

CONCORD COMMUNICATIONS INC

Form 10-Q

August 07, 2003

Table of Contents

**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**FORM 10-Q**

- x **QUARTERLY REPORT PURSUANT TO SECTION 13 or 15(d) OF THE  
SECURITIES EXCHANGE ACT OF 1934.  
For the quarterly period ended June 30, 2003.**

OR

- 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 0-23067

**CONCORD COMMUNICATIONS, INC.**

(Exact name of registrant as specified in its charter)

**Massachusetts**  
(State of incorporation)

**04-2710876**  
(IRS Employer Identification Number)

**600 Nickerson Road**  
**Marlboro, Massachusetts 01752**  
**(508) 460-4646**  
(Address and telephone of principal executive offices)

Indicate by check mark whether registrant (1) has filed all reports required to be filed by section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

YES X NO

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act).

YES X NO

17,803,381 shares of the registrant's Common stock, \$0.01 par value, were outstanding as of July 31, 2003.

**THIS DOCUMENT CONTAINS 39 PAGES.  
THE EXHIBIT INDEX IS ON PAGE 38.**



**TABLE OF CONTENTS**

**PART I: FINANCIAL INFORMATION**

**ITEM 1. FINANCIAL STATEMENTS**

**CONDENSED CONSOLIDATED BALANCE SHEETS (Unaudited)**

**CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS (Unaudited)**

**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (Unaudited)**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

**ITEM 3. Quantitative and Qualitative Disclosures about Market Risk**

**ITEM 4. Controls and Procedures**

**PART II: OTHER INFORMATION**

**Item 1. Legal Proceedings**

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

**Item 3. Defaults Upon Senior Securities**

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

**Item 5. Other Information**

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

**SIGNATURE**

**EXHIBIT INDEX**

**EX-31.1 CERTIFICATION OF JOHN A. BLAESER**

**EX-31.2 CERTIFICATION OF MELISSA H. CRUZ**

**EX-32.1 CERTIFICATION TO SECTION 906 (BLAESER)**

**EX-32.2 CERTIFICATION TO SECTION 906 (CRUZ)**

---

**Table of Contents**

**CONCORD COMMUNICATIONS, INC.**

**FORM 10-Q, June 30, 2003**

**CONTENTS**

	<b>Page</b>
<b>PART I: FINANCIAL INFORMATION</b>	
Item 1. Condensed Consolidated Financial Statements	
Condensed Consolidated Balance Sheets:	
June 30, 2003 and December 31, 2002	3
Condensed Consolidated Statements of Operations:	
Three and six months ended June 30, 2003 and June 30, 2002	4
Condensed Consolidated Statements of Cash Flows:	
Six months ended June 30, 2003 and June 30, 2002	5
Notes to Condensed Consolidated Financial Statements	6-10
Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations	11-32
Item 3. Quantitative and Qualitative Disclosures about Market Risk	33
Item 4. Controls and Procedures	34
<b>PART II: OTHER INFORMATION</b>	
Item 1. Legal Proceedings	35
Item 2. Changes in Securities and Use of Proceeds	35
Item 3. Defaults Upon Senior Securities	35
Item 4. Submission of Matters to a Vote of Security Holders	35
Item 5. Other Information	35
Item 6. Exhibits and Reports on Form 8-K	35
SIGNATURE	37
EXHIBIT INDEX	38-39

**Table of Contents****PART I: FINANCIAL INFORMATION**  
**ITEM 1. FINANCIAL STATEMENTS****CONCORD COMMUNICATIONS, INC.**  
**CONDENSED CONSOLIDATED BALANCE SHEETS (Unaudited)**  
**(In thousands, except share and per share data)**

	<b>June 30, 2003</b>	<b>December 31, 2002</b>
<b>ASSETS</b>		
Current Assets:		
Cash and cash equivalents	\$ 12,774	\$ 10,362
Marketable securities	67,588	62,469
Restricted cash	539	839
Accounts receivable, net of allowance of \$1,169 and \$1,480 at June 30, 2003 and December 31, 2002, respectively	18,576	17,417
Prepaid expenses and other current assets	2,141	2,882
	<u>101,618</u>	<u>93,969</u>
Equipment and improvements, at cost:		
Equipment	24,782	22,987
Leasehold improvements	6,146	6,111
	<u>30,928</u>	<u>29,098</u>
Less accumulated depreciation and amortization	23,471	20,853
	<u>7,457</u>	<u>8,245</u>
Deferred tax assets	3,500	3,500
Other long-term assets	321	216
	<u>3,821</u>	<u>3,716</u>
Total assets	<u>\$ 112,896</u>	<u>\$ 105,930</u>
<b>LIABILITIES AND STOCKHOLDERS EQUITY</b>		
Current Liabilities:		
Accounts payable	\$ 2,276	\$ 3,584
Accrued expenses (including customer deposits of \$834 and \$180 at June 30, 2003 and December 31, 2002, respectively)	10,777	10,062
Deferred revenue	27,750	23,348
	<u>40,803</u>	<u>36,994</u>
Commitments and Contingencies (Note 2)		
Stockholders Equity:		
Common stock, \$0.01 par value:		
Authorized 50,000,000 shares		
Issued and outstanding 17,443,128 and 17,246,005 shares at June 30, 2003 and December 31, 2002, respectively	174	172

Edgar Filing: CONCORD COMMUNICATIONS INC - Form 10-Q

Additional paid-in capital	100,161	98,893
Deferred compensation	(26)	(60)
Accumulated other comprehensive income	2,227	2,408
Accumulated deficit	(30,443)	(32,477)
	<u>          </u>	<u>          </u>
Total stockholders' equity	72,093	68,936
	<u>          </u>	<u>          </u>
Total liabilities and stockholders' equity	\$ 112,896	\$ 105,930
	<u>          </u>	<u>          </u>

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

**Table of Contents**

**CONCORD COMMUNICATIONS, INC.**  
**CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS (Unaudited)**  
(In thousands, except share and per share data)

	Three Months Ended		Six Months Ended	
	June 30, 2003	June 30, 2002	June 30, 2003	June 30, 2002
<b>Revenues:</b>				
License revenues	\$ 13,154	\$ 12,258	\$ 26,063	\$ 26,319
Service revenues	12,461	10,693	23,669	20,870
<b>Total revenues</b>	<b>25,615</b>	<b>22,951</b>	<b>49,732</b>	<b>47,189</b>
<b>Cost of Revenues:</b>				
Cost of license revenues	683	394	1,272	961
Cost of service revenues	4,045	3,721	8,087	7,540
<b>Total cost of revenues</b>	<b>4,728</b>	<b>4,115</b>	<b>9,359</b>	<b>8,501</b>
<b>Gross profit</b>	<b>20,887</b>	<b>18,836</b>	<b>40,373</b>	<b>38,688</b>
<b>Operating Expenses:</b>				
Research and development (excluding stock-based compensation of \$14, \$27, \$34 and \$60, respectively)	5,423	5,445	10,850	11,187
Sales and marketing	12,579	11,890	23,944	24,025
General and administrative	2,060	1,772	4,305	3,826
Stock-based compensation	14	27	34	60
<b>Total operating expenses</b>	<b>20,076</b>	<b>19,134</b>	<b>39,133</b>	<b>39,098</b>
<b>Operating income (loss)</b>	<b>811</b>	<b>(298)</b>	<b>1,240</b>	<b>(410)</b>
<b>Other Income (Expense):</b>				
Interest income	709	802	1,426	1,579
Other expense	(146)	(16)	(370)	(45)
<b>Total other income, net</b>	<b>563</b>	<b>786</b>	<b>1,056</b>	<b>1,534</b>
<b>Income before income taxes</b>	<b>1,374</b>	<b>488</b>	<b>2,296</b>	<b>1,124</b>
Provision for income taxes	177	93	262	240
<b>Net income</b>	<b>\$ 1,197</b>	<b>\$ 395</b>	<b>\$ 2,034</b>	<b>\$ 884</b>
<b>Net income per common and potential common share:</b>				
Basic	\$ 0.07	\$ 0.02	\$ 0.12	\$ 0.05
Diluted	\$ 0.07	\$ 0.02	\$ 0.11	\$ 0.05
<b>Weighted average common and potential common shares outstanding:</b>				
Basic	17,372,070	17,017,410	17,313,416	16,974,305
Diluted	18,022,181	17,861,027	17,767,593	17,969,848

Edgar Filing: CONCORD COMMUNICATIONS INC - Form 10-Q

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

**Table of Contents**

**CONCORD COMMUNICATIONS, INC.**  
**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (Unaudited)**  
(In thousands)

	Six Months Ended	
	June 30, 2003	June 30, 2002
<b>Cash Flows from Operating Activities:</b>		
Net income	\$ 2,034	\$ 884
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	2,618	3,001
Stock-based compensation	34	60
Changes in current assets and liabilities:		
Accounts receivable	(1,159)	469
Prepaid expenses and other current assets	741	42
Accounts payable	(1,308)	(382)
Accrued expenses	715	(1,020)
Deferred revenue	4,402	2,277
Net cash provided by operating activities	<u>8,077</u>	<u>5,331</u>
<b>Cash Flows from Investing Activities:</b>		
Purchases of equipment and improvements	(1,830)	(1,827)
Change in other assets	(105)	(42)
Investments in marketable securities	(15,988)	(2,592)
Proceeds from sales of marketable securities	10,688	2,290
Deposit of restricted cash		(1,014)
Release of restricted cash	300	
Net cash used in investing activities	<u>(6,935)</u>	<u>(3,185)</u>
<b>Cash Flows from Financing Activities:</b>		
Proceeds from issuance of common stock	1,270	1,683
Net cash provided by financing activities	<u>1,270</u>	<u>1,683</u>
Net increase in cash and cash equivalents	2,412	3,829
Cash and cash equivalents, beginning of period	10,362	9,011
Cash and cash equivalents, end of period	<u>\$ 12,774</u>	<u>\$ 12,840</u>
<b>Supplemental Disclosure of Cash Flow Information:</b>		
Cash paid for income taxes	\$ 247	\$ 130
<b>Supplemental Disclosure of Noncash Financing and Investing Transactions:</b>		
Reversal of deferred compensation related to forfeitures of stock options	\$	\$ (65)
Unrealized loss on available-for-sale securities	\$ (181)	\$ (8)

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

**Table of Contents**

**CONCORD COMMUNICATIONS, INC.**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**(UNAUDITED)**  
**FORM 10-Q, June 30, 2003**

**1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

***(a) Basis of Presentation***

The accompanying unaudited consolidated financial statements have been presented by Concord Communications, Inc. (the Company or Concord) in accordance with accounting principles generally accepted in the United States of America for interim financial statements and with the instructions to Form 10-Q and Regulation S-X pertaining to interim financial statements. Accordingly, these interim financial statements do not include all information and footnotes required by accounting principles generally accepted in the United States of America for complete financial statements. These financial statements reflect all adjustments and accruals of a normal recurring nature, which management considers necessary for a fair presentation of the Company's financial position as of June 30, 2003 and December 31, 2002, and the Company's results of operations for the three and six months ended June 30, 2003 and 2002. The results for the interim periods presented are not necessarily indicative of results to be expected for any future period. The financial statements should be read in conjunction with the audited financial statements and the notes thereto included in the Company's 2002 Annual Report on Form 10-K filed with the Securities and Exchange Commission in March 2003.

***(b) Financial Instruments, Concentration of Credit Risk and Significant Customers***

The Company has estimated the fair value of financial instruments using available market information and appropriate valuation methodologies. The carrying values of cash, cash equivalents, restricted cash, marketable securities, accounts receivable, accounts payable and accrued expenses approximate fair market value due to the short-term nature of these financial instruments. Financial instruments that potentially subject the Company to concentrations of credit risk are principally cash, cash equivalents, restricted cash, marketable securities and accounts receivable. The Company has no significant off-balance-sheet or concentration of credit risk exposure such as foreign exchange contracts or option contracts. The Company maintains its cash, cash equivalents, restricted cash and marketable securities with established financial institutions. Concentration of credit risk with respect to accounts receivable is limited to certain customers to whom the Company makes substantial sales. To reduce its credit risk, the Company routinely assesses the financial strength of its customers. The Company maintains an allowance for potential credit losses but historically has not experienced any significant losses related to individual customers or groups of customers in any particular industry or geographic area. No individual customer or reseller accounted for more than 10% of revenues for the three and six months ended June 30, 2003 or June 30, 2002. No one customer accounted for more than 10% of the Company's accounts receivable at June 30, 2003. One customer, a reseller in Europe, accounted for 11.0% of the Company's accounts receivable at December 31, 2002. As of June 30, 2003, this customer represented approximately 1.0% of accounts receivable.

***(c) Derivative Financial Instruments***

The Company uses forward contracts to reduce its exposure to foreign currency risk and variability in operating results due to fluctuations in exchange rates underlying the value of accounts receivable denominated in foreign currencies until such receivables are collected. A forward contract obligates the Company to exchange predetermined amounts of specified foreign currencies at specified exchange rates on specified dates. These foreign currency forward exchange contracts are denominated in the same currency in which the underlying foreign currency receivables are denominated and bear a contract value and maturity date that approximate the value and expected settlement date, respectively, of the underlying transactions. For contracts that are designated and effective as hedges, unrealized gains and losses on open contracts at the end of each accounting period, resulting from changes in the fair value of these contracts, are recognized in earnings in the same period as gains and losses on the underlying foreign denominated receivables are recognized and generally offset. Gains and losses on forward contracts and foreign denominated receivables are included in other income (expense), net. The Company does not

**Table of Contents**

enter into or hold derivatives for trading or speculative purposes and only enters into contracts with highly rated financial institutions.

At June 30, 2003, the Company had one forward contract outstanding, which is presented in the table below. The notional exchange rate is quoted using market conventions where the currency is expressed in currency units per U.S. dollar.

<u>Currency</u>	<u>Position</u>	<u>Maturity Date</u>	<u>Notional Amount</u>	<u>Notional Exchange Rate</u>	<u>Fair Market Value as of June 30, 2003</u>
Euro	Sell	8/29/03	\$ 108,000	1.1474	\$ 123,000

**(d) Stock-Based Compensation**

The Company accounts for employee stock-based compensation arrangements under the provisions of Accounting Principles Board ( APB ) Opinion No. 25 and related interpretations. Statement of Financial Accounting Standards ( SFAS ) No. 123 permits the use of either a fair-value based method or the intrinsic value method under APB No. 25 to account for employee stock-based compensation arrangements. Companies that elect to use the intrinsic value method provided in APB No. 25 are required to disclose the pro forma net income (loss) and net income (loss) per share that would have resulted from the use of the fair value method. The Company has provided below the pro forma disclosures of the effect on net income (loss) and net income (loss) per share as if SFAS No. 123, as amended by SFAS No. 148, had been applied in measuring compensation expense for all periods presented.

	<u>Three Months Ended</u>		<u>Six Months Ended</u>	
	<u>June 30, 2003</u>	<u>June 30, 2002</u>	<u>June 30, 2003</u>	<u>June 30, 2002</u>
<b>(In thousands, except per share data)</b>				
Net income:				
As reported	\$ 1,197	\$ 395	\$ 2,034	\$ 884
Add:				
Stock-based employee compensation expense included in reported net income, net of related taxes	14	27	34	60
Less:				
Total stock-based employee compensation expense determined under the fair value based method for all awards, net of related tax effects	(1,541)	(2,303)	(3,202)	(4,758)
Pro forma net loss	\$ (330)	\$ (1,881)	\$ (1,134)	\$ (3,814)
Basic net income (loss) per share:				
As reported	\$ 0.07	\$ 0.02	\$ 0.12	\$ 0.05
Pro forma	\$ (0.02)	\$ (0.11)	\$ (0.07)	\$ (0.22)
Diluted net income (loss) per share:				
As reported	\$ 0.07	\$ 0.02	\$ 0.11	\$ 0.05
Pro forma	\$ (0.02)	\$ (0.11)	\$ (0.07)	\$ (0.22)

**2. INDEMNIFICATIONS**

As permitted under Massachusetts law, the Company has agreements whereby it indemnifies its officers and directors for certain events or occurrences while the officer or director is, or was serving, at the Company's request in such capacity. The term of the indemnification period is for the officer or director's lifetime. The maximum potential amount of future payments the Company could be required to make under these indemnification agreements is unlimited; however, the Company has a Director and Officer insurance policy pursuant to which the company may recover all or a portion of amounts it pays to Directors or Officers under their indemnification agreements. As a result of its insurance policy coverage, the Company believes the estimated fair value of these indemnification agreements is minimal.

## Edgar Filing: CONCORD COMMUNICATIONS INC - Form 10-Q

The Company warrants that its software products will perform in all material respects in accordance with its standard published specifications in effect at the time of delivery of the licensed products to the customer for a period of 90 days. Additionally, the Company warrants that its maintenance services will be performed consistent

**Table of Contents**

with its maintenance policy in effect at the time those services are delivered. The Company believes its maintenance policy is consistent with generally accepted industry standards. If necessary, the Company would provide for the estimated cost of product and service warranties based on specific warranty claims and claim history, however, the Company has never incurred significant expense under product or services warranties. As a result, the Company believes the estimated liability of these warranties is minimal.

The Company enters into standard indemnification agreements in the ordinary course of its business. Pursuant to these agreements, the Company indemnifies, holds harmless, and agrees to reimburse the indemnified party for losses suffered or incurred by the indemnified party, generally its business partners or customers, in connection with any patent, copyright, trademark, trade secret or other intellectual property infringement claim by any third party with respect to our products. The term of these indemnification agreements is generally perpetual any time after execution of the agreement. The maximum potential amount of future payments the Company could be required to make under these indemnification agreements is often capped at a dollar figure. The Company has never incurred costs to defend lawsuits or settle claims related to these indemnification agreements. As a result, the Company believes the estimated fair value of these agreements is minimal.

When, as part of an acquisition, Concord acquires all of the stock or all or a portion of the assets and/or liabilities of a company, it may assume liability for certain events or occurrences that took place prior to the date of acquisition. The maximum potential amount of future payments it could be required to make for such obligations is undeterminable at this time. Concord has no liabilities recorded for these liabilities as of June 30, 2003.

**3. NET INCOME PER SHARE**

The Company computes earnings per share following the provisions of SFAS No. 128, *Earnings per Share*. Basic net income per share is computed using the weighted-average number of common shares outstanding for a period. Diluted net income per share is computed using the weighted-average number of common and dilutive potential common shares outstanding for the period. For the three and six months ended June 30, 2003 and 2002, dilutive potential common shares consisted of outstanding stock options. The dilutive effect of outstanding stock options is computed using the treasury stock method.

Calculations of the basic and diluted net income per common share and potential common share are as follows:

	Three Months Ended		Six Months Ended	
	June 30, 2003	June 30, 2002	June 30, 2003	June 30, 2002
(in thousands except share and per share data)				
Basic:				
Net income applicable to common stockholders	\$ 1,197	\$ 395	\$ 2,034	\$ 884
Weighted average common shares outstanding	17,372,070	17,017,410	17,313,416	16,974,305
Net income per common share	\$ 0.07	\$ 0.02	\$ 0.12	\$ 0.05
Diluted:				
Net income applicable to common stockholders	\$ 1,197	\$ 395	\$ 2,034	\$ 884
Weighted average common shares outstanding	17,372,070	17,017,410	17,313,416	16,974,305
Potential common shares pursuant to stock options	650,111	843,617	454,177	995,543
Diluted weighted average shares	18,022,181	17,861,027	17,767,593	17,969,848

Edgar Filing: CONCORD COMMUNICATIONS INC - Form 10-Q

Diluted net income per common share	\$	0.07	\$	0.02	\$	0.11	\$	0.05
-------------------------------------	----	------	----	------	----	------	----	------

Diluted weighted average shares outstanding does not include 2,395,746, 2,455,829, 2,131,725 and 2,017,582 potential common shares for the three and six months ended June 30, 2003 and 2002, respectively, as their effect would have been antidilutive.

**Table of Contents****4. COMPREHENSIVE INCOME**

Comprehensive income is defined as the change in net assets of the Company during a period from transactions generated from non-owner sources. It includes all changes in equity during a period except those resulting from investments by owners and distributions to owners. Comprehensive income for the three and six months ended June 30, 2003 and 2002 is as follows:

	Three Months Ended		Six Months Ended	
	June 30, 2003	June 30, 2002	June 30, 2003	June 30, 2002
	(in thousands)		(in thousands)	
Net income available to common stockholders	\$ 1,197	\$ 395	\$ 2,034	\$ 884
Unrealized (loss) gain on marketable securities	(68)	590	(180)	(8)
Comprehensive income	\$ 1,129	\$ 985	\$ 1,854	\$ 876

**5. SEGMENT REPORTING AND INTERNATIONAL INFORMATION**

The Company follows the provisions of SFAS No. 131, *Disclosures about Segments of an Enterprise and Related Information*. SFAS No. 131 establishes standards for reporting information regarding operating segments in annual financial statements and requires selected information for those segments to be presented in interim financial reports issued to stockholders. SFAS No. 131 also establishes standards for related disclosures about products and services and geographic areas. Operating segments are identified as components of an enterprise about which separate, discrete financial information is available for evaluation by the chief operating decision maker, or decision-making group, in making decisions on how to allocate resources and assess performance. The Company's chief decision-making group, as defined under SFAS No. 131, is the executive management committee which is comprised of the executive officers of the Company.

The following table presents the approximate revenues by major geographical regions:

	Three Months Ended		Six Months Ended	
	June 30, 2003	June 30, 2002	June 30, 2003	June 30, 2002
	(in thousands)		(in thousands)	
United States	\$ 14,445	\$ 14,660	\$ 26,419	\$ 29,356
United Kingdom	2,152	1,074	6,147	3,283
Europe (excluding United Kingdom)	5,297	4,430	9,914	7,616
Rest of the World	3,721	2,787	7,252	6,934
Total	\$ 25,615	\$ 22,951	\$ 49,732	\$ 47,189

For the three months ended June 30, 2003, no one country, except the United States, accounted for greater than 10% of total revenues. For the six months ended June 30, 2003, no one country, except the United States and the United Kingdom, accounted for greater than 10% of total revenues. For the three and six months ended June 30, 2002, no one country, except the United States, accounted for greater than 10% of total revenues. Substantially all of the Company's assets are located in the United States.

The Company's reportable segments are determined by customer type: managed service providers/ telecommunications carriers ( MSP/TC ) and enterprise. The accounting policies of the segments are the same as those described in Note 1. The executive management committee evaluates segment performance based on revenues. Accordingly, all expenses are considered corporate level activities and are not allocated to segments. Also, the executive management committee does not assign assets to these segments.



**Table of Contents**

The following table presents the approximate revenues by reportable segment:

	Three Months Ended		Six Months Ended	
	June 30, 2003	June 30, 2002	June 30, 2003	June 30, 2002
	(in thousands)		(in thousands)	
MSP/TC	\$ 16,982	\$ 7,870	\$ 32,965	\$ 17,791
Enterprise	8,633	15,081	16,767	29,398
<b>Total</b>	<b>\$ 25,615</b>	<b>\$ 22,951</b>	<b>\$ 49,732</b>	<b>\$ 47,189</b>

**6. RECENT ACCOUNTING PRONOUNCEMENTS**

In April 2003, the Financial Accounting Standards Board (FASB) released Statement of Financial Accounting Standards (SFAS) No. 149, Amendment of Statement 133 on Derivative Instruments and Hedging Activities. SFAS No. 149 clarifies under what circumstances a contract with an initial net investment meets the characteristics of a derivative, amends the definition of an underlying contract, and clarifies when a derivative contains a financing component in order to increase the comparability of accounting practices under SFAS No. 133. The statement 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 is not expected to have a material impact on the Company's consolidated financial statements.

In May 2003, the FASB issued SFAS No. 150, Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity. This Statement 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). Many of those instruments were previously classified as equity. The Statement is effective for financial instruments entered into or modified after May 31, 2003. The Company adopted this standard on June 1, 2003. Its adoption did not have any impact on the financial statements.

**7. SUBSEQUENT EVENTS**

On July 11, 2003, Concord entered into a license agreement with Tavve Software Company (Tavve) whereby Concord licensed components of Tavve's technology. Concord has licensed Tavve's root cause analysis and discovery of layer 2 and 3 network topology to build upon Concord's current position in optimizing application availability and performance across networks and systems. The value of the transaction estimated at \$1.2 million will be accounted for as in-process-research-and-development as the integrated product has not reached technological feasibility and has no alternative future use.

On July 17, 2003, the Company acquired privately-held netViz Corporation. netViz's software enables users to visualize business processes and allows them to map relationships within the supporting technology infrastructure through data-driven icons. The acquisition was valued at \$10 million and paid in a combination of \$5 million cash and \$5 million in shares of the Company's common stock. The acquisition will be completed in the third quarter of 2003 and will be accounted for under the purchase method of accounting.

**Table of Contents**

**CONCORD COMMUNICATIONS, INC.  
FORM 10-Q, June 30, 2003**

**ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

**OVERVIEW**

Concord develops, markets and supports an application availability and performance software solution, over networks and systems, its eHealth® Suite family of products. Concord's solutions ensure the high availability of the information technology (IT) infrastructure by providing an end-to-end view across the components of this infrastructure: the network, the systems and the applications.

This document contains forward-looking statements. Any statements contained in this document that do not describe historical facts are forward-looking statements. Concord makes such forward-looking statements under the provisions of the safe harbor section of the Private Securities Litigation Reform Act of 1995. In particular, statements contained in Management's Discussion and Analysis of Financial Condition and Results of Operations, which are not historical facts (including, but not limited to, statements concerning: the plans and objectives of management; decreases as a percentage of revenues in, research and development, and general and administrative expenses; customization of products and services for international markets; changes in contribution of reportable segments to total revenues; changes in gross profit; expectations regarding increased competition and Concord's ability to compete successfully; sustenance of revenue growth both domestically and internationally; the size, scope and description of Concord's target customer market; future product development, including but not limited to anticipated expense levels to fund product development, acquisitions and the integration of acquired companies; and our expected liquidity and capital resources) constitute forward-looking statements. Forward-looking statements contained herein are based on current expectations, but are subject to a number of risks and uncertainties. Concord's actual future results may differ significantly from those stated in any forward-looking statements. Factors that may cause such differences include, but are not limited to, the factors discussed below.

The forward-looking statements contained herein are based on current expectations but are subject to a number of risks and uncertainties. The factors that could cause actual results to differ materially from current expectations include the following: risks of intellectual property rights and litigation, risks in technology development and commercialization, risks in product development and market acceptance of and demand for the Company's products, risks of downturns in economic conditions generally, and in the software, networking and telecommunications industries specifically, risks associated with competition and competitive pricing pressures, risks associated with international sales, risks associated with a limited family of products and other risks detailed in this Form 10-Q under the heading "Factors that Could Affect Future Results" and elsewhere in the Company's filings with the Securities and Exchange Commission.

**SUBSEQUENT EVENTS**

On July 11, 2003, Concord entered into a license agreement with Tavve Software Company (Tavve) whereby Concord licensed components of Tavve's technology. Concord has licensed Tavve's root cause analysis and discovery of layer 2 and 3 network topology to build upon Concord's current position in optimizing application availability and performance across networks and systems. The value of the transaction estimated at \$1.2 million will be accounted for as in-process-research-and-development as the integrated product has not reached technological feasibility and has no alternative future use.

On July 17, 2003, the Company acquired privately-held netViz Corporation. netViz's software enables users to visualize business processes and allows them to map relationships within the supporting technology infrastructure through data-driven icons. The acquisition was valued at \$10 million and paid in a combination of \$5 million cash and \$5 million in shares of the Company's common stock. This will be accounted for under the purchase method of accounting.

**Table of Contents**

**CRITICAL ACCOUNTING POLICIES, SIGNIFICANT ESTIMATES AND JUDGMENTS**

The accompanying discussion and analysis of our financial condition and results of operations are based upon our consolidated financial statements, which have been prepared in accordance with generally accepted accounting principles in the United States ( US GAAP ). The preparation of consolidated financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities. These estimates form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. We base our estimates and judgments on historical experience and on various other assumptions that we believe are reasonable under the circumstances. However, future events are subject to change and the best estimates and judgments routinely require adjustment. US GAAP requires us to make estimates and judgments in several areas. See our note to condensed consolidated financial statements (unaudited) attached hereto and our audited consolidated financial statements and notes thereto which contain accounting policies and other disclosures required by generally accepted accounting principles included in the Company's 2002 Annual Report on Form 10-K filed with the Securities and Exchange Commission in March 2003.

We believe that the policies, significant estimates and judgments discussed below are the most critical to our financial statements and the understanding of our financial condition and results of operations because their application places the most significant demands on management's judgment.

*(a) Revenue Recognition*

Our revenues consist of software license revenues and service revenues. Software license revenues are recognized in accordance with the American Institute of Certified Public Accountants' Statement of Position ( SOP ) 97-2, *Software Revenue Recognition*, as modified by SOP 98-9, *Modification of SOP 97-2, Software Revenue Recognition with respect to Certain Transactions*. Under SOP 97-2, software license revenues are recognized when persuasive evidence of an arrangement exists and delivery of the software has occurred, provided that the license fee is fixed or determinable, collection is considered reasonably assured and no customer acceptance clauses exist. If an arrangement includes an acceptance provision, revenue recognition occurs upon the earlier of a receipt of a written customer acceptance or expiration of the acceptance period. If the fee is determined not to be fixed or determinable, revenue is recognized when the fee becomes due. If collection is not considered reasonably assured, revenue is recognized upon the receipt of cash. Revenues under multiple-element arrangements, which typically include software products, services and maintenance sold together, are allocated to each element using the residual method in accordance with SOP 98-9. Under the residual method, the fair value of the undelivered elements is deferred and subsequently recognized when these elements are delivered; the remainder of the arrangement consideration is allocated to the software. We have established sufficient vendor specific objective evidence for professional services, training and maintenance and customer support services based on the price charged when these elements are sold separately. Accordingly, software license revenues are recognized under the residual method in arrangements in which software is licensed with professional services, training, and maintenance and customer support services.

Service revenues include professional services, training and maintenance and customer support fees. Professional services are not essential to the functionality of the other elements in an arrangement and are accounted for separately. Service revenues are recognized as the services are performed, provided evidence of an arrangement exists, fees are fixed or determinable, and collection is considered reasonably assured.

We license our software to end-users, resellers and OEM's. All revenues generated from our worldwide operations are approved at our corporate headquarters, located in the United States. Our arrangements do not generally include clauses involving acceptance of our products by our customers. However, if an arrangement includes an acceptance provision, revenue recognition occurs upon the earlier of receipt of a written customer acceptance or expiration of the acceptance period.

For all sales, in the absence of a signed license agreement, we use either a purchase order or purchase order equivalent as evidence of an arrangement. If a signed license agreement is obtained, we use either the license agreement or the license agreement and a purchase order as evidence of an arrangement. Sales to resellers are usually evidenced by a master agreement governing the relationship together with purchase orders on a transaction-

**Table of Contents**

by-transaction basis. Sales to OEM s are usually evidenced by a master agreement governing the relationship together with a shipping report on a transaction-by-transaction basis.

Delivery generally occurs when product is delivered to a common carrier and the delivery terms are FOB Concord. In the case of arrangements with resellers or OEMs, revenue is recognized upon delivery to the reseller or OEM. Most of these arrangements involve a sell-through by the reseller or OEM to an end user. For a reseller, evidence usually comes in the form of a purchase order identifying the end-user while for an OEM, evidence of sell-through usually comes in the form of a shipping report, which usually identifies the ship to location.

At the time of the transaction, we assess whether the fee associated with our revenue transaction is fixed or determinable and whether or not collection is reasonably assured. We assess whether the fee is fixed or determinable based on the payment terms associated with the transaction. If a significant portion of a fee is due after our normal payment terms, which are usually 30 to 60 days from invoice date, we account for the fee as not being fixed or determinable. In these cases, we recognize revenue when the fee is due.

We assess collection based on a number of factors, including past transaction history with the customer and the credit-worthiness of the customer. We do not request collateral from our customers. If we determine that collection of a fee is not reasonably assured, we defer the fee and recognize revenue upon receipt of cash.

For arrangements with multiple obligations (for example, undelivered maintenance and support or undelivered specified software upgrades), we allocate revenue to each component of the arrangement using the residual value method based on the fair value of the undelivered elements. This means that we defer revenue from the fee arrangement equivalent to the fair value of the undelivered elements. We determine fair values for ongoing maintenance and support obligations using our internal pricing policies for maintenance and by referencing the prices at which we have sold separate maintenance contract renewals to our customers. We determine fair value of services, such as training or consulting, by referencing the prices at which we have separately sold comparable services to our customers. For specified undelivered software upgrades, we recognize revenue upon shipment of these upgrades.

*(b) Accounts Receivable*

We perform ongoing credit evaluations of our customers and adjust credit limits based upon payment history and the customer s current credit worthiness, as determined by our review of their current credit information. We continuously monitor collections and payments from our customers and maintain a provision for estimated credit losses based on our historical experience and any specific customer collection issues that we have identified. While such credit losses have historically been within our expectations and appropriate reserves have been established, we cannot guarantee that we will continue to experience the same credit loss rates that we have experienced in the past.

*(c ) Accounting for Income Taxes*

As part of the process of preparing our consolidated financial statements, we are required to estimate our income taxes in each of the jurisdictions in which we operate. To do this, we estimate our actual current tax liabilities, while also assessing temporary differences resulting from differing treatment of items, such as deferred revenue and expense accruals, for tax and accounting purposes. These differences result in deferred tax assets and liabilities, which are included within our consolidated balance sheet. We must then assess the likelihood that our deferred tax assets will be recovered from future taxable income. To the extent we believe that recovery is not likely, we must establish a valuation allowance. To the extent we establish a valuation allowance or increase this allowance in a period, we must include an expense within the tax provision in the statement of operations.

Significant management judgment is required in determining our provision for income taxes, our deferred tax assets and liabilities and any valuation allowance recorded against our net deferred tax assets. We have recorded a valuation allowance as of June 30, 2003, due to uncertainties related to our ability to utilize some of our deferred tax assets, primarily consisting of the utilization of certain net operating loss carryforwards from prior years. We are unsure whether we will have sufficient future taxable income to allow us to use these net operating losses and tax credit carryforwards before they expire. The valuation allowance is based on our estimates of taxable income by jurisdiction in which we operate and the period over which our deferred tax assets will be recoverable. In the event

**Table of Contents**

that actual results differ from these estimates or we adjust these estimates in future periods, we may need to establish an additional valuation allowance. Establishing new or additional valuation allowances could materially adversely impact our financial position and results of operations.

**Pro Forma Financial Results**

We prepare and release quarterly unaudited financial statements prepared in accordance with generally accepted accounting principles ( GAAP ). We also disclose and discuss certain pro forma financial information, used to evaluate our performance, in related earnings releases and investor conference calls. We believe that current shareholders and potential investors in our company use multiples of pro-forma earnings per share ( EPS ) in making investment decisions about our company. We use pro-forma EPS to evaluate the results of our ongoing operations. Pro-forma EPS is calculated by dividing pro-forma net income by the diluted number of shares. Pro-forma net income excludes certain non-cash and special charges, consisting primarily of non-cash compensation charges and transaction costs associated with acquisitions. This proforma calculation also substitutes current period GAAP tax provisions with a pro forma tax rate. We have significant deferred tax assets and have not recorded a significant federal tax provision. The tax provision relates mostly to state and foreign taxes. This measure, and other pro-forma information, should not be considered an alternative to measurements required by accounting principles generally accepted in the United States of America ( U.S. GAAP ) such as net income and net cash provided by operations and should not be considered a measurement of our liquidity. In addition, our non-GAAP measures may not be comparable to similar measures reported by other companies.

**Table of Contents****RESULTS OF OPERATIONS**

The following table sets forth, for the periods indicated, certain financial data as percentages of the Company's total revenues:

	Three Months Ended		Six Months Ended	
	June 30, 2003	June 30, 2002	June 30, 2003	June 30, 2002
<b>Revenues:</b>				
License revenues	51.4%	53.4%	52.4%	55.8%
Service revenues	48.6	46.6	47.6	44.2
<b>Total revenues</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>
<b>Cost of Revenues:</b>				
Cost of license revenues	2.7	1.7	2.6	2.0
Cost of service revenues	15.8	16.2	16.3	16.0
<b>Total cost of revenues</b>	<b>18.5</b>	<b>17.9</b>	<b>18.8</b>	<b>18.0</b>
<b>Gross profit</b>	<b>81.5</b>	<b>82.1</b>	<b>81.2</b>	<b>82.0</b>
<b>Operating Expenses:</b>				
Research and development (excluding stock-based compensation)	21.2	23.7	21.8	23.7
Sales and marketing	49.1	51.8	48.1	50.9
General and administrative	8.0	7.7	8.7	8.1
Stock-based compensation	0.1	0.1	0.1	0.1
<b>Total operating expenses</b>	<b>78.4</b>	<b>83.4</b>	<b>78.7</b>	<b>82.9</b>
<b>Operating income (loss)</b>	<b>3.2</b>	<b>(1.3)</b>	<b>2.5</b>	<b>(0.9)</b>
<b>Other Income (Expense):</b>				
Interest income	2.8	3.5	2.9	3.3
Other expense	(0.6)	(0.1)	(0.7)	(0.1)
<b>Total other income, net</b>	<b>2.2</b>	<b>3.4</b>	<b>2.1</b>	<b>3.3</b>
<b>Income before income taxes</b>	<b>5.4</b>	<b>2.1</b>	<b>4.6</b>	<b>2.4</b>
Provision for income taxes	0.7	0.4	0.5	0.5
<b>Net income</b>	<b>4.7%</b>	<b>1.7%</b>	<b>4.1%</b>	<b>1.9%</b>

**Total Revenues**

Concord's total revenues are generated from license revenue and service revenue. License revenues are derived from the licensing of software products. Service revenues consist of fees for maintenance, training and professional services

**Three Months Ended**

**Six Months Ended**

Edgar Filing: CONCORD COMMUNICATIONS INC - Form 10-Q

(Dollars in thousands)	June 30, 2003	Percent Change	June 30, 2002	June 30, 2003	Percent Change	June 30, 2002
License revenues	\$ 13,154	7.3%	\$ 12,258	\$ 26,063	-1.0%	\$ 26,319
Service revenues	12,461	16.5%	10,693	23,669	13.4%	20,870
<b>Total revenues</b>	<b>\$25,615</b>	<b>11.6%</b>	<b>\$22,951</b>	<b>\$49,732</b>	<b>5.4%</b>	<b>\$47,189</b>
<b><i>Percent of Total Revenues</i></b>						
License revenues	51.4%		53.4%	52.4%		55.8%
Service revenues	48.6%		46.6%	47.6%		44.2%

The increase in total revenues for the three and six months ended June 30, 2003 as compared to the three and six months ended June 30, 2002 was mostly due to an increase of service revenues. The increase in service revenues for the three and six months ended June 30, 2003 as compared to the three and six months ended June 30, 2002 was

**Table of Contents**

mainly due to higher demand for professional and educational services and a significant increase in maintenance revenues which are generated from new and renewed maintenance contracts.

**License Revenues**

Concord's license revenues are derived from the licensing of software products. The increase in license revenues for the three months ended June 30, 2003 as compared to the corresponding prior year period was mostly due to increased sales to European service providers. License revenues remained relatively constant for the first six months of fiscal 2003 as compared to the corresponding prior year period as lower sales in the United States were offset by higher international license revenues. License revenues are dependent on our ability to sell to new customers as well as to our installed base. License revenues can also be dependent on the number of transactions over \$100,000 that we are able to close during the period.

	Three Months Ended			Six Months Ended		
	June 30, 2003	Percent Change	June 30, 2002	June 30, 2003	Percent Change	June 30, 2002
New Customers	38	-47.9%	73	81	-42.6%	141
Transactions greater than \$100K	36	-7.7%	39	72	-16.3%	86
<b>Percent of Total Revenues</b>						
New Customers	19%		23%	21%		25%

The reduction in License revenues from new customers and transactions greater than \$100,000 was due, primarily, to the economic slowdown. The decrease in license revenues as a percent of total revenues was primarily the result of a significant increase in service revenues, consisting mainly of maintenance revenues. There were no material price increases for products during the three months and six months ended June 30, 2003 or 2002. Inflation did not have a significant impact on our revenues or income during the three and six months ended June 30, 2003 or 2002.

**Service Revenues**

Concord's service revenues consist of fees for maintenance, training and professional services. The increase in service revenues for the three and six months ended June 30, 2003 as compared to the three and six months ended June 30, 2002 was mainly due to higher demand for professional and educational services and a significant increase in maintenance revenues which are generated from new and renewed maintenance contracts. Maintenance revenues represent fees earned by granting our customers rights to technical support, software product upgrades and maintenance patches during the support period, which is usually one year. The majority of our license customers purchase maintenance upon the initial licensing of our software. In addition, the majority of these customers renew their maintenance agreements annually. An increase in the number of the Company's customers and the resulting demand for these services further helped drive the increase in service revenues for the three and six months ended June 30, 2003.

**International Revenues**

Concord has twelve international subsidiaries and one international branch office. Concord has customers in 63 countries.

**Table of Contents**

(Dollars in thousands)	Three Months Ended			Six Months Ended		
	June 30, 2003	Percent Change	June 30, 2002	June 30, 2003	Percent Change	June 30, 2002
<b>International Revenues</b>						
United Kingdom	\$ 2,152	100.4%	\$ 1,074	\$ 6,147	87.2%	\$ 3,283
Europe (excluding United Kingdom)	5,297	19.6%	4,430	9,914	30.2%	7,616
Rest of the World	3,721	33.5%	2,787	7,253	4.6%	6,934
<b>Total International Revenues</b>	<b>\$ 11,170</b>	<b>34.7%</b>	<b>\$ 8,291</b>	<b>\$ 23,314</b>	<b>30.7%</b>	<b>\$ 17,833</b>
<b>Percent of Revenues</b>						
Domestic	56.4%		63.9%	53.1%		62.2%
Europe (Including United Kingdom)	29.1%		24.0%	32.3%		23.1%
Rest of the World	14.5%		12.1%	14.6%		14.7%

The increase in international revenues for the three and six months ended June 30, 2003 as compared to the corresponding prior year periods was driven primarily by strong demand by European managed service providers. We expect revenue from international customers will be 40% to 50% of total revenues; however, there can be no assurance that we will be successful in meeting this target. We believe that continued growth and profitability will require further expansion of our sales, marketing and customer service functions in international markets. We expect to commit additional time and development resources to customizing our products and services for selected international markets.

**Segment Revenues**

Concord's reportable segments are determined by customer type: managed service providers/telecommunications carriers (MSP/TC) and enterprise.

(Dollars in thousands)	Three Months Ended			Six Months Ended		
	June 30, 2003	Percent Change	June 30, 2002	June 30, 2003	Percent Change	June 30, 2002
<b>Segment Revenues</b>						
MSP/TC	\$ 16,982	115.8%	\$ 7,870	\$ 32,965	85.3%	\$ 17,791
Enterprise	8,633	-42.8%	15,081	16,767	-43.0%	29,398
<b>Total Revenues</b>	<b>\$ 25,615</b>	<b>11.6%</b>	<b>\$ 22,951</b>	<b>\$ 49,732</b>	<b>5.4%</b>	<b>\$ 47,189</b>
<b>Percent of Revenues</b>						
MSP/TC	66.3%		34.3%	66.3%		37.7%
Enterprise	33.7%		65.7%	33.7%		62.3%

The increase of MSP/TC revenue for the three and six months ended June 30, 2003 as compared to the corresponding prior year periods was driven primarily by strong demand by European managed service providers. We expect that MSP/TC revenue will be 40% to 50% of total revenues; however, there can be no assurance that we will be successful in meeting this target.

**Cost of Revenues**

Cost of revenues includes cost of license revenues and cost of service revenues. Cost of license revenues includes expenses associated with royalty fees, production, fulfillment and product documentation. Royalty costs are composed of third party software costs. Cost of service revenues includes the personnel costs associated with providing customer support in connection with maintenance, training and professional

service contracts.

**Table of Contents**

(Dollars in thousands)	Three Months Ended			Six Months Ended		
	June 30, 2003	Percent Change	June 30, 2002	June 30, 2003	Percent Change	June 30, 2002
Cost of license revenues	\$ 683	73.4%	\$ 394	\$ 1,272	32.4%	\$ 961
Cost of service revenues	4,045	8.7%	3,721	8,087	7.3%	7,540
<b>Total cost of revenues</b>	<b>\$4,728</b>	<b>14.9%</b>	<b>\$4,115</b>	<b>\$9,359</b>	<b>10.1%</b>	<b>\$8,501</b>
<b>Percent of Total Revenues</b>						
Cost of license revenues	2.7%		1.7%	2.6%		2.0%
Cost of service revenues	15.8%		16.2%	16.3%		16.0%

The increase in total cost of revenues for the period ended June 30, 2003 compared to the three and six months ended June 30, 2002 is driven by higher royalty costs and the costs associated with the opening, in the first quarter of 2003, of a technical support call center in Australia which is servicing our customers in the Asia-Pacific region.

**Gross Profit**

Total gross profit includes gross profit from license revenues and gross profit from service revenues.

(Dollars in thousands)	Three Months Ended			Six Months Ended		
	June 30, 2003	Percent Change	June 30, 2002	June 30, 2003	Percent Change	June 30, 2002
Gross Profit	\$20,887	10.9%	\$ 18,836	\$40,373	4.4%	\$38,688
<b>Percent of Revenues</b>						
Gross Profit	81.5%		82.1%	81.2%		82.0%

The increase in total gross profit, in dollars, for the three and six months ended June 30, 2003 as compared to the corresponding prior year periods is due to an increase in total revenues. The decrease in gross profit percentage for the three months ended June 30, 2003 compared to the three months ended June 30, 2002 was mainly attributable to an increase in royalties costs. The decrease in gross profit percentage for the six months ended June 30, 2003 compared to the six months ended June 30, 2002 was mainly attributable to an increase in royalties costs and the costs associated with the opening, in the first quarter of 2003, of a technical support call center in Australia which is servicing our customers in the Asia-Pacific region. We expect to increase our gross profit in absolute dollars; however, this will depend upon our revenue growth, among other factors. Accordingly, there can be no assurance that we will be successful in increasing our gross profit on an absolute dollars basis of total revenues.

**Research and Development Expenses**

Research and development expenses consist primarily of personnel costs associated with software development.

**Table of Contents**

(Dollars in thousands)	Three Months Ended			Six Months Ended		
	June 30,	Percent Change	June 30,	June 30,	Percent Change	June 30,
	2003		2002	2003		2002
Research and Development	\$5,423	-0.4%	\$5,445	\$10,850	-3.0%	\$11,187
<b>Percent of Total Revenues:</b>						
Research and Development	21.2%		23.7%	21.8%		23.7%

Research and development expenses remained constant for the three months ended June 30, 2003 compared to the same period in the prior year due to cost control measures. The same expenses decreased for the six months ended June 30, 2003 compared to the six months ended June 30, 2002 due to lower consulting costs. We intend to decrease our research and development expenses as a percentage of total revenues. Our ability to decrease these expenses as a percentage of total revenues will depend upon our revenue growth, among other factors. Accordingly, there can be no assurance that we will be successful in decreasing our research and development expenses as a percentage of total revenues.

**Sales and Marketing Expenses**

Sales and marketing expenses consist primarily of salaries, commissions to sales personnel and agents, travel, tradeshow participation, public relations, advertising and other promotional expenses.

Dollars in thousands	Three Months Ended			Six Months Ended		
	June 30,	Percent Change	June 30,	June 30,	Percent Change	June 30,
	2003		2002	2003		2002
Sales and Marketing	\$12,579	5.8%	\$11,890	\$23,944	-0.3%	\$24,025

The sales and marketing expenses increased for the three months ended June 30, 2003 compared to the same period in the prior year due to increased employee related costs in our foreign operations. This increase in costs was driven by a weaker United States dollar relative to other local currencies. Sales and marketing expenses remained relatively constant for the six months ended June 30, 2003 compared to the same period in the prior year as increased sales expenses were offset by lower marketing program expenses. We expect to decrease these expenses as a percentage of total revenues, however, this will ultimately depend upon our revenue growth, among other factors. Accordingly, there can be no assurance that we will be successful in decreasing our sales and marketing expenses as a percentage of total revenues.

**General and Administrative Expenses**

General and administrative expenses consist primarily of salaries for financial, accounting, legal, investor relations, human resources, administrative and management personnel.

Dollars in thousands	Three Months Ended			Six Months Ended		
	June 30,	Percent Change	June 30,	June 30,	Percent Change	June 30,
	2003		2002	2003		2002
General and Administrative	\$2,060	16.3%	\$1,772	\$4,305	12.5%	\$3,826
<b>Percent of Total Revenue</b>						
General and Administrative	8.0%		7.7%	8.7%		8.1%

**Table of Contents**

General and administrative expenses increased for the three and six months ended June 30, 2003 as compared to the corresponding prior year periods due, in part, to higher salaries and incentive related expenses, higher legal and auditing fees, which was offset, in part, by lower bad debt expenses. We expect to decrease these expenses as a percentage of total revenues, however, this will ultimately depend upon our revenue growth, among other factors. Accordingly, there can be no assurance that we will be successful in decreasing our expenses as a percentage of total revenues.

**Stock-Based Compensation**

Stock-based compensation relates to the issuance of stock options with exercise prices below the deemed fair value of the Company's common stock at the date of grant. Deferred stock-based compensation resulted solely from the issuance of stock options to employees of FirstSense Software, Inc. (FirstSense) in connection with the Company's acquisition of FirstSense on February 4, 2000 and is amortized through charges to operations over the vesting period of the options, which is generally four years. Stock-based compensation was \$14,000 and \$27,000 for the three months ended June 30, 2003 and 2002, respectively. Stock based compensation for the six months ended June 30, 2003 and 2002 was \$34,000 and \$60,000 respectively. For the three and six months ended June 30, 2003, the Company did not record any forfeiture-related reversals of deferred stock based compensation. For the three and six months ended June 30, 2002, the Company recorded reversals of deferred stock based compensation resulting from forfeiture of unvested employee stock options of \$30,000 and \$65,000 respectively.

**Other Income**

Other income consists of interest earned on funds available for investment, net of foreign currency exchange gains and losses, and miscellaneous foreign taxes.

Dollars in thousands	Three Months Ended			Six Months Ended		
	June 30, 2003	Percent Change	June 30, 2002	June 30, 2003	Percent Change	June 30, 2002
Interest income	\$ 709	-11.6%	\$ 802	\$ 1,426	-9.7%	\$ 1,579
Other	(146)	-812.5%	(16)	(370)	-722.2%	(45)
Total other income, net	\$ 563	-28.4%	\$ 786	\$ 1,056	-31.2%	\$ 1,534
<b>Percent of Total Revenues</b>						
Other Income	2.2%		3.4%	2.1%		3.3%

The decrease in other income for the three and six months ended June 30, 2003 as compared to the three and six months ended June 30, 2002 was primarily attributable to lower yield on our investment portfolio, which is due to lower interest rates and larger foreign currency transaction and translation losses attributable to a weaker United States dollar relative to other local currencies.

**Provision for Income Taxes**

The Company recorded an income tax provision of \$177,000 and \$93,000 for the three months ended June 30, 2003 and 2002, respectively, and \$262,000 and \$240,000 for the six months ended June 30, 2003 and 2002. The income tax provisions for the three and six months ended June 30, 2003 and 2002 are mainly related to foreign taxes.

**Table of Contents****LIQUIDITY AND CAPITAL RESOURCES**

(Dollars in thousands)	June 30, 2003	Change	Dec 31, 2002
Working Capital	\$60,815	6.7%	\$56,975
Cash, cash equivalents and short-term investments (excluding restricted cash)	\$80,362	10.3%	\$72,831

(Dollars in thousands)	Six Months Ended June 30,		
	2003	Change	2002
Cash provided by operating activities	\$ 8,077	51.5%	\$ 5,331
Cash used for investing activities	\$(6,934)	117.7%	\$(3,185)
Cash provided by financing activities	\$ 1,269	-24.6%	\$ 1,683

*Working capital*

The increase in working capital was primarily attributable to an increase in cash, cash equivalents and marketable securities due to income from continuing operations during the first half of 2003.

*Cash, cash equivalents and short-term investments (net of restricted cash)*

Cash, cash equivalents and short-term investments consist of highly liquid investments in time deposits held at major banks, commercial paper, United States government agency discount notes, money market mutual funds and other money market securities with original maturities of 90 days or less.

*Cash provided by operating activities*

Net cash provided by operating activities was \$8.1 million for the six months ended June 30, 2003 and \$5.3 million for the six months ended June 30, 2002. Accounts receivable increased \$1.2 million primarily due to revenue growth. Our quarterly days sales outstanding (DSO) decreased to 65 days at June 30, 2003 compared to 66 days at December 31, 2002. DSO measures both the age, in terms of days, of our accounts receivable and the average time it takes to turn the receivable into cash. There are a number of factors affecting DSO, including our payment terms and collection ability. Deferred revenue increased \$4.4 million for the six months ended June 30, 2003 mainly due to an increase in new and renewed maintenance contracts.

*Cash used for investing activities*

Investing activities have consisted of the acquisition of property and equipment, most notably computer and networking equipment to support the corporate infrastructure, and also investments in marketable securities. The Company manages its market risk on its investment securities by selecting investment grade securities with the highest credit ratings and relatively short duration that trade in highly liquid markets.

*Cash provided by financing activities*

Financing activities consisted primarily of the issuance of common stock from the exercise of stock options during the six months ended June 30, 2003 and 2002.

As of June 30, 2003, the Company has future payments under facility and certain equipment lease agreements expiring through August 2008 of \$3.7 million, \$6.7 million and \$1.4 million in one year, two to three years, and thereafter, respectively.

**Table of Contents**

As of December 31, 2002, the Company had available for federal income tax purposes net operating loss carryforwards of approximately \$18,453,000, which expire at various dates through 2021. In addition, as of December 31, 2002, the Company had federal research and development tax credit carryforwards of approximately \$3,274,000, which expire at various dates through 2022. Under current tax law, the utilization of net operating loss carryforwards may be subject to annual limitations in the event of certain changes in ownership.

As required by SFAS No. 109, management of the Company has evaluated the positive and negative evidence bearing upon the realizability of the Company's deferred tax assets. The Company has significantly reserved for its deferred tax assets by recording a valuation allowance. The resulting net deferred tax asset of \$3.5 million is based on the Company's estimate of future taxable income it expects to generate; all other tax assets have been fully reserved. The factors that weighed most heavily on management's decision to record this amount of a valuation allowance were the Company's history of prior profitability, current profitability, current economic conditions and forecasted profitability over the next several years. In addition, the Company is subject to rapid technological change, competition from substantially larger competitors, a limited family of products and other related risks, as more thoroughly described in the "Factors That Could Affect Future Results" section of the Company's Form 10-Q for the quarterly period ended June 30, 2003. As a result, the Company found the evidence described above to be the most reliable objective evidence available in determining that a valuation allowance against its tax assets would be necessary. Significant management judgment is required in determining the valuation allowance recorded against the net deferred tax assets. Management is unsure whether the Company will have sufficient future taxable income to allow it to use all net operating losses and tax credit carryforwards before they expire. The valuation allowance is based on management's estimates of taxable income by jurisdiction in which the Company operates and the period over which the deferred tax assets will be recoverable. In the event that actual results differ from these estimates or the Company adjusts these estimates in future periods, the Company may need to establish an additional valuation allowance. Establishing new or additional valuation allowances could materially adversely impact the Company's financial position and results of operations.

Pursuant to the Tax Reform Act of 1986, the utilization of NOL carryforwards for tax purposes may be subject to an annual limitation if a cumulative change of ownership of more than 50% occurs over a three-year period.

As of December 31, 2002, the Company has recorded a deferred tax asset of \$4,175,000 reflecting the benefit of deductions from the exercise of stock options. When and if the Company realizes the asset, the benefit from this \$4,175,000 will be recorded as a credit to additional paid-in capital when realized.

As of June 30, 2003, Concord's principal sources of liquidity included cash, cash equivalents and marketable securities. The Company believes that its current cash, cash equivalents, marketable securities and cash provided by future operations will be sufficient to meet its working capital and anticipated capital expenditure requirements for at least the next 12 months. Although operating activities may provide cash in certain periods, to the extent Concord experiences growth in the future, its operating and investing activities may require additional cash. Consequently, any such future growth may require Concord to obtain additional equity or debt financing.

**Table of Contents**

**FACTORS THAT COULD AFFECT FUTURE RESULTS**

*References in these risk factors to we, our, the Company, Concord, and us refer to Concord Communications, Inc., a Massachusetts corporation. Any investment in our common stock involves a high degree of risk. If any of the following risks actually occur, our business, results of operations and financial condition would likely suffer.*

This document contains forward-looking statements. Any statements contained in this document that do not describe historical facts are forward-looking statements. Concord makes such forward-looking statements under the provisions of the safe harbor section of the Private Securities Litigation Reform Act of 1995. In particular, statements contained in Management's Discussion and Analysis of Financial Condition and Results of Operations, which are not historical facts (including, but not limited to, statements concerning: the plans and objectives of management; increases in absolute dollars or decreases as a percentage of revenues in sales and marketing, research and development, customer support and service, and general and administrative expenses; expectations regarding increased competition and Concord's ability to compete successfully; sustenance of revenue growth both domestically and internationally; the size, scope and description of Concord's target customer market; future product development, including but not limited to anticipated expense levels to fund product development, acquisitions and the integration of acquired companies; and our expected liquidity and capital resources) constitute forward-looking statements. Forward-looking statements contained herein are based on current expectations, but are subject to a number of risks and uncertainties. Concord's actual future results may differ significantly from those stated in any forward-looking statements. Factors that may cause such differences include, but are not limited to, the factors discussed below.

**Our future operating results are uncertain.**

Prior to 2001, we marketed and sold our products primarily in the performance management market. In 2001, our product functionality was expanded to include both fault and performance management features to penetrate the fault management market. While sales of our fault and application products were approximately 20% of our license revenues for the fiscal quarter ended June 30, 2003, we still have a limited operating history in this expanded market upon which we can evaluate our business. The integrated fault and performance market is highly competitive and rapidly evolving. Additionally, many of our competitors in this new market have a longer operating history and greater resources. Our limited operating history and an uncertain economic climate due to worldwide economic conditions make the prediction of future results of operations difficult or impossible. Our prospects must be considered in light of the risks, costs, and difficulties frequently encountered by emerging companies operating in the highly competitive software industry.

**Failure to successfully integrate acquired companies may adversely impact our business.**

In July 2003, we completed the acquisition of netViz Corporation, a developer of software that enables customers to visualize business processes and allows them to map relationships within the supporting technology infrastructure through data-driven icons. The acquisition of netViz Corporation provides us the opportunity to integrate the netViz products with our existing products and to manage the continued marketing and selling of the netViz products as a distinct product set. Additionally, we must integrate the netViz personnel, manage operations with a workforce located in multiple locations, and retain netViz customers. Our efforts to integrate netViz may not be successful. This would adversely impact our business. This acquisition may adversely impact our business through:

- failure to successfully integrate the acquired products;
- failure to successfully integrate personnel and management structures;
- failure to retain key customers;
- loss of key employees;
- failure to effectively control costs associated with the integration;

**Table of Contents**

failure to meet expected timelines for product development and commercialization; and

exposure to liabilities of the acquired company that were not known or accurately evaluated by us prior to consummating the acquisition.

Even if the acquisition is successfully integrated, we may not fully realize all of the expected benefits of the acquisition, including the expected financial results or the expected benefits to our product line.

**We cannot ensure that our revenues will grow or that we will continue to be profitable.**

We have expended considerable resources to the research and development of new technologies and new or improved product features that have enabled us to penetrate new markets both in the United States and internationally. This investment in product development allowed the company to achieve revenue growth and profitability for the fiscal quarter ended June 30, 2003. Despite our results in the second fiscal quarter of 2003, we cannot ensure that we can generate revenue growth on a quarterly or annual basis, or that we can achieve or sustain any revenue growth in the future.

In an effort to retain profitability, we continue to work to reduce operating expenses while maintaining funding for product development. However, competition in the marketplace may require us to increase our operating expenses in the future in order to:

fund higher levels of research and development;

increase our sales and marketing efforts;

develop new distribution channels;

broaden our customer support capabilities;

expand our administrative resources in anticipation of future growth; and

respond to unforeseeable economic or business circumstances.

To the extent that increases in our expenses precede or are not followed by increased revenues, our profitability will be at risk.

In addition, in view of the rapidly evolving nature of our business and markets, the uncertain economic and geopolitical landscape, and our limited operating history in our current market, we believe that one should not rely on period-to-period comparisons of our financial results as an indication of our future performance.

**Our quarterly operating results may fluctuate.**

We are likely to experience significant fluctuations in our quarterly operating results caused by many factors, including, but not limited to:

changes in the demand for our products by customers or groups of customers;

the timing, composition, and size of orders from our customers, including the tendency for significant bookings to occur in the final two weeks of each fiscal quarter;

our customers' spending patterns and budgetary resources for our products;

geopolitical conditions in the world;

the success of our new customer generation activities;

introductions or enhancements of products, or delays in the introductions or enhancements of products, by us or our competitors;

changes in our pricing policies or those of our competitors;

**Table of Contents**

changes in the distribution channels through which our products are sold;

our success in anticipating and effectively adapting to developing markets and rapidly changing technologies;

our success in attracting, retaining, and motivating qualified personnel;

the publication of opinions about us and our products, or our competitors and their products, by industry analysts or others;

changes in general economic conditions; and

changes in accounting rules, such as recording expenses for employee stock option grants.

Though our service revenues have been increasing as a percentage of total revenues, we do not have a significant ongoing revenue stream that may mitigate quarterly fluctuations in operating results, as do other software companies with a longer history of operations. Increases in our revenues will also depend on our successful implementation of our distribution strategy as we attempt to expand our channels of distribution. There also may be other factors, such as seasonality and the timing of receipt and delivery of orders within a fiscal quarter, that significantly affect our quarterly results, which are often difficult to predict.

A significant portion of our product sales occurs in the final two weeks of each fiscal quarter. Any delay in the shipment of products near the end of the quarter may result in decreased revenues for the quarter. Additionally, intense competition and budgetary constraints placed upon our customers typically increase during the final two weeks of a fiscal quarter and may adversely affect our revenues for that quarter.

Due to all of the foregoing factors, we believe that our quarterly operating results are likely to vary significantly in the future. Therefore, in some future quarter our results of operations may fall below the expectations of securities analysts and investors. In such event, the trading price of our common stock will likely suffer.

**Our success is dependent upon sales to telecommunication carriers, service providers, and enterprise customers.**

We derive and likely will continue to derive a significant portion of our revenues from the sales of our products to telecommunication carriers, service providers, and enterprise customers. These markets worldwide have suffered from a turbulent economy during 2002 and the first half of fiscal 2003. We have been negatively affected by the general weakness in capital spending within these markets. The volume of sales of our products and services to telecommunication carriers, service providers, and enterprise customers may increase slower than we expect or may decrease.

**The market for application performance management software is emerging.**

The market for our application performance management software is in an early stage of development. Management of the end user's experience through optimizing the performance of computer applications is critical to our customers' business profitability and is the core of the information technology infrastructure management. Targeting this market is central to the development and marketing of our products, but this market is emerging and highly competitive, and it is difficult to assess:

the size of the application performance management market;

the appropriate features and prices for products to address this market;

the optimal distribution strategy; and

the market that will develop and the impact of large competitors within the market.

This market is very competitive and we are in direct competition with larger companies with substantially greater resources. These larger companies are able to devote considerable resources to the development of

**Table of Contents**

competitive products and the creation and maintenance of direct and indirect sales channels. The rapidly evolving application performance market and the continued presence of larger companies in this market may impact our ability to retain or increase our market share.

**The market for application availability and performance management software is emerging.**

The market for our application availability and performance solution is still in an early stage of development. Although the rapid expansion and increasing complexity of computer applications, systems, and networks in recent years have increased the demand for fault and performance management software products, the awareness of, and the demand for, an integrated fault and performance solution is a recent development; therefore, it is difficult to assess:

the size of this market;

the appropriate features and prices for products to address this market;

the optimal distribution strategy; and

the market that will develop and the impact of large competitors within the market.

The development of this market and our growth will depend significantly upon the desire and success of telecommunication carriers, managed services providers, and enterprises to integrate availability and performance management into their applications, systems, and networks. Moreover, this market is very competitive and we are in direct competition with larger companies with substantially greater resources. These larger companies are able to devote considerable resources to the development of competitive products and the creation and maintenance of direct and indirect sales channels. The presence of these larger companies in this market may impact our ability to retain or increase our market share.

**The market for our products is intensely competitive and rapidly evolving.**

The market for our products is intensely competitive and rapidly evolving. Our current and future competitors include:

application performance software vendors;

fault management software vendors;

IT visualization software vendors;

report toolset niche vendors;

enterprise management software, framework and platform providers;

software vendors providing service assurance for the wireless market;

large, well established management framework companies that have developed network or application management platforms;

developers of network element management solutions;

probe vendors;

telecommunications vendors;

system agent vendors; and

vendors that provide, as a service, some of the functionality of our products.

We expect competition to persist, increase, and intensify in the future which will likely result in price competition within our relevant market. If we do not provide products that achieve success in our market in the short

## **Table of Contents**

term, we could suffer an insurmountable loss in market share and brand name acceptance. We cannot ensure that we will compete effectively with current and future competitors.

### **Market acceptance of our eHealth® product family is critical to our success.**

We currently derive substantial product revenues from our eHealth® Suite product family, and we expect that revenues from these products will continue to account for substantially all of our product revenues in the foreseeable future. Broad market acceptance of these products is critical to our future success. We cannot ensure that market acceptance of our eHealth® Suite of products will increase or even remain at current levels. Factors that may affect the market acceptance of our integrated solution include:

the availability and price of competing integrated solutions, products and technologies;

the demand for integrated, as opposed to stand-alone, solutions; and

the success of our sales efforts and those of our marketing partners.

Moreover, if demand for integrated fault and performance management software products increases, we anticipate that our competitors will introduce additional competitive products and new competitors could enter our market and offer alternative products resulting in decreased market acceptance of our products.

### **We may need future capital funding.**

We plan to continue to expend substantial funds on the continued development, marketing, and sale of the eHealth® product family. While we have approximately \$80.4 million in short term investments (cash, cash equivalents and marketable securities), excluding restricted cash totaling \$539,000 as of June 30, 2003, we cannot ensure that our existing capital resources and any funds that may be generated from future operations together will be sufficient to finance our future operations or that other sources of funding will be available on terms acceptable to us, if at all. In addition, future sales of substantial amounts of our securities in the public market could adversely affect prevailing market prices and could impair our future ability to raise capital through the sale of our securities.

### **We must introduce product enhancements and new products on a timely basis.**

Because of rapid technological change in the software industry, potential changes in the architecture of the IT infrastructure, changes in the fault and performance management software market, and changes in industry standards, the market acceptance of versions of our eHealth® Suite is difficult to estimate. We cannot ensure that:

we will successfully develop and market enhancements to our eHealth® Suite or successfully develop new products that respond to technological changes, evolving industry standards, or customer requirements;

we will not experience difficulties that could delay or prevent the successful development, introduction, and sale of enhancements or new products; or

enhancements or new products will adequately address the requirements of the marketplace and achieve market acceptance.

### **The need for our products may decrease if manufacturers incorporate our product features into their product offerings.**

Our products manage the performance of computer applications, systems, and networks. Presently, manufacturers of both hardware and software have not implemented these management functions into their products in any significant manner. These products typically include, but are not limited to, operating systems, workstations, network devices, and software. If manufacturers begin to incorporate these management functions into their products it may decrease the value of our products and have a substantial impact on our business.

**Table of Contents**

**Current geopolitical instability and the continuing threat of domestic and international terrorist attacks may adversely impact our revenues.**

International tensions, exacerbated by the war in Iraq contribute to an uncertain political and economic climate, both in the United States and globally, which may affect our ability to generate revenue on a predictable basis. In addition, the continuing threat of terrorist attacks internationally has contributed to international tension and uncertainty, which has exacerbated the weakening of the worldwide economy. As we sell products both in the United States and internationally, the threat of future terrorist attacks may adversely affect our business.

**Our common stock price could experience significant volatility.**

The market price of our common stock may be highly volatile and could be subject to wide fluctuations in response to:

variations in results of operations;

announcements of technological innovations or new products by us or our competitors;

changes in financial estimates by securities analysts;

announcements of results of operations by other companies;

announcements by government or other agencies regarding the economic health of the United States and the rest of the world;

announcements relating to financial improprieties by public companies; or

other events or factors.

In addition, the financial markets have experienced significant price and volume fluctuations that have particularly affected the market prices of equity securities of many high technology companies and that often have been unrelated to the operating performance of such companies or have resulted from the failure of the operating results of such companies to meet market expectations in a particular quarter. Broad market fluctuations or any failure of our operating results in a particular quarter to meet market expectations may adversely affect the market price of our common stock leading to an increased risk of securities class action litigation. Such litigation could result in substantial costs and a diversion of our attention and resources.

**Our industry is subject to rapid technological change. Our success depends upon maintenance of standard protocols.**

The software industry is characterized by:

rapid technological change;

frequent introductions of new products;

changes in customer demands; and

evolving industry standards.

The introduction of products embodying new technologies and the emergence of new industry standards can render existing products and integrated solutions obsolete and unmarketable. While we actively work to develop products that operate with standard protocols, any change in industry standards or the emergence of new network technologies could affect the compatibility of our products, which in turn could affect the demand for, or the pricing of, our products and solutions.

**We rely on strategic partners and other evolving distribution channels.**

Our distribution strategy is to develop multiple distribution channels, including sales through:

**Table of Contents**

strategic marketing partners;

value added resellers;

system integrators;

telecommunication carriers;

original equipment manufacturers; and

independent software vendors and international distributors.

We have developed a number of these relationships and intend to continue to develop new channel partner relationships. We have focused on identifying and developing our key distribution partners worldwide to maximize the success of our indirect sales. As part of this process, we have decreased the total number of distributors selling our products, but increased the quality and focus of our most valuable distributors through improved training and development programs. Our success will depend in large part on our development of these more focused distribution relationships and on the performance and success of these third parties, particularly telecommunication carriers and other network service providers. We sell our products in the United States through both direct sales to customers and indirect sales to customers through our channel partners. Outside the United States, we sell our products primarily through indirect sales via our channel partners. Our international channel partners are located in Europe, the Middle East, Africa, Asia, and North and South America and are subject to local laws, regulations, and customs that may make it difficult to accurately assess the potential revenues that can be generated from a certain market. Our success depends upon our ability to attract and retain valuable channel partners and to accurately assess the size and vitality of the markets in which our products are sold. While we have implemented policies and procedures to achieve this, we cannot predict the extent to which we are able to attract and retain financially stable, motivated channel partners. Additionally, our channel partners may not be successful in marketing and selling our products. We may:

fail to attract important and effective channel partners;

fail to penetrate our targeted market segments through the use of channel partners; or

lose any of our channel partners, as a result of competitive products offered by other companies, products developed internally by these channel partners, their financial insolvency or otherwise.

**We may fail to manage successfully the growth of our business.**

We have experienced employee turnover in our sales and operations personnel; our products have become increasingly complex; and our product distribution channels are being developed and expanded. The rapid evolution of our markets and the increasing complexity of our products has placed, and is likely to continue to place, significant strains on our administrative, operational, and financial resources and increase demands on our internal systems, procedures, and controls that may impact our ability to grow our business.

**Our success depends on our retention of key personnel.**

Our performance depends substantially on the performance of our key technical, senior management, and sales and marketing personnel. We may lose the services of any of such persons. Our success depends on our continuing ability to identify, hire, train, motivate, and retain highly qualified management, technical, and sales and marketing personnel. Despite current weak economic conditions, we experience intense competition for such personnel and are constantly exploring new avenues for attracting and retaining key personnel. However, we cannot ensure that we will successfully attract, assimilate, or retain highly qualified technical, managerial or sales and marketing personnel in the future.

**Our failure to continue to expand into international markets could harm our business.**

## **Table of Contents**

We intend to continue to expand our operations outside of the United States and enter additional international markets, primarily through the establishment of channel partner arrangements. As mentioned above, we have concentrated recently on developing more focused relationships with fewer key distributors. We expect to commit additional time and development resources to customizing our products and services for selected international markets and to developing international sales and support channels. We cannot ensure that such efforts will be successful.

We face certain difficulties and risks inherent in doing business internationally, including, but not limited to:

- costs of customizing products and services for international markets;
- dependence on independent resellers;
- multiple and conflicting regulations;
- exchange controls;
- longer payment cycles;
- unexpected changes in regulatory requirements;
- import and export restrictions and tariffs;
- difficulties in staffing and managing international operations;
- greater difficulty or delay in accounts receivable collections;
- potentially adverse tax consequences;
- compliance with a variety of laws outside the United States;
- the impact of possible recessionary environments in economies outside the United States;
- political and economic instability; and
- exposure to foreign currency fluctuations.

Our successful expansion into certain countries will require additional modification of our products, particularly national language support. Presently, the majority of our current export sales are denominated in United States dollars. To the extent that international sales continue to be denominated in United States dollars, an increase in the value of the United States dollar relative to other currencies could make our products and services more expensive and, therefore, potentially less competitive in international markets. In certain European Union countries, however, we have introduced pricing in Euros. While we do maintain a foreign currency hedging program on accounts receivable, to the extent that future international sales are denominated in foreign currency, our operating results will be subject to risks associated with foreign currency fluctuation. Additionally, as we increase our international sales, seasonal fluctuations in revenue generation resulting from lower sales that typically occur during the summer months in Europe and other parts of the world may affect our total revenues.

### **Our failure to protect our intellectual property rights may harm our competitive position.**

Our success depends significantly upon our proprietary technology. We rely on a combination of patent, copyright, trademark and trade secret laws, non-disclosure agreements, and other contractual provisions to establish, maintain, and protect our proprietary rights. These means afford only limited protection.

We have nine issued and twelve pending U.S. patents, and various foreign counterparts as of June 30, 2003. We cannot ensure that patents will issue from our pending applications or from any future applications or that, if issued, any claims allowed will be sufficiently broad to protect our technology. In addition, we cannot ensure that any patents that have been or may be issued will not be challenged, invalidated or circumvented, or that any rights granted by those patents would protect our proprietary rights. Failure of any patents to protect our technology may make it easier for our competitors to offer equivalent or superior technology.

**Table of Contents**

We have sought also to protect our intellectual property through the use of copyright, trademark, and trade secret laws. Despite our efforts to protect our proprietary rights, unauthorized parties may attempt to copy aspects of our products or services, or to obtain and use information that we regard as proprietary. Third parties may also independently develop similar technology without breach of our proprietary rights.

In addition, the laws of some foreign countries do not protect proprietary rights to as great an extent as do the laws of the United States. In addition, many of our products are licensed under end user license agreements (also known as shrinkwrap licenses) that are not signed by licensees. The law governing the enforceability of shrinkwrap license agreements is not settled in most jurisdictions. There can be no guarantee that we would achieve success in enforcing one or more shrinkwrap license agreements if we sought to do so in a court of law.

**We license certain technologies from third parties.**

We license from third parties, generally on a non-exclusive basis, certain technologies used in our products. The termination of any such licenses, or the failure of the third-party licensors to adequately maintain or update their products, could result in delay in our shipment of certain of our products while we seek to implement technology offered by alternative sources, and any required replacement licenses could prove costly. While it may be necessary or desirable in the future to obtain other licenses relating to one or more of our products or relating to current or future technologies, we cannot ensure that we will be successful in doing so on commercially reasonable terms or at all.

We have started shipping Oracle® software as the database on which the eHealth® Suite runs. While we believe the switch to Oracle will make our products even more robust and we are comfortable with the choice of Oracle as a database vendor, there is no guarantee that our customers will readily accept this change. As with any vendor, there also is no guarantee that Oracle will be able to continue to deliver to us an acceptable database solution, nor that the product Oracle delivers will continue to interface effectively in conjunction with our eHealth Suite of products.

**Intellectual property infringement claims would harm our business.**

Although we do not believe that we are infringing upon the intellectual property rights of others, claims of infringement are becoming increasingly common as the software industry develops legal protections for software products. Litigation may be necessary to protect our proprietary technology, and third parties may assert infringement claims against us with respect to their proprietary rights. Any claims or litigation can be time-consuming and expensive regardless of their merit. Infringement claims against us can cause product release delays, require us to redesign our products, or require us to enter into royalty or license agreements which may not be available on terms acceptable to us or at all.

**We may not have sufficient protection against product liability claims.**

Because our products are used by our customers to identify and predict current and future application, system, and network problems and to avoid failures of the network to support critical business functions, design defects, software errors, misuse of our products, incorrect data from network elements, or other potential problems, within or out of our control, may arise from the use of our products and could result in financial or other damages to our customers. Our license agreements with our customers typically contain provisions designed to limit our exposure to potential claims as well as any liabilities arising from such claims. As a matter of practice, our license agreements limit our liability in regards to product liability claims, and in many agreements, our maximum liability for product liability claims is limited to the equivalent of the cost of the products licensed under that agreement. However, any litigation or similar procedure related to a product liability claim may require considerable resources to be expended that could adversely affect our business and financial condition and decrease future revenues.

**The conviction of Arthur Andersen LLP may limit potential recoveries related to their prior service as our independent auditors.**

Arthur Andersen LLP served as our independent auditors until June 10, 2002. On June 15, 2002, Arthur Andersen LLP was found guilty on federal obstruction of justice charges arising from the government s

**Table of Contents**

investigation of Enron Corporation. Following this indictment, Arthur Andersen LLP informed the SEC that it would cease its operations. On June 10, 2002, we dismissed Arthur Andersen LLP and on June 11, 2002, we retained PricewaterhouseCoopers LLP as our independent auditors. Securities and Exchange Commission ( SEC ) rules require us to present historical audited financial statements in various SEC filings, such as registration statements, along with consents from Arthur Andersen LLP to include its audit report in those filings. In light of the cessation of Arthur Andersen LLP 's SEC practice, we will not be able to obtain the consent of Arthur Andersen LLP for the inclusion of its audit report in our relevant current and future filings. The SEC has provided regulatory relief designed to allow companies that file reports with the SEC to dispense with the requirement to file a consent of Arthur Andersen LLP in certain circumstances, but purchasers of securities sold under our registration statements, which were not filed with the consent of Arthur Andersen LLP for the inclusion of its audit report will not be able to file suit against Arthur Andersen LLP pursuant to Section 11(a)(4) of the Securities Act and therefore their right of recovery under that section may be limited as a result of the lack of our ability to obtain the consent of Arthur Andersen LLP.

**Limitations on the effectiveness of controls.**

The Company 's management, including the Chief Executive Officer and the Chief Financial Officer, does not expect that our disclosure controls or our internal controls will prevent all errors and intentional misrepresentations. 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, 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 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 control. 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 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 intentional conduct may occur and not be detected.

**Table of Contents****ITEM 3. Quantitative and Qualitative Disclosures about Market Risk*****(a) Market and Interest Rate Risk***

Most of Concord's current export sales are denominated in United States dollars. To the extent that a majority of our international sales continue to be denominated in United States dollars, an increase in the value of the United States dollar relative to other currencies could make our products and services more expensive and, therefore, potentially less competitive in international markets. Substantially all of our business outside the United States is conducted in U.S. dollar-denominated transactions, whereas our operating expenses in our international branches are denominated in local currency. We believe that the operating expenses of our foreign operations are immaterial, and therefore any associated market risk is unlikely to have a material adverse effect on our business, results of operations or financial condition.

All of the Company's investments are in investment grade securities with high credit ratings of relatively short duration that trade in highly liquid markets and are carried at fair value on the Company's books. Accordingly, the Company has no quantitative information concerning the market risk of participating in such investments. Due to the short-term nature of our investments, we believe we have minimal market risk. The Company's investment portfolio of cash equivalents and marketable securities is subject to interest rate fluctuations, but the Company believes this risk is immaterial due to the short-term nature of these investments.

***(b) Foreign Currency Exchange Rate Risk***

We use forward contracts to reduce our exposure to foreign currency risk due to fluctuations in exchange rates underlying the value of accounts receivable denominated in foreign currencies held until such receivables are collected. A forward contract obligates us to exchange predetermined amounts of specified foreign currencies at specified exchange rates on specified dates. These forward contracts, to qualify as hedges of existing assets, are denominated in the same currency in which the underlying foreign currency receivables are denominated and bear a contract value and maturity date that approximate the value and expected settlement date, respectively, of the underlying transactions. For contracts that are designated and effective as hedges, unrealized gains and losses on open contracts at the end of each accounting period, resulting from changes in the fair value of these contracts, are recognized in earnings in the same period as gains and losses on the underlying foreign denominated receivables are recognized and generally offset.

We do not enter into or hold derivatives for trading or speculative purposes, and we only enter into contracts with highly-rated financial institutions. At June 30, 2003, the Company had one forward contract outstanding, which is presented in the table below. The notional exchange rate is quoted using market conventions where the currency is expressed in currency units per U.S. dollar.

<u>Currency</u>	<u>Position</u>	<u>Maturity Date</u>	<u>Notional Amount</u>	<u>Notional Exchange Rate</u>	<u>Fair Market Value as of June 30, 2003</u>
Euro	Sell	8/29/03	\$ 108,000	1.1474	\$ 123,000

We plan to continue to utilize forward contracts and other instruments in the future to reduce our exposure to exchange rate fluctuations from accounts receivable denominated in foreign currencies, and we may not be able to do this successfully. Accordingly, we may experience economic loss and a negative impact on earnings and equity as a result of foreign currency exchange rate fluctuations.

**Table of Contents**

**ITEM 4. Controls and Procedures**

*(a) Evaluation of Disclosure Controls and Procedures.*

As of the end of the period covered by this report, the Company carried out an evaluation, under the supervision and with the participation of the Company's management, including the Company's President and Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of the Company's disclosure controls and procedures, as defined in Exchange Act Rule 15d-14(c). Based upon that evaluation, the Company's President and Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures are effective in enabling the Company to record, process, summarize, and report information required to be included in the Company's periodic SEC filings within the required time period.

*(b) Changes in Internal Controls.*

There were no significant changes in the Company's internal controls or to our knowledge, in other factors that could significantly affect our disclosure controls and procedures subsequent to the Evaluation Date (as defined in the Statement of Principal Executive Officer).

**Table of Contents**

**CONCORD COMMUNICATIONS, INC.  
FORM 10-Q, June 30, 2003**

**PART II: OTHER INFORMATION**

**Item 1. Legal Proceedings**

The Company is not a party to any litigation that it believes could have a material adverse effect on the business, results of operations or financial condition of the Company.

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

(a) Use of Proceeds

On October 16, 1997, the Company commenced an initial public offering ( IPO ) of 2,900,000 shares of Common Stock, pursuant to the Company's final prospectus dated October 15, 1997 (the Prospectus ). The Prospectus was contained in the Company's Registration Statement on Form S-1, which was declared effective by the Securities and Exchange Commission (SEC File No. 333-33227) on October 15, 1997. Of the 2,900,000 shares of Common Stock offered, 2,300,000 shares were offered and sold by the Company and 600,000 shares were offered and sold by certain shareholders of the Company. As part of the IPO, the Company granted the several underwriters an over allotment option to purchase up to an additional 435,000 shares of Common Stock (the Underwriters' Option ). The IPO closed on October 21, 1997 upon the sale of 2,900,000 shares of Common Stock to the underwriters. On October 24, 1997, the Representatives, on behalf of the several underwriters, exercised the Underwriters' Option, purchasing 435,000 additional shares of Common Stock from the Company. The aggregate offering price of the shares of Common Stock in the IPO to the public was \$40,600,000 (exclusive of the Underwriters' Option), with proceeds to the Company and selling shareholders, after deduction of the underwriting discount, of \$29,946,000 (before deducting offering expenses payable by the Company) and \$7,812,000 respectively. The aggregate offering price of the Underwriters' Option exercised was \$6,090,000, with proceeds to the Company, after deduction of the underwriting discount, of \$5,663,700 (before deducting offering expenses payable by the Company). The aggregate amount of expenses incurred by the Company in connection with the issuance and distribution of the shares of Common Stock offered and sold in the IPO were approximately \$3.6 million, including \$2.7 million in underwriting discounts and commissions and \$950,000 in other offering expenses. The net proceeds to the Company from the IPO, after deducting underwriting discounts and commissions and other offering expenses, were approximately \$34.7 million. To date, the Company has not utilized any of the net proceeds from the IPO. The Company has invested all such net proceeds primarily in US treasury obligations and other interest bearing investment grade securities.

**Item 3. Defaults Upon Senior Securities**

*Not Applicable*

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

*No matters were submitted to a vote of security holders during the three months ended June 30, 2003.*

**Item 5. Other Information**

*Not Applicable*

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

**Table of Contents**

(a) *Exhibits*

The exhibits listed in the accompanying Exhibit Index on page 38 and 39 are filed, furnished or incorporated by reference as part of this Report.

(b) *Reports on Form 8-K*

Current Report on Form 8-K furnished to the Commission on April 15, 2003, furnished information under Item 9 of Form 8-K rather than Item 12 of Form 8-K pursuant SEC Release No. 33-8126.

Current Report on Form 8-K furnished to the Commission on April 17, 2003, furnished information under Item 9 of Form 8-K rather than Item 12 of Form 8-K pursuant SEC Release No. 33-8126.

Current Report on Form 8-K furnished to the Commission on July 15, 2003, furnished information under Item 9 of Form 8-K rather than Item 12 of Form 8-K pursuant SEC Release No. 33-8126.

**Table of Contents**

**CONCORD COMMUNICATIONS, INC.  
FORM 10-Q, June 30, 2003**

**SIGNATURE**

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

Concord Communications, Inc.

/s/ Melissa H. Cruz

August 7, 2003

---

Name: Melissa H. Cruz  
Title: Executive Vice President, Business Services  
Chief Financial Officer and Treasurer

(Principal Financial Officer and Principal  
Accounting Officer)

**Table of Contents****EXHIBIT INDEX**

The following designated exhibits are either filed herewith or, where information is provided under the SEC Document Reference heading corresponding to such exhibit, incorporated by reference to such filing

<b>Exhibit No.</b>	<b>Description</b>	<b>SEC Document Reference</b>
3.01	Restated Articles of Organization of the Company	Exhibit No. 3.01 on Form 10-K, for the period ended December 31, 1997
3.02	Restated By-laws of the Company	Exhibit No. 3.02 on Form 10-K, for the period ended December 31, 1998
10.01	Working Capital Loan Agreement between the Company and Silicon Valley Bank dated April 3, 1997	Exhibit No. 10.01 to Registration Statement on Form S-1 (No. 333-33227)
10.02	Revolving Promissory Note made by the Company in favor of Silicon Valley Bank	Exhibit No. 10.02 to Registration Statement on Form S-1 (No. 333-33227)
10.03	Equipment Line of Credit Letter Agreement between the Company and Fleet Bank dated as of June 9, 1997	Exhibit No. 10.03 to Registration Statement on Form S-1 (No. 333-33227)
10.04	1995 Stock Plan of the Company	Exhibit No. 10.04 to Registration Statement on Form S-1 (No. 333-33227)
10.05	1997 Stock Plan of the Company	Exhibit No. 10.01 on Form 10-Q, for the period ended June 30, 1998
10.06	1997 Stock Plan of the Company, as amended on March 12, 1998, March 1, 1999, May 15, 1999 and March 8, 2000	Exhibit No. 10.06 on Form 10-K, for the period ended December 31, 2000
10.07	1997 Employee Stock Purchase Plan of the Company	Exhibit No. 10.06 to Registration Statement on Form S-1 (No. 333-33227)
10.08	1997 Non-Employee Director Stock Option Plan as amended on March 8, 2000 and April 25, 2001	Exhibit No. 10.08 on Form 10-Q filed on August 13, 2002
10.09	The Profit Sharing/401(K) Plan of the Company	Exhibit No. 10.08 to Registration Statement on Form S-1 (No. 333-33227)
10.10	Lease Agreement between the Company and John Hancock Mutual Life Insurance Company dated March 17, 1994, as amended on March 25, 1997	Exhibit No. 10.09 to Registration Statement on Form S-1 (No. 333-33227)
10.11	First Amendment to Lease Agreement between the Company and John Hancock Mutual Life Insurance Company dated March 25, 1997	Exhibit No. 10.10 to Registration Statement on Form S-1

## Edgar Filing: CONCORD COMMUNICATIONS INC - Form 10-Q

10.12	Form of Indemnification Agreement for directors and officers of the Company	(No. 333-33227) Exhibit No. 10.11 to Registration Statement on Form S-1
10.13	Restated Common Stock Registration Rights Agreement between the Company and certain investors dated August 7, 1986	(No. 333-33227) Exhibit No. 10.12 to Registration Statement on Form S-1
10.14	Amended and Restated Registration Rights Agreement between the Company and certain investors dated December 28, 1995	(No. 333-33227) Exhibit No. 10.13 to Registration Statement on Form S-1
10.15	Management Change in Control Agreement between the Company and John A. Blaeser dated as of August 7, 1997	(No. 333-33227) Exhibit No. 10.14 to Registration Statement on Form S-1
10.16	Management Change in Control Agreement between the Company and Kevin J. Conklin dated as of July 23, 1997	(No. 333-33227) Exhibit No. 10.15 to Registration Statement on Form S-1
10.17	Management Change in Control Agreement between the Company and Ferdinand Engel dated as of July 23, 1997	(No. 333-33227) Exhibit No. 10.16 to Registration Statement on Form S-1
10.18	Management Change in Control Agreement between the Company and Gary E. Haroian dated as of July 23, 1997	(No. 333-33227) Exhibit No. 10.17 to Registration Statement on Form S-1
10.19	Management Change in Control Agreement between the Company and Melissa H. Cruz dated as of June 12, 2000	(No. 333-33227) Exhibit No. 10.18 on Form 10-Q filed on August 14, 2000
10.20	Management Change in Control Agreement between the Company and Daniel D. Phillips, Jr. dated as of July 23, 1997	Exhibit No. 10.18 to Registration Statement on Form S-1
10.21	Stock Option Agreement dated January 1, 1996 between the Company and John A. Blaeser	(No. 333-33227) Exhibit No. 10.19 to Registration Statement on Form S-1
10.22	Stock Option Agreement dated January 1, 1996 between the Company and John A. Blaeser	(No. 333-33227) Exhibit No. 10.20 to Registration Statement on Form S-1
10.23	Letter Agreement between the Company and Silicon Valley Bank dated March 25, 1996 together with the Loan Modification Agreement dated November 14, 1996	(No. 333-33227) Exhibit No. 10.21 to Registration Statement on Form S-1
10.24	Form of Shrink-Wrap License	(No. 333-33227) Exhibit No. 10.22 to Registration Statement on Form S-1
10.25	Agreement and Plan of Reorganization dated as of October 19, 1999 by and among Concord Communications, Inc., E Acquisition Corp., Empire Technologies, Inc. and the stockholders of Empire Technologies, Inc.	(No. 333-33227) Exhibit No. 2.1 on Form 8-K filed on November 12, 1999
10.26	Agreement and Plan of Reorganization dated as of January 20, 2000 by and among Concord Communications, Inc., F Acquisition Corp., and FirstSense Software, Inc.	Exhibit No. 2.1 on Form 8-K filed on February 10, 2000



**Table of Contents**

<b>Exhibit No.</b>	<b>Description</b>	<b>SEC Document Reference</b>
10.27	Registration Rights Agreement dated as of February 4, 2000 by and among Concord Communications, Inc. and Timothy Barrows, as Securityholder Agent	Exhibit No. 99.1 on Form 8-K filed on February 10, 2000
10.28	2000 Non-Executive Employee Equity Incentive Plan	Exhibit 10.28 on Form 10-K, for the period ended December 31, 2000
10.29	Management Change in Control Agreement between the Company and Ellen Kokos dated as of February 2, 2001	Exhibit No. 10.29 on Form 10-Q filed on May 9, 2001
10.30	Management Change in Control Agreement between the Company and John F. Hamilton dated as of April 16, 2001	Exhibit No. 10.30 on Form 10-Q filed July 31, 2001
10.31	2001 Non-Executive Employee Stock Purchase Plan	Exhibit No. 10.31 on Form 10-Q filed on November 5, 2001
10.32	Management Agreement between the Company and John Hamilton dated May 6, 2002	Exhibit No. 10.32 on Form 10-Q filed on August 13, 2002
10.33	Management Agreement between the Company and Kevin Conklin dated September 9, 2002	Exhibit No. 10.33 on Form 10-Q filed on November 5, 2002
10.34	Management Change in Control Agreement between the Company and Douglas Batt dated as of November 18, 2002	Exhibit No. 10.34 on Form 10-K, for the period ended December 31, 2002
10.35	Management Change in Control Agreement between the Company and Daniel Sheahan dated as of November 18, 2002	Exhibit No. 10.35 on Form 10-K, for the period ended December 31, 2002
10.36	Employment Agreement dated August 10, 2001	Exhibit No. 10.36 on Form 10-K, for the period ended December 31, 2002
31.1	Certification of John A. Blaeser pursuant to Section 302 of the Sarbanes-Oxley Act of 2002	Exhibit No. 31.1 on Form 10-Q for the period ended June 30, 2003
31.2	Certification of Melissa H. Cruz pursuant to Section 302 of the Sarbanes-Oxley Act of 2002	Exhibit No. 31.2 on Form 10-Q for the period ended June 30, 2003
32.1	Certification of John A. Blaeser pursuant to Section 906 of the Sarbanes-Oxley Act of 2002	Exhibit No. 32.1 on Form 10-Q for the period ended June 30, 2003
32.2	Certification of Melissa H. Cruz pursuant to Section 906 of the Sarbanes-Oxley Act of 2002	Exhibit No. 32.2 on Form 10-Q for the period ended June 30, 2003