and 14%, respectively, from 2003, and representing 56% and 59% of total revenue, respectively. Services revenue for the three and six months ended June 30, 2004 was $215.1 million and $398.5 million, respectively, an increase of 38% and 34% from 2003, and representing 44% and 41% of total net revenue, respectively. Diluted net income per share for the three and six months ended June 30, 2004 was $0.20 and $0.42, respectively, up from $0.11 and $0.21 for the three and six months ended June 30, 2003, primarily as a result of earnings leverage from revenue growth and a reduction in acquisition-related expenses, such as amortization of intangibles and in-process research and development.

We continue to generate cash from operations and to retain a significant balance of cash and short-term investments. As of June 30, 2004, we had $2,750.1 million in cash, cash equivalents and short-term investments, which represented 74% of our tangible assets. We generated $321.0 million of cash from operating activities for the six months ended June 30, 2004. We utilize cash in ways that management believes will provide an optimal return on investment. Principal uses of our cash include acquisitions of businesses and technologies and purchases of property and equipment.

Recent Acquisitions

In July 2004, we acquired all of the outstanding capital stock of Invio, a privately held supplier of IT process automation technology. We acquired Invio to extend the capability of software products that enable utility computing by offering customers a tool for standardizing and automating IT service delivery in key areas such as storage provisioning, server provisioning and data protection. We will account for the Invio acquisition using the purchase method of accounting for cash consideration of approximately $35 million.

In January 2004, we acquired Ejasent, a privately held provider of application virtualization technology for utility computing. We acquired Ejasent to add important application migration technology, which allows IT personnel to move an application from one server to another without disrupting or terminating the application. We accounted for the Ejasent acquisition using the purchase method of accounting for total purchase consideration of $61.4 million. We have included the results of operations of Ejasent in our consolidated financial statements beginning January 20, 2004. In connection with the acquisition of Ejasent, we allocated approximately $0.4 million of the purchase price to in-process research and development, or IPR&D, that had not yet reached technological feasibility and had no alternative future use. We have expensed this amount in our condensed consolidated statement of operations for the six months ended June 30, 2004.

In June 2003, we acquired Precise Software Solutions Ltd., a provider of application performance management products. We acquired Precise to expand our product and service offerings across storage, databases and application performance management. We accounted for the Precise acquisition using the purchase method of accounting for total purchase consideration of $715.1 million. We have included the results of operations of Precise in our consolidated financial statements beginning July 1, 2003. In connection with the acquisition of Precise, we allocated approximately $15.3 million of the purchase price to IPR&D that had not yet reached technological feasibility and had no alternative future use. We have expensed this amount in our condensed consolidated statement of operations for the three and six months ended June 30, 2003.

In January 2003, we acquired Jareva Technologies, Inc., or Jareva, a privately held provider of automated server provisioning products that enable businesses to automatically deploy additional servers without manual intervention. We acquired Jareva to integrate its technology into our software products. This technology enables our customers to optimize their investments in server hardware by deploying new server resources on demand. We accounted for the Jareva acquisition using the purchase method of accounting for total purchase consideration of $68.7 million. We have expensed the acquired IPR&D of $4.1 million in our consolidated statement of operations for the six months ended June 30, 2003.

Critical Accounting Policies and Estimates

We believe that there are several accounting policies that are critical to understanding our historical and future performance, as these policies affect the reported amounts of revenue and other significant areas that involve management s judgments and estimates. These critical accounting policies and estimates include:

revenue recognition;

restructuring expenses and related accruals;

impairment of long-lived assets; and

accounting for income taxes.

These policies and estimates and our procedures related to these policies and estimates are described in detail below and under specific areas within the discussion and analysis of our financial condition and results of operations. Please refer to the Notes to Consolidated Financial Statements in our annual report on Form 10-K for the year ended December 31, 2003 for further discussion of our accounting policies and estimates.

Revenue Recognition

We make significant judgments related to revenue recognition. For each arrangement, we make significant judgments regarding the fair value of multiple elements contained in our arrangements, judgments regarding whether our fees are fixed or determinable and judgments regarding whether collectibility is probable. We also make significant judgments when accounting for concurrent transactions with our suppliers and in our accounting for potential product returns and, in some cases, we also have discretion over the timing of product shipments. These decisions, and their effect on revenue recognition, are discussed below.

Multiple Element Arrangements

We typically enter into arrangements with customers that include perpetual software licenses, maintenance and technical support. Some arrangements may also include consulting and education services. Software licenses are sold as site licenses or on a per copy basis. Site licenses give customers the right to copy licensed software on either a limited or unlimited basis during a specified term. Per copy licenses give customers the right to use a single copy of licensed software. We make judgments regarding the fair value of each element in the arrangement and generally account for each element separately.

Assuming all other revenue recognition criteria are met, license revenue is recognized upon delivery using the residual method in accordance with Statement of Position, or SOP, No. 98-9, *Modification of SOP No. 97-2, Software Revenue Recognition, with Respect to Certain Transactions.* Under the residual method, we allocate and defer revenue for the undelivered elements based on vendor-specific objective evidence, or VSOE, of fair value, and recognize the difference between the total arrangement fee and the amount deferred for the undelivered elements as revenue. Undelivered elements typically include maintenance and technical support, consulting and education services. The determination of fair value of each undelivered element in multiple element arrangements is based on the price charged when the same element is sold separately. If sufficient evidence of fair value cannot be determined for any undelivered item, all revenue from the arrangement will be deferred until VSOE of fair value can be established or until all elements of the arrangement have been delivered. If the only undelivered element is maintenance and technical support for which we cannot establish VSOE, we will recognize the entire arrangement fees ratably over the maintenance and support term.

Our VSOE of fair value for maintenance and technical support is based upon stated renewal rates for site licenses and historical renewal rates for per copy licenses. Maintenance and technical support revenue is recognized ratably over the maintenance term. Our VSOE of fair value for education services is based upon the price charged when sold separately. Revenue is recognized when the customer has completed the course. For annual education passes, revenue is recognized ratably over the one-year term. Our VSOE of fair value for consulting is based upon the price charged when sold separately. Consulting revenue is recognized as work is performed when reasonably dependable estimates can be made of the extent of progress toward completion, contract revenue and contract costs. Otherwise, consulting revenue is recognized when the services are complete.

The Fee is Fixed or Determinable

We make judgments, at the outset of an arrangement, regarding whether the fees are fixed or determinable. Our customary payment terms are generally within 30 days after invoice date. Arrangements with payment terms extending beyond 90 days after invoice date are not considered to be fixed or determinable, in which case revenue is recognized as the fees become due and payable.

Collection is Probable

We also make judgments at the outset of an arrangement regarding whether collection is probable. Probability of collection is assessed on a customer-by-customer basis. We typically sell to customers with whom we have a history of successful collections. New customers are subjected to a credit review process to evaluate the customer s financial position and ability to pay. If it is determined at the outset of an arrangement that collection is not probable, revenue is recognized upon receipt of payment.

Indirect Channel Sales

We generally recognize revenue from licensing of software products through our indirect sales channel upon sell-through or when evidence of an end-user exists. For certain types of customers, such as distributors, we recognize revenue upon receipt of a point of sales report, which is our evidence that the products have been sold through to an end-user. For resellers, we recognize revenue when we obtain evidence that an end-user exists, which is usually when the software is delivered. For licensing of our software to original equipment manufacturers, or OEMs, royalty revenue is recognized when the OEM reports the sale of software to an end-user customer, generally on a quarterly basis. In addition to license royalties, some OEMs pay an annual flat fee and/or support royalties for the right to sell maintenance and technical support to the end-user. We recognize revenue from OEM support royalties and fees ratably over the term of the support agreement.

Transactions with our Suppliers

Some of our customers are also our suppliers. Occasionally, in the normal course of business, we purchase goods or services for our operations from these suppliers at or about the same time we license our software to them. We also have multi-year agreements under which we receive sub-licensing royalty payments from OEMs from whom we may also purchase goods or services. We identify and review significant transactions to confirm that they are separately negotiated, settled in cash, and recorded at terms we consider to be arm s length. In addition, the goods or services have generally been budgeted in advance of the transaction, are necessary for our current operations and are expected to be placed in service shortly after purchase. In cases where the transactions are not separately negotiated, we apply the provisions of Accounting Principles Board, or APB, Opinion No. 29, *Accounting for Nonmonetary Transactions,* and Emerging Issues Task Force Issue, or EITF, No. 01-02, *Interpretations of APB Opinion 29.* If the fair values are reasonably determinable, revenue is recorded at the fair values of the products delivered or products or services received, whichever is more readily determinable. If we can not determine fair value of either of the goods or services involved within reasonable limits, we record the transaction on a net basis. License revenue associated with software licenses entered into with our suppliers at or about the same time we purchase goods or services from them is not material to our consolidated financial statements.

Product Returns

We estimate potential future product returns based on our analysis of historical return rates and reduce current period product revenue accordingly. Actual returns may vary from estimates if we experience a change from historical sales and returns patterns or if there are unanticipated changes in competitive or economic conditions that affect our actual returns.

Delivery of Software Products

Delivery of our software products is a prerequisite to the recognition of software license revenue. We consider delivery complete when the software products have been shipped and the customer has access to license keys. If arrangements include an acceptance provision, we defer revenue and recognize it upon the earlier of receipt of written customer acceptance or expiration of the acceptance period. In some cases, we have discretion over the timing of product shipments, which affects the timing of revenue recognition for software license orders. In those cases, we consider a number of factors, including: the effect of the related license revenue on our business plan; the delivery dates requested by customers and resellers; the amount of software license orders received in the quarter; the amount of software license orders shipped in the quarter; the degree to which software license orders received are concentrated at the end of a quarter; and our operational capacity to fulfill software license orders at the end of a quarter.

Restructuring Expenses and Related Accruals

We monitor and regularly evaluate our organizational structure and associated operating expenses. Depending on events and circumstances, we may decide to restructure our operations to reduce operating costs.

We applied the provisions of Emerging Issues Task Force, or EITF, Issue No. 94-3, *Liability Recognized for Certain Employee Termination Benefits and other Costs to Exit an Activity (Including Certain Costs Incurred in a Restructuring)*, to all of our restructuring activities initiated before January 1, 2003. For exit or disposal activities initiated on or after January 1, 2003, we apply the provisions of Statement of Financial Accounting Standards, or SFAS, No. 146, *Accounting for Costs Associated with Exit or Disposal Activities.*

Our restructuring costs and any resulting accruals involve significant estimates made by management using the best information available at the time the estimates are made, some of which may be provided by third parties. These estimates include facility exit costs, such as lease termination costs, and amount and timing of sublease income and related sublease expense costs, such as brokerage fees.

We regularly evaluate a number of factors to determine the appropriateness and reasonableness of our restructuring accruals. These factors include, but are not limited to, our ability to enter into sublease or lease termination agreements and market data about lease rates, timing and term of potential subleases and costs associated with terminating certain leases on vacated facilities.

Our estimates involve a number of risks and uncertainties, some of which are beyond our control, including future real estate market conditions and our ability to successfully enter into subleases or lease termination agreements upon terms as favorable as those assumed under our restructuring plan. Actual results may differ significantly from our estimates and may require adjustments to our restructuring accruals and operating results in future periods. For example, if the actual proceeds from our sublease agreements were to differ by 10% from the estimate we included in our facility restructuring plan, the facility restructuring charge recorded in operating expenses during the fourth quarter of 2002 would have been different by approximately $6 million.

Impairment of Long-Lived Assets

We review our goodwill for impairment annually or whenever events or changes in circumstances suggest that the carrying amount may not be recoverable. We are required to test our goodwill for impairment at the reporting unit level. We have determined that we have only one reporting unit. The test for goodwill impairment is a two-step process:

Step 1- We compare the carrying amount of our reporting unit, which is the book value of our entire company, to the fair value of our reporting unit, which corresponds to our market capitalization. If the carrying amount of our reporting unit exceeds its fair value, we have to perform the second step of the process. If not, no further work is required.

Table of Contents

Step 2- We compare the implied fair value of our reporting unit s goodwill to its carrying amount. If the carrying amount of our reporting unit s goodwill exceeds its fair value, an impairment loss will be recognized in an amount equal to that excess.

We completed this test during the fourth quarter of 2003 and were not required to record an impairment loss on goodwill.

We review our long-lived assets, including property and equipment and other intangibles, for impairment whenever events indicate that their carrying amount may not be recoverable. When we determine that one or more impairment indicators are present for an asset, we compare the carrying amount of the asset to net future undiscounted cash flows that the asset is expected to generate. If the carrying amount of the asset is greater than the net future undiscounted cash flows that the asset is expected to generate, we would compare the fair value to the book value of the asset. If the fair value is less than the book value, we would recognize an impairment loss. The impairment loss would be the excess of the carrying amount of the asset over its fair value.

Some of the events that we consider as impairment indicators for our long-lived assets, including goodwill, are:

significant underperformance of our company relative to expected operating results;

our net book value compared to our market capitalization;

significant adverse economic and industry trends;

significant decrease in the market value of the asset;

the extent to which we use an asset or changes in the manner in which we use it; and

significant changes to the asset since we acquired it.

Significant assumptions and estimates are made when determining if our goodwill or other long-lived assets have been impaired or if there are indicators of impairment. We base our estimates on assumptions that we believe to be reasonable, but actual future results may differ from those estimates as our assumptions are inherently unpredictable and uncertain. Our estimates include estimates of future market growth and trends, forecasted revenue and costs, expected periods of asset utilization, appropriate discount rates and other variables. Based on our assumptions and estimates, we do not expect to record an impairment loss on our long-lived assets in the near future.

Accounting for Income Taxes

We are required to estimate our income taxes in each federal, state and international jurisdiction in which we operate. This process requires that we estimate the current tax exposure as well as assess temporary differences between the accounting and tax treatment of assets and liabilities, including items such as accruals and allowances not currently deductible for tax purposes. The income tax effects of the differences we identify are classified as current or long-term deferred tax assets and liabilities in our consolidated balance sheets. Our judgments, assumptions and estimates relative to the current provision for income tax take into account current tax laws, our interpretation of current tax laws and possible outcomes of current and future audits conducted by foreign and domestic tax authorities. Changes in tax laws or our interpretation of tax laws and the resolution of current and future tax audits could significantly impact the amounts provided for income taxes in our balance sheet and results of operations. We must also assess the likelihood that deferred tax assets will be realized from future taxable income and, based on this assessment, establish a valuation allowance, if required. As of June 30, 2004, we determined the valuation allowance to be $138.4 million based upon uncertaintie