SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

Form 10-Q

[X] **QUARTERLY REPORT UNDER SECTION 13 or 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the Quarter Ended March 30, 2002

OR

[ ] **TRANSITION REPORT PURSUANT TO SECTION 13 or 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

Commission File Number 1-10228

Enterasys Networks, Inc.
(Exact name of registrant as specified in its charter)

Delaware	**04-2797263**
(State or other jurisdiction of incorporation or organization)	*(I.R.S. Employer Identification No.)*

35 Industrial Way
Rochester, New Hampshire 03866
(603) 332-9400
(Address, including zip code, and telephone number, including area code, of registrant's principal executive offices)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months, (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes [ ] No [X]

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12-2 in the Exchange Act) Yes [X] No [ ]

As of January 10, 2003, there were 201,966,247 shares of the Registrant's common stock, $0.01 par value, outstanding.

Explanatory Statement

This quarterly report on Form 10-Q contains consolidated financial statements for the quarterly period ended June 2, 2001 which have previously been restated. On November 26, 2002, we filed our transition report on Form 10-K for the ten-month transition period ended December 29, 2001. The Form 10-K contained restated consolidated financial statements for the fiscal year ended March 3, 2001 and certain restated financial information with respect to the quarters within that fiscal year and within the ten-month transition period ended December 29, 2001.

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PART I — FINANCIAL INFORMATION

Item 1. Consolidated Financial Statements

ENTERASYS NETWORKS, INC.
CONSOLIDATED BALANCE SHEETS

(In thousands, except share and per share amounts)	March 30, 2002 (unaudited)	December 29, 2001	June 2, 2001 (unaudited) (restated)
ASSETS			
Current assets:			
Cash and cash equivalents	$ 92,147	$ 114,800	$ 218,648
Marketable securities	69,037	47,532	98,583
Accounts receivable, net	49,821	67,698	110,714
Inventories, net	112,887	118,214	116,974
Income tax receivable	119,075	—	—
Prepaid expenses and other current assets	28,363	25,368	155,814
Current portion of notes receivable	1,000	15,000	14,152
Assets of discontinued operations	40,356	103,415	363,843
Total current assets	512,686	492,027	1,078,728
Long-term portion of notes receivable	—	—	7,125
Restricted cash, cash equivalents and marketable securities	23,599	27,882	25,248
Long-term marketable securities	70,277	63,920	163,279
Investments	63,990	63,684	115,926
Property, plant and equipment, net	57,062	56,924	64,777
Intangible assets, net	43,424	45,601	171,821
Total assets	$ 771,038	$ 750,038	$1,626,904
LIABILITIES, REDEEMABLE CONVERTIBLE PREFERRED STOCK AND STOCKHOLDERS' EQUITY			
Current liabilities:			
Accounts payable	$ 64,777	$ 74,764	$ 43,354
Accrued expenses	97,818	78,162	68,990
Deferred revenue	75,736	77,376	60,655
Customer advances and billings in excess of revenues	15,215	56,115	—
Income taxes payable	64,119	37,970	53,314
Liabilities of discontinued operations	20,981	33,316	66,303
Total current liabilities	338,646	357,703	292,616
Deferred income taxes	—	—	1,199
Total liabilities	338,646	357,703	293,815
Commitments and contingencies			
Contingent redemption value of common stock put options	—	842	—
Redeemable convertible preferred stock, $1.00 par value, 65,000 shares of Series D and 25,000 shares of Series E were designated, issued and outstanding at March 30, 2002 and December 29, 2001 (aggregate liquidation preference of Series D and E at March 30, 2002, $69,226 and $26,629, respectively, and $68,542 and $26,356, respectively, at December 29, 2001) 65,000 shares of Series A, 25,000 shares of Series B and 45,471 shares of Series C were designated, issued and outstanding at June 2, 2001 (aggregate liquidation preference of Series A and B at June 2, 2001, $66,967 and $25,760, respectively)	79,665	61,789	112,669
Stockholders' equity:			
Undesignated preferred stock, $1.00 par value. Authorized 1,859,000 shares	—	—	—
Common stock, $0.01 par value. Authorized 450,000,000 shares; issued 204,143,533, 202,941,544 and 191,513,438 shares, respectively	2,041	2,029	1,915
Additional paid-in capital	1,174,848	1,141,089	997,869
Retained earnings (accumulated deficit)	(761,895)	(748,199)	293,134

Unearned stock-based compensation	(1,780)	(2,802)	(14,439)
Treasury stock, at cost (3,053,201 common shares at March 30, 2002 and December 2001 and 2,150,000 common shares at June 2, 2001)	(64,890)	(64,890)	(57,732)
Accumulated other comprehensive income (loss)	4,403	2,477	(327)
Total stockholders' equity	352,727	329,704	1,220,420
Total liabilities, redeemable convertible preferred stock and stockholders' equity	$ 771,038	$ 750,038	$1,626,904

See accompanying notes to consolidated financial statements.

ENTERASYS NETWORKS, INC.
CONSOLIDATED STATEMENTS OF OPERATIONS
(unaudited)

(In thousands, except per share amounts)	Three months ended March 30, 2002	Three months ended June 2, 2001 (restated)
Net revenue:		
Product	$ 85,025	$142,068
Services	35,741	39,582
Total revenue	120,766	181,650
Cost of revenue:		
Product	62,764	82,129
Services	9,682	11,608
Total cost of revenue	72,446	93,737
Gross margin	48,320	87,913
Operating expenses:		
Research and development(a)	25,537	20,799
Selling, general and administrative	65,628	75,326
Amortization of intangible assets	2,177	10,378
Stock-based compensation	1,021	1,630
Total operating expenses	94,363	108,133
Loss from operations	(46,043)	(20,220)
Interest income, net	1,958	6,539
Other income (expense), net	(15,780)	20,131
Income (loss) from continuing operations before income taxes and cumulative effect of a change in accounting principle	(59,865)	6,450
Income tax expense (benefit)	(61,039)	2,910
Income from continuing operations before cumulative effect of a change in accounting principle	1,174	3,540
Discontinued operations:		
Operating loss (net of tax benefit of $4,229)	—	(11,112)
Loss on disposal (net of tax benefit of $0)	(11,700)	—
Loss from discontinued operations	(11,700)	(11,112)
Cumulative effect of a change in accounting principle (net of tax expense of $4,950)	—	7,741
Net income (loss)	(10,526)	169
Accretive dividend and accretion of discount on preferred shares	(3,170)	(3,067)
Net loss available to common shareholders	$ (13,696)	$ (2,898)
Basic and diluted income (loss) per common share:		
Income (loss) from continuing operations available to common shareholders	$ (0.01)	$ —
Loss from discontinued operations	(0.06)	(0.06)
Cumulative effect of a change in accounting principle	—	0.04
Net loss available to common shareholders	$ (0.07)	$ (0.02)
Weighted average number of common shares outstanding:		
Basic	200,742	188,833
Diluted	200,742	192,103

(a) Excludes non-cash, stock-based compensation expense.

See accompanying notes to consolidated financial statements.

ENTERASYS NETWORKS, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS
(unaudited)

(In thousands)	Three months ended March 30, 2002	Three months ended June 2, 2001 (restated)
Cash flows from operating activities:		
Net income (loss)	$ (10,526)	$ 169
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:		
Loss from discontinued operations	11,700	11,112
Depreciation and amortization	11,225	19,659
Provision for losses on accounts receivable	(1,585)	900
Provision for excess and obsolete inventory	—	9,804
Deferred income taxes	—	(299)
Stock-based compensation	1,021	1,630
Net realized gain on sale of securities	—	(60,151)
Gain on expiration of put options	(842)	—
Loss on investment write-downs	424	20,453
Unrealized loss on Riverstone stock derivative	14,706	—
Changes in current assets and liabilities:		
Accounts receivable	19,462	26,101
Inventories	5,327	(35,811)
Prepaid expenses and other assets	(2,996)	(11,108)
Accounts payable and accrued expenses	(13,784)	(37,456)
Customer advances and billings in excess of revenues	(40,900)	—
Deferred revenue	(1,640)	(27,787)
Income taxes payable, net	(60,517)	1,920
Net cash used in operating activities	(68,925)	(80,864)
Cash flows from investing activities:		
Capital expenditures	(9,186)	(4,838)
Proceeds from sale of minority investments	947	—
Cash paid for minority investments	(1,677)	(18,790)
Purchase of available-for-sale securities	(49,058)	(48,332)
Sales/maturities of marketable securities	64,582	327,114
Net cash provided by investing activities	5,608	255,154
Cash flows from financing activities:		
Cash flows related to discontinued operations	23,115	(15,170)
Common stock issued pursuant to employee stock purchase plans	—	4,438
Payments from notes receivable	14,000	1,723
Issuance of notes receivable	—	(13,000)
Repurchase of common stock	—	(1,253)
Proceeds from exercise of stock options	3,506	4,395
Net cash provided by (used in) financing activities	40,621	(18,867)
Effect of exchange rate changes on cash	43	(1,153)
Net (decrease) increase in cash and cash equivalents	(22,653)	154,270
Cash and cash equivalents at beginning of period	114,800	64,378
Cash and cash equivalents at end of period	$ 92,147	$218,648
Supplemental disclosure of cash flow information:		
Cash refunds on income taxes	$ 530	$ 50
Non-cash transactions:		
Accretive dividend and accretion of discount on preferred shares	$ 3,170	$ 3,067
Inventory exchanged for investments	$ —	$ 6,839

See accompanying notes to consolidated financial statements.

ENTERASYS NETWORKS, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (unaudited)

1. Basis of Presentation

The accompanying unaudited consolidated financial statements of Enterasys Networks, Inc. and its subsidiaries (the "Company") have been prepared in accordance with the instructions to Form 10-Q and Article 2 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. In the opinion of management, all adjustments necessary for a fair presentation of the results of operations for the interim periods presented have been reflected herein. The results of operations for the interim periods are not necessarily indicative of the results to be expected for the entire year. Certain prior period balances have been reclassified to conform to the current period presentation. The accompanying financial statements should be read in conjunction with the consolidated financial statements and footnotes thereto included in the Company's Transition Report on Form 10-K for the transition period ended December 29, 2001 filed with the SEC on November 26, 2002.

On September 28, 2001, the Company's Board of Directors amended the by-laws to change the Company's fiscal year-end from the Saturday closest to the last day in February of each year to the Saturday closest to the last day in December of each year, and the Company filed a Form 10-K for the ten-month transition period ended December 29, 2001. The Company has filed this Form 10-Q for the three-month period ended on March 30, 2002, which is the first quarter of fiscal year 2002. The Company did not include comparable three-month financial information for the period December 30, 2000 through March 31, 2001, because it was impracticable to do so due to certain inherent limitations in the Company's interim monthly closing process and the complexity of the restatement of the Company's quarterly 2001 financial statements.

2. Restatement

On January 31, 2002, the Company discovered that a previously recognized $4.0 million sale in its Asia Pacific region did not qualify for revenue recognition during the period in which the Company had originally reported the revenue. Also on January 31, 2002, the Company learned that the SEC had opened a formal order of investigation into the financial accounting and reporting practices of the Company and its affiliates. In response to these developments, the Company's Board of Directors formed a Special Committee to conduct an internal review into the Company's financial accounting and reporting for the fiscal year ended March 3, 2001 and the ten-month transition period ended December 29, 2001. The Special Committee appointed the law firm of Ropes & Gray to conduct the internal review, and Ropes & Gray hired the forensic accounting group of Deloitte & Touche LLP to assist with the internal review. The Special Committee has completed the internal review, and the Company has restated its financial statements for the fiscal year ended March 3, 2001, the fiscal quarters within that fiscal year, and the first three fiscal quarters within the ten-month transition period ended December 29, 2001. The restatements are included in the Company's Transition Report on Form 10-K filed with the SEC on November 26, 2002. The principal adjustments to restate the financial statements for the three months ended June 2, 2001 were as follows:

Sales/Investment Transactions

The Company entered into a number of transactions in which it made an investment in a customer in exchange for cash and/or the Company's products and services. The amounts originally recorded by the Company relating to a number of these transactions were in error. The Company reviewed all investment transactions and corrected the amount recorded for each transaction for which an error was noted. In making those corrections, the investment value and the amount of revenue recorded by the Company were determined based upon the nature of the transaction and fair value of the investment instrument received. When it was not appropriate to recognize revenue, the Company recorded the difference between the cost of the consideration given and the fair value of the investment received as other expense. The fair value of the investment in these instances was limited to the cost of the product given. These corrections resulted in a reduction to reported investments and revenue of $0.3 million and $13.5 million, respectively, for the three months ended June 2, 2001. The Company also increased other expense, net by $6.0 million for the three months ended June 2, 2001.

Asia Pacific and Latin America Distributors

As a result of the internal review, the Company determined that beginning in the fiscal year ended March 3, 2001 practices related to several distributor relationships in the Asia Pacific and Latin America regions were such that, with respect to sales to these distributors, the Company should not recognize revenue until the distributor has paid the Company. As a result of these findings, and in accordance with SEC Staff Accounting Bulletin ("SAB") No. 101, *"Revenue Recognition in Financial Statements,"* the Company restated sales to such distributors in these two regions to a cash basis methodology. This resulted in a reduction to reported revenue of $7.8 million for the three months ended June 2, 2001.

Pricing Allowances

In the course of the internal review, the Company identified certain pricing allowances extended to customers that had not been recorded by the Company in the appropriate period. The impact of correcting these errors resulted in a reduction to reported revenue of $2.0 million for the three months ended June 2, 2001.

Return Rights

The Company determined that sales reserves established to account for future product returns in certain cases did not properly take into consideration all relevant information available at the time the estimates were made; and as a result, the Company has adjusted reserves for certain periods. The impact of correcting for these errors resulted in an increase to reported revenue of $0.5 million for the three months ended June 2, 2001.

Other Revenue Corrections

The Company determined that other reductions to revenue for the three months ended June 2, 2001 were required to correct previously reported amounts including premature recognition of revenue associated with incomplete integration projects and software arrangements aggregating $0.2 million, barter transactions of $3.1 million, premature recognition of intermediary shipments as revenue totaling $6.6 million, and other miscellaneous transactions aggregating $14.6 million.

Cost of Revenues

Cost of revenues was reduced by $20.8 million in the three months ended June 2, 2001, primarily as a result of the foregoing adjustments reducing revenue.

Operating Expenses

Operating expenses were decreased by $1.1 million in the three months ended June 2, 2001, primarily as a result of expenses not properly recorded in Latin America as well as errors associated with the recognition of cooperative marketing expenses.

Discontinued Operations

The loss from discontinued operations was increased by $2.5 million in the three months ended June 2, 2001 primarily due to sales/investment transactions and return rights as discussed above.

Balance Sheet

The balance sheet impact at June 2, 2001 of correcting the revenue items discussed above decreased accounts receivable by $34.2 million, increased inventory by $33.3 million and decreased investments by $30.0 million. Other balance sheet corrections included a $51.1 million decrease in cash and cash equivalents and a $1.2 million decrease in accounts payable to properly record outstanding checks and to record deposits in transit, a $3.5 million increase in intangible assets, a $2.7 million increase in accrued expenses to correct product credits and a $6.7 million increase in deferred revenue.

Cash Flow

The restatements discussed above account for substantially all of the changes to the consolidated statement of cash flows for the three months ended June 2, 2001.

Summary of Restatement Adjustments

The following table outlines the effect of the restatement adjustments on the three months ended June 2, 2001 as well as the reclassifications of discontinued operations as discussed in Note 4 and marketing development expenses as discussed in Note 3:

	Consolidated Statement of Operations			
	Three months ended June 2, 2001			
(In thousands)	As originally reported	Reclassifications	Restatements	As restated
Net revenue	$306,898	$(78,068)	$(47,180)	$181,650
Gross margin	$158,817	$(44,546)	$(26,358)	$ 87,913
Income of continuing operations available to common shareholders	$ 2,059	$ 8,569	$(10,155)	$ 473
Loss of discontinued operations	$ —	$ (8,569)	$ (2,543)	$(11,112)
Net income (loss) available to common shareholders	$ 9,800	$ —	$(12,698)	$ (2,898)
Basic and diluted income (loss) per common share:				
Income (loss) from continuing operations available to common shareholders	$ 0.01	$ 0.05	$ (0.06)	$ —
Loss from discontinued operations	$ —	$ (0.05)	$ (0.01)	$ (0.06)
Net income (loss) available to common shareholders	$ 0.05	$ —	$ (0.07)	$ (0.02)

	Consolidated Balance Sheet			
	June 2, 2001			
(In thousands)	As originally reported	Reclassifications	Restatements	As restated
Assets of continuing operations	$1,749,674	$(405,558)	$(81,055)	$1,263,061
Assets of discontinued operations	—	370,532	(6,689)	363,843
Total assets	$1,749,674	$ (35,026)	$(87,744)	$1,626,904
Liabilities of continuing operations	$ 328,125	$(103,008)	$ 2,395	$ 227,512
Liabilities of discontinued operations	—	67,982	(1,679)	66,303
Total liabilities	$ 328,125	$ (35,026)	$ 716	$ 293,815
Total stockholders’ equity	$1,308,880	$ —	$(88,460)	$1,220,420

3. Accounting Policies

Principles of Consolidation

The consolidated financial statements include the accounts of Enterasys Networks, Inc. and its subsidiaries. All significant intercompany balances and transactions have been eliminated in consolidation. The consolidated financial statements and related notes have been reclassified to reflect the results of Aprisma, Riverstone and GNTS as discontinued operations as discussed in Note 4. In addition to the reclassification due to discontinued operations, certain prior year balances have been reclassified to conform to the current period presentation.

Use of Estimates

The preparation of consolidated financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. These estimates include assessing the fair value of acquired assets, the amount and timing of revenue recognition, the collectibility of accounts and notes receivable, the valuation of fair value investments, the use and recoverability of inventory and tangible and intangible assets, and the amounts of incentive compensation liabilities, accrued restructuring charges, litigation liabilities and contingencies, among others. The Company bases its estimates on historical experience, current conditions and various other assumptions that are believed to be reasonable under the circumstances. The markets for the Company's products are characterized by rapid technological development, intense competition and frequent new product introductions, all of which could affect the future realizability of the Company's assets. Estimates and assumptions are reviewed on an on-going basis and the effects of revisions are reflected in the consolidated financial statements in the period they are determined to be necessary. Actual results could differ from those estimates under different assumptions or conditions.

New Accounting Pronouncements

Effective December 30, 2001, the Company adopted the Financial Accounting Standards Board ("FASB") Emerging Issues Task Force ("EITF") No. 00-25, "Vendor Income Statement Characterization of Consideration Paid to a Reseller of the Vendor's Products," which requires among other things, that payments made to resellers by the Company for cooperative advertising, buy-downs and similar arrangements should be classified as reductions to net sales or an increase in selling expenses, depending upon the application of the funds by the customer. As a result, the financial statement presentation for the three months ended March 30, 2002 conforms to the requirements of EITF No. 00-25, and the amounts for the three months ended June 2, 2001 have been reclassified to comply with the guidelines of the consensus. The reclassification for the three months ended June 2, 2001 resulted in a reduction of net revenue of $3.4 million, a reduction of cost of revenue of $5.0 million and an increase in selling, general and administrative expenses of $1.6 million. The above reclassification had no impact on net loss or loss per share.

Effective December 30, 2001, the Company adopted Statement of Financial Accounting Standards ("SFAS") No. 142, "Goodwill and Other Intangible Assets." See Note 8 for further information concerning the Company's adoption of SFAS 142.

In June 2001, the FASB issued SFAS No. 143, "Accounting for Asset Retirement Obligations," which addresses financial accounting and reporting for obligations associated with the retirement of tangible long-lived assets and the associated asset retirement costs. SFAS No. 143 requires recognition of asset retirement obligations as a liability rather than a contra-asset. SFAS No. 143 is effective for the Company's fiscal year ending January 3, 2004. The Company is currently evaluating the impact that the adoption will have on the consolidated financial statements.

Effective December 30, 2001, the Company adopted SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets," which excludes from the definition of long-lived assets goodwill and other intangibles that are not amortized in accordance with SFAS No. 142. SFAS No. 144 requires long-lived assets disposed of by sale to be measured at the lower of carrying amount or fair value less cost to sell, whether reported in continuing operations or in discontinued operations. SFAS No. 144 also expands the reporting of discontinued operations to include components of an entity that have been or will be disposed of rather than limiting such discontinuance to a segment of a business.

The transition provisions of SFAS No. 144 require that disposal activities that were initiated before the initial application of SFAS No. 144 continue to be accounted for and displayed in the income statement in accordance with the prior pronouncement applicable to the disposal. However, SFAS No. 144 requires a company to reclassify previously issued statements of financial position presented for comparative purposes if a company presented as a single net line item the assets and liabilities of a disposal group. As a result, the Company continues to account for and present in its consolidated statements of operations, the Riverstone, Aprisma and GNTS discontinued operations in accordance with Accounting Principles Board Opinion No. 30, "Reporting the Results of Operations — Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions," and has reclassified the assets and liabilities of Aprisma on the consolidated balance sheets to conform to the presentation required by SFAS No. 144. See Note 4 for a discussion of the Company's discontinued operations. The adoption of SFAS No. 144 did not have any impact on the book value of the Company's long-lived assets.

In April 2002, the FASB issued SFAS No. 145, "Rescission of FASB Statements No. 4, 44 and 64, Amendment of FASB Statement No. 13, and Technical Corrections." SFAS No. 145, among other things, rescinds SFAS No. 4, which required all gains and losses from the extinguishment of debt to be classified as an extraordinary item and amends SFAS No. 13 to require that certain lease modifications that have economic effects similar to sale-leaseback transactions be accounted for in the same manner as sale-leaseback transactions. This statement was issued effective for fiscal years beginning May 15, 2002 or later. The Company does not expect this statement will have an impact on its consolidated financial statements.

In July 2002, the FASB issued SFAS No. 146, "Accounting for Costs Associated with Exit or Disposal Activities," which requires companies to recognize costs associated with exit or disposal activities when a liability is incurred rather than at the date of a commitment to an exit or disposal plan. This statement is effective for fiscal years beginning after December 31, 2002. The Company is currently evaluating the impact the adoption will have on the consolidated financial statements.

4. Discontinued Operations

In February 2000, Cabletron Systems, Inc. ("Cabletron") transferred substantially all of its operating assets and liabilities to four operating subsidiaries, Enterasys Networks, Inc. ("Enterasys Subsidiary"), Riverstone Networks, Inc. ("Riverstone"), Aprisma Management Technologies, Inc. ("Aprisma"), and Global *Network* Technology Services, Inc. ("GNTS"). In July 2001, the operations of GNTS were discontinued through the acquisition of a portion of GNTS by a third party, the assumption of certain contracts and employees of GNTS by Enterasys Subsidiary and Aprisma, and the discontinuance of the remaining business operations of GNTS. Following the initial public offering of a portion of Riverstone's common stock in February 2001, Cabletron distributed its holdings of Riverstone's common stock to Cabletron's stockholders in a spin-off transaction on August 6, 2001. Also on August 6, 2001, Enterasys Subsidiary was merged with and into Cabletron and the name of the surviving corporation was changed to "Enterasys Networks, Inc." On August 9, 2002, the Company completed the sale of Aprisma to a third party for proceeds, net of expenses, of approximately $7.4 million. For the three months ended March 30, 2002, the Company recorded an additional charge of $11.7 million due to a change in estimate of the loss on disposal of Aprisma. The consolidated financial statements present GNTS, Riverstone and Aprisma as discontinued operations for all applicable periods presented.

The Company's discontinued operations for the three months ended June 2, 2001, included sales to customers in which the Company had investments in debt and equity securities accounted for under the cost method of accounting. These revenues are disclosed separately in the following table as "Revenue from related parties — minority investees." The following revenue is recorded in the consolidated statements of operations in loss from discontinued operations:

(In thousands)	Three months ended June 2, 2001 (restated)
Revenue (trade) from discontinued operations	$50,001
Intercompany revenue — Enterasys, Aprisma, GNTS and Riverstone	3,704
Revenue from related parties — minority investees	19,257
Subtotal	72,962
Eliminations	(3,704)
Total discontinued operations revenue	$69,258

5. Segment Information

As a result of the Company's decision to discontinue or dispose of the operations of Riverstone, GNTS and Aprisma, the Company operates its business as one segment, which is the business of developing, marketing and supporting comprehensive network solutions.

Revenues by geography

($ In thousands)	Three months ended March 30, 2002 Revenue	Percent	June 2, 2001 Revenue (restated)	Percent
North America	$ 68,372	56.6%	$ 97,227	53.5%
Europe, Middle East and Africa	36,509	30.2%	53,862	29.6%
Asia Pacific	5,817	4.8%	19,924	11.0%
Latin America	10,068	8.4%	10,637	5.9%
Total revenues	$120,766	100.0%	$181,650	100.0%

6. Accounts Receivable

Accounts receivable are summarized as follows:

(In thousands)	March 30, 2002	December 29, 2001
Gross accounts receivable	$ 98,549	$125,617
Less: Deferred revenue on shipments to stocking distributors	(17,359)	(25,350)
Allowance for doubtful accounts	(31,369)	(32,569)
Accounts receivable, net	$ 49,821	$ 67,698

Beginning in September 2001, the Company deferred revenue on product shipments to certain stocking distributors until those distributors have sold the product to their customer. At March 30, 2002 and December 29, 2001, $26.0 million and $68.9 million, respectively, of product shipments had been billed and deferred, of which $17.4 million and $25.4 million, respectively, are reflected as a reduction to accounts receivable and $8.6 million and $43.5 million, respectively, have been collected (or credited) and are included in customer advances and billings in excess of revenues.

7. Income Tax Receivable

The Company established an income tax receivable during the three months ended March 30, 2002 to reflect the refunds anticipated as a result of the Job Creation and Worker Assistance Act of 2002. This receivable at March 30, 2002 was approximately $119.1 million, and was comprised of the realization of tax benefits of approximately $17.4 million, $24.5 million and $47.0 million for the three months ended March 30, 2002, the ten months ended December 29, 2001 and fiscal year ended March 3, 2001, respectively. Also included in the income tax receivable were increases to additional paid-in capital of approximately $11.7 million and $18.5 million for the ten months ended December 29, 2001 and fiscal year ended March 3, 2001, respectively.

8. Goodwill and Intangible Assets

The Company adopted SFAS No. 142, "Goodwill and Other Intangible Assets," on December 30, 2001. SFAS No. 142 requires that existing and future goodwill and intangible assets with indefinite lives not be amortized, but written down, as needed, based upon an impairment analysis that must occur at least annually. Intangible assets that have finite useful lives continue to be amortized over their useful lives. The Company is currently in the process of completing the transitional impairment test required by SFAS No. 142 to determine whether there was an impairment of recorded goodwill as of December 30, 2001. In accordance with SFAS No. 142, step one of the two-part transitional impairment test requires the Company to compare the fair value of each reporting unit with its respective carrying amount, including goodwill. If the carrying amount of a reporting unit exceeds its fair value, step two of the transitional impairment test will be performed to measure the amount of impairment loss. Step one of the transitional impairment test must be completed in connection with our reporting for the second quarter of fiscal year 2002. Step two of the transitional impairment test must be completed by the end of fiscal year 2002 and the resulting impairment loss, if any, will be recorded as a cumulative effect of accounting change in the consolidated statements of operations. The amount of any such impairment loss cannot be determined at this time. The amount of any such loss, however, could be material to the Company's consolidated financial results. In addition to the transitional impairment test, SFAS No. 142 also requires the Company to perform an annual impairment test and an impairment test if an event occurs or circumstances change that would more likely than not result in an impairment loss. Such subsequent impairment losses, if any, will be reflected in operating income in the consolidated statement of operations in the period the event occurs. Such an event occurred during the quarter ended June 29, 2002. The Company is assessing the impact of this event and anticipates that any necessary adjustment would be recorded in the quarter ended June 29, 2002. Goodwill, net of accumulated amortization, as of March 30, 2002 and December 29, 2001 was $15,129.

The impact of discontinuing the amortization of goodwill on net income and on basic and diluted earnings per share for the quarter ended March 30, 2002 is approximately $1.1 million, or $.01 per share on a basic and fully diluted basis as presented below:

	Three months ended	
	March 30, 2002	June 2, 2001
(In thousands, except per share amounts)		(restated)
Net loss available to common shareholders	$(13,696)	$ (2,898)
Add back: Goodwill amortization expense	—	7,553
Adjusted net income (loss) available to common shareholders	$(13,696)	$ 4,655
Basic and diluted earnings (loss) per share		
Net income (loss) available to common shareholders	$ (0.07)	$ (0.02)
Goodwill amortization expense	—	0.04
Adjusted net income (loss) available to common shareholders	$ (0.07)	$ 0.02

The table below presents gross amortizable intangible assets and the related accumulated amortization at March 30, 2002:

(In thousands)	Gross carrying amount	Accumulated amortization	Net carrying value of intangible assets
Customer relations	$28,600	$(16,962)	$11,638
Patents and technology	32,200	(15,543)	16,657
Total	$60,800	$(32,505)	$28,295

The table below presents expected amortization expense for intangible assets at March 30, 2002:

	2002	2003	2004	2005	2006	After 2006
Estimated amortization expense	$6,531	$6,007	$5,693	$5,693	$2,988	$1,383

9. Inventories, net

Inventories, net, consisted of the following:

(In thousands)	March 30, 2002	December 29, 2001
Raw materials	$ 8,400	$ 8,130
Finished goods	104,487	110,084
Inventories, net	$112,887	$118,214

Finished goods at March 30, 2002 and December 29, 2001 included $29.6 million and $43.8 million, respectively, of inventory held by certain distributors as a result of the Company's decision in September of 2001 to recognize revenue from certain distributors when the distributor ships the Company's product to its customers.

10. Accrued Expenses

Accrued expenses consisted of the following:

(In thousands)	March 30, 2002	December 29, 2001
Salaries and benefits	$27,975	$31,525
Accrued restructuring charges	3,501	6,182
Accrued legal and audit costs	14,898	6,721
Accrued marketing development obligations	14,737	15,073
Accrued liability on lease guarantees	6,439	7,100
Accrued loss on disposal of Aprisma	12,981	1,281
Other	17,287	10,280
Total accrued expenses	$97,818	$78,162

11. Accrued Restructuring Charges

The following table summarizes accrued restructuring activity for the three months ended March 30, 2002:

(In thousands)	Severance benefits	Facility exit costs	Total
Balance, December 29, 2001	$ 3,952	$2,230	$ 6,182
Reclassification	(572)	572	—
Cash payments	(2,086)	(595)	(2,681)
Balance, March 30, 2002	$ 1,294	$2,207	$ 3,501

During the second quarter of the ten months ended December 29, 2001, the Company recorded restructuring charges of $10.3 million to reduce the expense structure of the Company. These charges reflected the write-down of a vacant office building in Rochester, NH to its estimated fair value of $1.5 million, exit costs associated with the planned closure of eight sales offices worldwide and executive severance costs. As of March 30, 2002 the remaining balance of the accrued exit costs primarily consists of long-term lease commitments which will be paid out over several years.

In the fourth quarter of the ten months ended December 29, 2001, the Company recorded a restructuring charge of $12.4 million for employee severance costs associated with the reduction of approximately 400 individuals from the Company's global workforce. The reduction in the global workforce involved principally sales, engineering and administrative personnel and has also included targeted reductions impacting most functions within the Company. As of March 30, 2002 the remaining balance of the accrued severance costs consists of severance that will be paid out during fiscal year 2002.

12. Other Income (Expense), Net

The following schedule reflects the components of other income (expense), net:

	Three months ended	
	March 30, 2002	June 2, 2001
(In thousands)		(restated)
Impairment of investments	$ (424)	$(20,453)
Loss on exchange of products for investments	—	(6,009)
Recognition of deferred gain on Efficient investment	—	46,778
Unrealized loss on Riverstone stock derivative	(14,706)	—
Net gain on sale of available for sale securities	—	834
Gain on expiration of common stock put options	842	—
Other	(1,492)	(1,019)
Total other income (expense)	$(15,780)	$ 20,131

The Company recorded, in other income (expense), net, impairments of investments of $0.4 million for the first quarter of fiscal year 2002 and $20.5 million for the first quarter of transition year 2001. These impairments of value are based on investee-specific events including declines in the investees' stock price in new rounds of financing, market capitalization relative to book value, deteriorating financial condition or results of operations and bankruptcy or insolvency.

During the first quarter of transition year 2001, the Company entered into a number of transactions in which it made an investment in a customer in exchange for cash and/or our products and services. In certain of these transactions the Company recorded the difference between the cost of the consideration given and the fair value of the investment received as other expense. These transactions resulted in other expense of $6.0 million for the first quarter of transition year 2001.

During the first quarter of transition year 2001, the Company sold 2.0 million shares of Efficient common stock and tendered its remaining 8.5 million shares for proceeds of $242.7 million in connection with a tender offer to acquire the outstanding shares of Efficient common stock made by Siemens A.G. In connection with these transactions, the Company recognized the remaining deferred gain of $46.8 million to other income.

The Company's convertible preferred stock redemption liability is offset by the value of 1.3 million shares of Riverstone stock received by the holders of the redeemable convertible preferred stock in connection with the Riverstone spin off in August 2001. During the first quarter of fiscal year 2002 the value of the Riverstone shares decreased $14.7 million, and the associated increase in the Company's redemption liability was recorded as other expense.

13. Comprehensive Income (Loss)

The Company's total comprehensive loss, net of tax, was as follows:

	Three months ended	
	March 30, 2002	**June 2, 2001**
(In thousands)		**(restated)**
Net income (loss)	$(10,526)	$ 169
Other comprehensive income (loss):		
Unrealized gain (loss) on available-for-sale securities	2,142	(2,283)
Foreign currency translation adjustment	43	1,152
Reclassification adjustment for gains (losses) on available-for-sale securities included in net income	(259)	834
Total comprehensive loss	$ (8,600)	$ (128)

14. Net Income (Loss) Per Share

A reconciliation of the shares used in the computation of the Company's basic and diluted earnings per common share is as follows:

	Three months ended	
	March 30, 2002	**June 2, 2001**
(In thousands)		
Weighted average number of common shares outstanding — basic	200,742	188,833
Dilutive effect:		
Net additional common shares upon exercise of common stock options	—	3,270
Weighted average number of common shares outstanding — diluted	200,742	192,103

For the three months ended March 30, 2002 options to purchase 15.0 million shares of common stock were outstanding but were not included in the calculation of diluted earnings per share since the effect was anti-dilutive. Also excluded for the three months ended March 30, 2002 were 7.4 million warrants to purchase shares of the Company's common stock.

15. Commitments and Contingencies

Legal Proceedings

Described below are material legal proceedings in which the Company is involved:

Securities Class Action in the District of Rhode Island. Between October 24, 1997 and March 2, 1998, nine shareholder class action lawsuits were filed against the Company and certain of its officers and directors in the United States District Court for the District of New Hampshire. By order dated March 3, 1998 these lawsuits, which are similar in material respects, were consolidated into one class action lawsuit, captioned *In re Cabletron Systems, Inc. Securities Litigation (C.A. No. 97-542-SD)* . The case has been transferred to the District of Rhode Island. The complaint alleges that the Company and several of its officers and directors disseminated materially false and misleading information about the Company’s operations and acted in violation of Section 10(b) and Rule 10b-5 of the Exchange Act during the period between March 3, 1997 and December 2, 1997. The complaint further alleges that certain officers and directors profited from the dissemination of such misleading information by selling shares of the Company's common stock during this period. The complaint does not specify the amount of damages sought on behalf of the class. In a ruling dated May 23, 2001, the District Court dismissed this complaint with prejudice. The plaintiffs appealed that ruling to the First Circuit Court of Appeals, and, in a ruling issued on November 12, 2002, the Court of Appeals reversed and remanded the case to the District Court for further proceedings. If the plaintiffs prevail on the merits of this case, we could be required to pay substantial damages.

Securities Class Action in the District of New Hampshire. Between February 7 and April 9, 2002, six class action lawsuits were filed in the United States District Court for the District of New Hampshire. Defendants are us, former chairman and chief executive officer Enrique Fiallo and former chief financial officer Robert Gagalis. By orders dated August 2, 2002 and September 25, 2002, these lawsuits, which are similar in material respects were consolidated into one class action lawsuit, captioned *In re Enterasys Networks, Inc. Securities Litigation (C.A. No. 02-CV-71)*. On December 9, 2002, the plaintiffs filed an amended consolidated complaint, adding two additional defendants, Piyush Patel, former chief executive officer of Cabletron Systems, Inc. ("Cabletron") and David Kirkpatrick, former chief financial officer of Cabletron. The amended complaint alleges violations of Sections 10(b) and 20(a) of the Exchange Act and Rule 10b-5 there under. Specifically, plaintiffs allege that during periods spanning from June 28, 2000 and August 3, 2001 and in the period between August 6, 2001 and February 1, 2002 (together the "Class Period"), defendants issued materially false and misleading financial statements and press releases that overstated the Company's revenues, income, and cash, and understated our net losses, because we purportedly recognized revenue in violation of Generally Accepted Accounting Principles ("GAAP) and the Company's own accounting policies in connection with various sales and/or investment transactions. The complaints seek unspecified compensatory damages in favor of the plaintiffs and the other members of the purported class against all of the defendants, jointly and severally as well as fees, costs and interest and unspecified equitable relief. By order of the court, the Company has not yet been required to file a responsive pleading. If plaintiffs prevail on the merits of the case, the Company could be required to pay substantial damages.

Shareholder Derivative Action in State of New Hampshire. On February 22, 2002, a shareholder derivative action was filed on the Company's behalf in the Superior Court of Rockingham County, State of New Hampshire. The suit is captioned *Nemes v. Fiallo, et al*. Individual defendants are former chairman and chief executive officer Fiallo and certain members of the Company's Board of Directors. Plaintiffs allege that the individual defendants breached their fiduciary duty to shareholders by causing or allowing the Company to conduct its business in an unsafe, imprudent, and unlawful manner and failing to implement and maintain an adequate internal accounting control system. Plaintiffs allege that this breach caused the Company to improperly recognize revenue in violation of GAAP and the Company's own accounting policies in connection with transactions in the Company's Asia Pacific region, and that this alleged wrongdoing resulted in damages to the Company. Plaintiffs seek unspecified compensatory damages. On October 7, 2002, the Superior Court approved the parties' joint stipulation to stay proceedings.

Shareholder Derivative Action in State of Delaware. On April 16, 2002, a shareholder derivative action was filed on the Company's behalf in the Court of Chancery of the State of Delaware in and for New Castle County. It is captioned, *Meisner v. Enterasys Networks, Inc., et al*. Individual defendants are former chairman and chief executive officer Fiallo and members of the Company's Board of Directors. Plaintiffs allege that the individual defendants permitted wrongful business practices to occur which had the effect of manipulating revenues and earnings, inadequately supervised the Company's employees and managers, and failed to institute legal actions against those officers, directors and employees responsible for the alleged conduct. The complaint alleges counts for breach of fiduciary duty, misappropriation of confidential information for personal profit, and contribution and indemnification. Plaintiffs seek judgment directing defendants to account to the Company for all damages sustained by the Company by reason of the alleged conduct, return all compensation of whatever kind paid to them by the Company, pay interest on the damages as well as costs of the action. On July 11, 2002, the individual defendants filed a motion to dismiss the complaint. The plaintiff has not yet filed a brief with respect to this motion.

Securities and Exchange Commission Investigation. After the close of business on January 31, 2002, the Securities and Exchange Commission, or SEC, notified the Company that it had commenced a *"Formal Order of Private Investigation"* into the Company's financial accounting and reporting practices. This investigation remains ongoing and the Company is fully cooperating with the SEC. The Company cannot predict when this investigation will conclude or its outcome. The SEC has not commenced legal proceedings against the Company in connection with this investigation; however, if the SEC were to conclude that legal action were appropriate, the Company could be required to pay significant penalties and/or fines and could become subject to an administrative order and/or a cease and desist order.

Other. In addition, the Company is involved in various other legal proceedings and claims arising in the ordinary course of business. Management believes that the disposition of these additional matters, individually or in the aggregate, is not expected to have a materially adverse effect on the financial condition or results of operations of the Company.

Other

Beginning on February 23, 2003, the holders of the Company's Series D and E preferred stock have the right to redeem these shares for approximately $99 million in cash, less the proceeds from the sale of any of the approximately 1.3 million shares of Riverstone stock distributed to them in connection with the Company's spin-off of Riverstone. The Company is engaged in discussions with the preferred stockholders concerning alternatives to this potential redemption right, although there can be no assurance as to the outcome of any such discussions.

The Company committed to make up to $20 million of additional capital contributions to a venture capital fund in which it is already an investor. In the event of future capital calls, the Company could be required to fund some or all of this commitment. If the Company fails to make a required contribution, then the Company’s existing investment with a carrying value of $3.8 million at March 30, 2002 would be significantly diluted. The fund has indicated that it does not anticipate issuing a capital call in the near future.

16. Related Party Transactions

Investments

The Company has minority investments in debt and equity securities of certain companies. The Company does not have a controlling interest in these entities. In certain instances during the three months ended June 2, 2001, the Company recorded revenue from transactions where it received equity instruments in exchange for products sold. Revenue recognized from investee transactions during that period was as follows:

	Three months ended	
	March 30, 2002	June 2, 2001
(In thousands)		(restated)
Revenue recognized in connection with investment transactions	$ —	$ 3,250
Revenue recognized from other sales to investee companies	2,418	8,474
Total revenue recognized from investee transactions	$2,418	$11,724

Consulting Arrangements

In connection with the senior management resignations in September 2001, the Company entered into consulting arrangements with two former members of senior management to provide strategic advice and assistance to the Company for a period of one year. The Company paid consulting fees of $0.06 million in the three months ended March 30, 2002.

17. Subsequent Events

On April 8, 2002, the Company announced a cost reduction plan including a reduction in work force of approximately 30%. The cost reduction plan also included other programs intended to reduce costs, including initiatives related to supply chain management and incentive programs with the Company's distributors and channel partners.

On April 26, 2002 the Board of Directors of the Company approved a dividend of one right to purchase one one-thousandth (1/1,000) of a share of Series F Preferred Stock, $1.00 par value per share, of the Company for each outstanding share of common stock, $.01 par value per share, of the Company. The Company paid this dividend on June 25, 2002 to shareholders of record at the close of business on June 11, 2002.

During the portion of fiscal year 2002 through November 2002, the Company incurred legal and forensic accounting fees of approximately $19 million for services rendered in connection with the SEC investigation into the Company's financial accounting and reporting practices, the subsequent restatement of the Company's fiscal year 2001 and transition year 2001 financial statements, and the various shareholder lawsuits discussed in Note 15. The Company has not received a determination as to whether and to what extent costs incurred to date are reimbursable under its insurance coverage and therefore such costs will be expensed to operating expenses as they are incurred until a reimbursement determination has been made. Costs incurred in the first quarter ended March 30, 2002 were $3.5 million.

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

This quarterly report on Form 10-Q and the following disclosure contain forward-looking statements. We caution you that any statements contained in this report which are not strictly historical statements constitute forward-looking statements. Such statements include, but are not limited to, statements reflecting management's expectations regarding our future financial performance; strategic relationships and market opportunities; and our other business and marketing strategies and objectives. These statements may be identified with such words as "we expect", "we believe", "we anticipate", or similar indications of future expectations. These statements are neither promises nor guarantees, and involve risks and uncertainties that could cause actual results to differ materially from such forward-looking statements. Such risks and uncertainties include, among other things, the following factors: the pending SEC investigation and our accounting restatements could materially harm our business, operating results and financial condition; worldwide economic weakness, deteriorating market conditions and recent political and social turmoil have and may continue to negatively affect our business and revenues and make forecasting more difficult, which could harm our financial condition; we have a history of losses in recent years and may not operate profitably in the future; our quarterly operating results are likely to fluctuate, which could cause us to fail to meet quarterly operating targets and result in a decline in our stock price; we earn a substantial portion of our revenue for each quarter in the last month of each quarter, which reduces our ability to accurately forecast our quarterly results and increases the risk that we will be unable to achieve previously forecasted results; we may need additional capital to fund our future operations and, if it is not available when needed, our business may be harmed; in February 2003, the holders of our Series D and E preferred stock may require redemption of their shares for cash, which could impair our cash position, or request the conversion of their shares into shares of our common stock, which would dilute our existing stockholders; pending and future litigation could materially harm our business, operating results and financial condition; the limitations of our director and officer liability insurance may materially harm our financial condition; our failure to improve our management information systems and internal controls could harm our business; we have experienced significant turnover of senior management and our current management team has been together for only a limited time, which could harm our business operations; retaining key management and employees is critical to our success; there is intense competition in the market for enterprise network equipment, which could prevent us from increasing our revenue and achieving profitability; we may be unable to expand our indirect distribution channels, which may hinder our ability to grow our customer base and increase our revenues; we expect the average selling prices of our products to decrease over time, which may reduce our revenue and gross margins; we use several key components for our products that we purchase from single or limited sources, and we could lose sales if these sources fail to fulfill our needs; we depend upon a limited number of contract manufacturers for substantially all of our manufacturing requirements, and the loss of our primary contract manufacturer would impair our ability to meet the demands of our customers; and those discussed in "Management's Discussion and Analysis of Financial Condition and Results of Operations" and elsewhere in this report. Readers are cautioned not to place undue reliance on these forward looking statements, which speak only as of the date hereof. We expressly disclaim any obligation to publicly update or revise any such statements to reflect any change in these forward-looking statements, or in events, conditions, or circumstances on which any such statements may be based, or that may affect the likelihood that actual results will differ from those set forth in the forward-looking statements.

All references in this quarterly report to "Enterasys Networks," "we," "our," or "us" mean Enterasys Networks, Inc.

You should read the following discussion in conjunction with the section below titled "Cautionary Statements," our Consolidated Financial Statements and related Notes, and other financial information appearing elsewhere in this report on Form 10-Q. The period covered by this report consists of the three-month period from December 30, 2001 through March 30, 2002, which is the first quarter of fiscal year 2002. The prior year fiscal period consists of the three-month transition period from March 4, 2001 through June 2, 2001. Our prior fiscal period consists of the ten-month transition period from March 4, 2001 through December 29, 2001, which we refer to as "transition year 2001" throughout this Item. We refer to our current fiscal year, the twelve-month period ended December 28, 2002, as "fiscal year 2002" throughout this Item.

Overview

We design, develop, market and support comprehensive networking solutions focusing on the network security, availability and mobility needs of enterprises. Our solutions empower customers to use their internal networks and the Internet to facilitate the exchange of information, increase productivity and reduce operating costs. Using our products, customers make information, applications and services readily available and customized to the needs of their employees, customers, suppliers, business partners and other network users. Our significant installed base of customers consists of commercial enterprises; governmental entities; healthcare, educational, financial and non-profit institutions; and other organizations.

On April 8, 2002, the Company announced a cost reduction plan including a reduction in work force of approximately 30%. The cost reduction plan also includes other programs intended to reduce costs, including initiatives related to supply chain management and incentive programs with the Company's distributors and channel partners.

Restatement

We have previously restated our financial statements for the fiscal year ended March 3, 2001, the fiscal quarters within that fiscal year, and the first three fiscal quarters within the ten-month transition period ended December 29, 2001. The principal adjustments to restate the financial statements for the three months ended June 2, 2001 are discussed in Note 2 to our consolidated financial statements included in Part 1 Item 1 of this quarterly report on Form 10-Q.

Fiscal Year Change

On September 28, 2001, our Board of Directors amended the by-laws to change our fiscal year-end from the Saturday closest to the last day in February of each year to the Saturday closest to the last day in December of each year, and we filed a Form 10-K for the ten-month transition period ended December 29, 2001. We have filed this Form 10-Q for the three-month period ended on March 30, 2002, which is the first quarter of fiscal year 2002. We did not include comparable three-month financial information for the period of December 30, 2000 through March 31, 2001 because it was impracticable to do so due to certain inherent limitations in our interim monthly closing process and the complexity of the restatement of our quarterly 2001 financial statements.

Application of Critical Accounting Policies

Our significant accounting policies are described in Note 3 to the consolidated financial statements included in Item 8 of our transition report on Form 10-K for the transition period ended December 29, 2001. The preparation of our consolidated financial statements in accordance with generally accepted accounting principles requires estimates and judgments that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the consolidated financial statements, and the reported amounts of revenue and expenses during the period reported. By their nature, these estimates and judgments are subject to an inherent degree of uncertainty. We base estimates and judgments on historical experience, market and industry trends, and other factors that we believe are reasonable under the circumstances. Actual results may differ materially from these estimates. We believe the following critical accounting policies impact our judgments and estimates used in the preparation of our consolidated financial statements.

Revenue Recognition. Our revenue is comprised of product revenue, which includes revenue from sales of our switches and routers, other network equipment and software, and services revenue, which includes revenue from maintenance, installation and system integration services. Revenue from service obligations under maintenance contracts is deferred and recognized on a straight-line basis over the contractual period, which is typically 12 months. We generally recognize product revenue from our end-user and reseller customers at the time of shipment, provided that persuasive evidence of an arrangement exists, the price is fixed or determinable and collectibility of sales proceeds is reasonably assured. When significant obligations remain after products are delivered, such as integration or customer acceptance, revenue and related costs are deferred until such obligations are fulfilled.

We provide an allowance for sales returns based on historical returns, return policies and contractual product return rights granted to our customers. The allowance has been reflected as a reduction to revenue in the consolidated statement of operations. If the data used by us to calculate the estimated sales returns and allowances does not properly reflect future returns, these estimates would have to be modified, thus impacting revenue recognized in future periods. Beginning in September 2001, we determined that we could no longer estimate the amount of future product returns from certain stocking distributors located in the United States and Europe. We now recognize revenue from these distributors when they ship our product to their customers. Beginning in fiscal 2001, we began recording revenue from certain distributors and resellers located in Asia Pacific and Latin America on a cash basis due to existing practices related to distribution/reseller arrangements.

In the past we sold products and services to customers in exchange for minority investments, consisting of debt or equity securities, accounted for under the cost method of accounting. In some instances, we issued product credits, or the right to purchase products which, when used, were exchanged for debt or equity securities by the investee company, and in other cases, we invested cash that was then used by the investee company to purchase products from us. The amount of revenue that we recognized in connection with minority investments was based upon the nature of the transaction and fair value of the debt or equity instrument received.

Allowance for Doubtful Accounts. We estimate the collectibility of our accounts receivable and the amount of bad debts that may be incurred in the future. We analyze specific customer accounts, historical experience, customer concentrations, credit ratings and current economic trends when evaluating the adequacy of the allowance for doubtful accounts.

Reserve for Excess and Obsolete Inventory. Inventory purchases and commitments are based upon future demand forecasts. Reserves for excess and obsolete inventory are established to account for the differences between our forecasted demand and the amount of purchased and committed inventory. We have experienced significant variances between the amount of inventory purchased and contractually committed to and our demand forecasts, resulting in material excess and obsolete inventory charges.

Valuation of Long-lived Assets. Long-lived assets are comprised of intangible assets and property, plant and equipment. We assess the impairment of identifiable intangibles, fixed assets and related goodwill whenever events or changes in circumstances indicate that the carrying value may not be recoverable. When we determine that the carrying value of intangibles, fixed assets and related goodwill may not be recoverable, we measure any impairment by the amount by which the carrying value of the long-lived asset or goodwill exceeds the related fair value. Estimated fair-value is generally based on projected discounted cash flows using a discount rate determined by management to be commensurate with the risk inherent in the underlying asset in question. In certain cases, we obtain an independent valuation of intangible assets to support the amount of our proposed impairment charge.

Valuation of Investments. Investments are comprised of privately held corporate debt and equity securities and in limited cases, common stock in thinly traded publicly held companies. We review these investments for potential impairments by monitoring significant declines in the invitee’s stock price in new rounds of financing, market capitalization relative to book value, bankruptcy or insolvency and deterioration in the financial condition or results of operations.

Restructuring Reserves. We have recorded restructuring charges in connection with our plans to reduce the cost structure of our business. These restructuring charges, which reflect management’s commitment to a termination or exit plan that will be completed within twelve months, are based on estimates of the expected costs associated with severance benefits and facility exit costs. If the actual cost incurred exceeds the estimated cost, an additional charge to earnings will result. If the actual cost is less than the estimated cost, a reduction to special charges will be recognized.

Deferred Tax Valuation Allowance. We estimate our income taxes in each of the jurisdictions in which we operate. This process involves estimating our actual current tax exposure together with assessing temporary differences resulting from differing treatment of items, such as deferred revenue, for tax and accounting purposes. These differences result in deferred tax assets and liabilities, which are included within our consolidated balance sheet. We then assess the likelihood that our deferred tax assets will be recovered from future taxable income and to the extent we believe that recovery is not likely, we establish a valuation allowance. To the extent we establish a valuation allowance or increase this allowance in a period, we increase or decrease our income tax provision in our statement of operations. If any of our estimates of our prior period taxable income or loss prove to be incorrect, material differences could impact the amount and timing of income tax benefits or payments for any period.

Summary of Critical Estimates Included in Our Consolidated Results of Operations. The following table summarizes the impact on our results of operations arising from our critical accounting estimates:

	Three months ended	
(In millions)	**March 30, 2002**	**June 2, 2001**
		(restated)
Provision for doubtful accounts	$ (1.6)	$ 0.9
Provision for excess and obsolete inventory	—	9.8
Impairment of investments	0.4	20.5
Deferred tax asset valuation provision	(17.0)	—
Total	$(18.2)	$31.2

Results of Operations

The quarter ended June 2, 2001 has been restated for the adjustments described in Note 2 to our consolidated financial statements included in Part I, Item 1. The discussion contained in this Item 2 of Part I reflects the restatement. The amounts shown for research and development expense below exclude stock-based compensation, which has been reported on a separate line in the consolidated statements of operations included in Part I, Item 1.

The table below sets forth the principal line items from our consolidated statement of operations, each expressed as a percentage of net revenue:

	Three months ended	
	March 30, 2002	June 2, 2001
		(restated)
Net revenue	100.0%	100.0%
Cost of revenue	60.0	51.6
Gross margin	40.0	48.4
Research and development	21.1	11.5
Selling, general and administrative	54.3	41.5
Amortization of intangible assets	1.8	5.7
Stock-based compensation	0.8	0.9
Total operating expenses	78.0	59.6
Loss from operations	(38.0)	(11.2)
Interest income, net	1.6	3.6
Other income (expense), net	(13.1)	11.1
Income (loss) from continuing operations before income taxes and cumulative effect of a change in accounting principle	(49.5)	3.5
Income tax expense (benefit)	(50.5)	1.6
Income from continuing operations before cumulative effect of a change in accounting principle	1.0	1.9
Discontinued operations:		
Operating loss (net of tax benefit)	—	(6.1)
Loss on disposal (net of tax benefit)	(9.7)	—
Cumulative effect of a change in accounting principle (net of tax expense)	—	4.3
Net income (loss)	(8.7)%	0.1%

Overview

For the three months ended March 30, 2002, we incurred a net loss from continuing operations before cumulative effect of a change in accounting principle primarily due to significantly lower sales volume and our cost structure, which was not aligned with our revenue base. This loss was partially reduced by lower amortization expense and a $61.0 million tax benefit.

A more detailed discussion of the individual components of our consolidated results of operations follows.

Net Revenue

We manage our sales and marketing based on four geographic regions: the United States and Canada (“North America”); Europe, the Middle East and Africa (“EMEA”); Asia and Australia (“Asia Pacific”); and South America, Mexico and the Caribbean (“Latin America”). Net revenue includes product and services revenue for each region and is summarized in the following table:

	Three months ended			
	March 30 ,2002		June 2, 2001	
	Revenue	Percent	Revenue	Percent
($ in millions)			(Restated)	
North America	$ 68.4	56.6%	$ 97.3	53.5%
EMEA	36.5	30.2%	53.9	29.6%
Asia Pacific	5.8	4.8%	19.9	11.0%
Latin America	10.1	8.4%	10.6	5.9%
Total net revenue	$120.8	100.0%	$181.7	100.0%

Net revenue declined by $60.9 million, or 34% from $181.7 million in the first quarter of transition year 2001 to $120.8 million in the first quarter of fiscal year 2002. Services revenue decreased by $3.8 million, or 10%, from $39.6 million in the first quarter of transition year 2001 to $35.7 million in the first quarter of fiscal year 2002. Services revenue is primarily revenue from maintenance contracts with customers in our installed base. The decrease in services revenue is primarily due to the lower level of new product sales which typically include associated maintenance.

Product revenue decreased by $57.1 million, or 40%, from $142.1 million in the first quarter of transition year 2001 to $85.0 million in the first quarter of fiscal year 2002 primarily due to the industry-wide slowdown and lengthening sales cycles and the uncertainty associated with the SEC investigation and our delay in releasing financial statements which resulted in hesitancy on the part of our customers and potential customers to purchase from us.

The market for telecommunications and networking equipment and solutions continued to be challenging during the first quarter of fiscal year 2002. In addition, we faced some unique challenges given the lack of availability of our detailed current financial information. We believe that our future revenue will generally fluctuate with overall changes in the markets that we currently serve. Our future revenue will be affected by the nature and timing of new product introductions by our competitors and us, as well as other competitive factors.

Gross Margin

Total gross margin declined by $39.6 million from $87.9 million in the first quarter of transition year 2001 to $48.3 million in the first quarter of fiscal year 2002. Services gross margin decreased by $1.9 million in the first quarter of fiscal year 2002 primarily due to lower services revenues but increased as a percent of service revenue to 73% in the current quarter compared with 71% in the first quarter of the prior year. Product gross margin as a percent of product revenue decreased from 42% in the first quarter of the prior year to 26% in the comparable period of fiscal year 2002 primarily as a result of fixed period costs not decreasing as quickly as revenue.

As a result of cost reduction activities undertaken in subsequent periods, the Company anticipates that margins will improve going forward to historical ranges.

Operating Expenses

Research and development expenses increased by $4.7 million from $20.8 million in the first quarter of transition year 2001 to $25.5 million in the first quarter of fiscal year 2002 due primarily to investments in new product development initiatives.

During the second quarter of fiscal year 2002 we implemented cost improvement initiatives to better align our cost structure with our revenue base. We anticipate that quarterly research and development expenses will decline in subsequent quarters to the approximate quarterly levels incurred in transition year 2001.

Selling, general and administrative expenses (''SG&A'') declined by $9.7 million from $75.3 million in the first quarter of transition year 2001 to $65.6 million in the first quarter of fiscal year 2002, due primarily to a $4.0 million decrease in selling expenses, a $3.5 million decrease in marketing expenses, and a $3.5 million decrease in costs associated with our reorganization of the company. In addition, we recorded a $1.6 million reduction to the provision for doubtful accounts. These decreases were slightly offset by the $3.5 million costs incurred during the first quarter of fiscal year 2002 associated with the SEC investigation. During the second quarter of fiscal year 2002 we implemented and expect to continue to implement cost improvement initiatives to better align our cost structure with our revenue base. However, we expect SG&A expenses will be adversely impacted by the increase in professional services fees incurred in connection with the SEC investigation, our internal review and associated stockholder litigation.

During the portion of fiscal year 2002 through November 2002, we have incurred legal and forensic accounting fees of approximately $19 million for services rendered in connection with the SEC investigation into our financial accounting and reporting practices, the subsequent restatement of our fiscal year 2001 and transition year 2001 financial statements, and the various shareholder lawsuits discussed in Note 15 to our consolidated financial statements included in Part 1 Item 1 of this quarterly report on Form 10-Q. We have not received a determination as to whether and to what extent costs incurred to date are reimbursable under our insurance coverage and therefore such costs will be expensed to operating expenses as they are incurred until a reimbursement determination has been made. Costs incurred in the first quarter ended March 30, 2002 were $3.5 million.

Amortization of intangibles decreased by $8.2 million from $10.4 million in the first quarter of transition year 2001 to $2.2 million in the first quarter of fiscal year 2002, due to the fact that we adopted Statement of Financial Accounting Standards ("SFAS") No. 142. See "Recent Accounting Announcements" below for further information on SFAS No. 142.

Stock-based compensation was $1.0 million in the first quarter of fiscal year 2002 and $1.6 million in the first quarter of transition year 2001 and related to stock and stock options issued in connection with the acquisition of Network Security Wizards and Indus River Networks that were contingent upon continued employment of key employees.

Loss from Operations

Loss from operations increased from $20.2 million in the first quarter of transition year 2001 to $46.0 million in the first quarter of fiscal year 2002 due to the factors discussed above. During the second quarter of fiscal year 2002, we implemented cost reduction programs, improved inventory management procedures and controls, and adopted other initiatives designed to reduce our loss from operations. We expect to incur significant operating losses in remaining quarters of fiscal year 2002 due to continued weakness in the markets that we serve, expenses associated with initiatives to align our cost structure with our revenue base, and costs associated with the SEC investigation and internal review. However, we expect our fiscal year 2002 operating losses will be substantially lower than our transition year 2001 operating losses.

Interest Income

Interest income declined from $6.5 million in the first quarter of transition year 2001 to $2.0 million in the first quarter of fiscal year 2002 due to lower cash, cash equivalents and marketable securities balances and lower interest rates.

Other Income (Expense), Net

The following schedule reflects the components of other income (expense), net:

	Three months ended	
	March 30, 2002	June 2, 2001
(In thousands)		(restated)
Impairment of investments	$ (424)	$(20,453)
Loss on exchange of products for investments	—	(6,009)
Recognition of deferred gain on Efficient investment	—	46,778
Unrealized loss on Riverstone stock derivative	(14,706)	—
Net gain on sale of available for sale securities	—	834
Gain on expiration of common stock put options	842	—
Other	(1,492)	(1,019)
Total other income (expense)	$(15,780)	$ 20,131

We recorded, in other income (expense), net, impairments of investments of $0.4 million for the first quarter of fiscal year 2002 and $20.5 million for the first quarter of transition year 2001. These impairments of value are based on investee-specific events including declines in the investees' stock price in new rounds of financing, market capitalization relative to book value, deteriorating financial condition or results of operations and bankruptcy or insolvency.

During the first quarter of transition year 2001, we entered into a number of transactions in which we made an investment in a customer in exchange for cash and/or our products and services. In certain of these transactions we recorded the difference between the cost of the consideration given and the fair value of the investment received as other expense. These transactions resulted in other expense of $6.0 million for the first quarter of transition year 2001.

During the first quarter of transition year 2001, we sold 2.0 million shares of Efficient common stock and tendered our remaining 8.5 million shares for proceeds of $242.7 million in connection with a tender offer to acquire the outstanding shares of Efficient common stock made by Siemens A.G. In connection with these transactions, we recognized the remaining deferred gain of $46.8 million to other income.

Our redeemable convertible preferred stock redemption liability is offset by the value of 1.3 million shares of Riverstone stock received by the holders of the redeemable convertible preferred stock in connection with the Riverstone spin off in August 2001. During the first quarter of fiscal year 2002 the value of the Riverstone shares decreased $14.7 million, and the associated increase in our redemption liability was recorded as other expense.

Income Tax Expense (Benefit)

For the first quarter of fiscal year 2002, we incurred net income tax benefits of $61.0 million due primarily to the tax loss carry back benefits associated with the passage of the Job Creation and Worker Assistance Act of 2002. In March 2002, a tax law change was enacted whereby the allowable period to carry back net operating losses was increased from two to five years. As a result, we received approximately $102 million of federal income tax refunds relating to tax losses incurred in fiscal and transition 2001. In addition, we have approximately $110 million of prior period taxable income available to offset potential losses in fiscal 2002, the use of which is expected to generate up to approximately $30 million of federal income tax refunds in fiscal 2003. For the first quarter of transition year 2001, we incurred a tax liability of $2.9 million.

Loss from Discontinued Operations

In the first quarter of fiscal year 2002, we recorded an additional charge of $11.7 million due to a change in estimate of the loss on disposal of Aprisma.

Financial Condition

Liquidity and Capital Resources

As of March 30, 2002, liquid investments totaled $231.4 million and consisted of $92.1 million of cash and cash equivalents, $69.0 million of marketable securities and $70.3 million of long-term marketable securities. In connection with the issuance of letters of credit by several banking institutions, we have agreed to maintain specified amounts of cash, cash equivalents and marketable securities in collateral accounts controlled by those institutions. These assets totaled $23.6 million at March 30, 2002 and are classified as "Restricted cash, cash equivalents and marketable securities" on the balance sheet.

Net cash used by operating activities was $68.9 million for the three months ended March 30, 2002. The components of cash used in operating activities for the three months ended March 30, 2002 as detailed in the Consolidated Statement of Cash Flows included in Part 1 Item 1 of this quarterly report on Form 10-Q included a $95.0 million increase in current assets and liabilities which was partially offset by net income and other non-cash reconciling items of $26.1 million. Cash flows from financing activities for the three months ended March 30, 2002 included $23.1 million of cash provided by discontinued operations. Our capital expenditures in the three months ended March 30, 2002 were $9.2 million and related primarily to information technology purchases and upgrades and facility-related expenditures.

Beginning on February 23, 2003, the holders of our Series D and E preferred stock have the right to redeem these shares for approximately $99 million in cash, less any proceeds from the sale of the approximately 1.3 million shares of Riverstone stock distributed to them in connection with our spin-off of Riverstone. We are engaged in discussions with the preferred stockholders concerning alternatives to this potential redemption right, although there can be no assurance as to the outcome of any such discussions.

We are focused on achieving cash-positive operations in the near-term and believe we have made, and will continue to make, substantial progress toward that goal. Based on our current liquid investment position and $30 million of estimated federal income tax refunds that we expect to receive in 2003 relating to losses expected to be incurred in 2002, we believe that we have sufficient liquid investments to fund our on-going operations and future obligations for at least the next twelve months.

Changes in Financial Condition

Accounts receivable, net of allowance for doubtful accounts, were $49.8 million at March 30, 2002 compared with $67.7 million at December 29, 2001. The decrease in accounts receivable is due primarily to the decline in net revenue in the first quarter of fiscal year 2002. We anticipate that in the future our accounts receivable balance will fluctuate at approximately the same rate of change as our revenue. The days sales outstanding was 37 days at March 30, 2002, compared to 34 days at December 29, 2001.

Inventories were $112.9 million at March 30, 2002, or 2.7 turns per annum, compared with $118.2 million at December 29, 2001, or 2.8 turns per annum. We believe that our inventory turnover rate will improve in the future as we implement better forecasting procedures and restructure arrangements with our contract manufacturers.

As of March 30, 2002, we had an income tax receivable of $119.1 million due to tax loss carry back benefits associated with the passage of the Job Creation and Workers Assistance Act of 2002.

New Accounting Pronouncements

Effective December 30, 2001, we adopted the Financial Accounting Standards Board (“FASB”) Emerging Issues Task Force (“EITF”) No. 00-25, “Vendor Income Statement Characterization of Consideration Paid to a Reseller of the Vendor’s Products,” which requires among other things, that payments made to resellers by us for cooperative advertising, buy-downs and similar arrangements should be classified as reductions to net sales or an increase in selling expenses, depending upon the application of the funds by the customer. As a result, the financial statement presentation for three months ended March 30, 2002 conforms to the requirements of EITF No. 00-25 and the amounts for the three months ended June 2, 2001 have been reclassified to comply with the guidelines of the consensus. The reclassification for the three months ended June 2, 2001 resulted in a reduction of net revenue of $3.4 million a reduction of cost of revenue of $5.0 million and an increase in selling, general and administrative expenses of $1.6 million. The above reclassification had no impact on the net loss or loss per share.

Effective December 30, 2001, we adopted SFAS No. 142, “Goodwill and Other Intangible Assets.” See Note 8 to our consolidated financial statements included in Part 1 Item 1 of this quarterly report on Form 10-Q for further information concerning our adoption of SFAS No. 142.

In June 2001, the FASB issued SFAS No. 143, “Accounting for Asset Retirement Obligations,” which addresses financial accounting and reporting for obligations associated with the retirement of tangible long-lived assets and the associated asset retirement costs. SFAS No. 143 requires recognition of asset retirement obligations as a liability rather than a contra-asset. SFAS No. 143 is effective for our fiscal year ending January 3, 2004. We are currently evaluating the impact that the adoption will have on the consolidated financial statements.

Effective December 30, 2001, we adopted SFAS No. 144, “Accounting for the Impairment or Disposal of Long-Lived Assets,” which excludes from the definition of long-lived assets goodwill and other intangibles that are not amortized in accordance with SFAS No. 142. SFAS No. 144 requires long-lived assets disposed of by sale to be measured at the lower of carrying amount or fair value less cost to sell, whether reported in continuing operations or in discontinued operations. SFAS No. 144 also expands the reporting of discontinued operations to include components of an entity that have been or will be disposed of rather than limiting such discontinuance to a segment of a business.

The transition provisions of SFAS No. 144 require that disposal activities that were initiated before the initial application of SFAS No. 144 continue to be accounted for and displayed in the income statement in accordance with the prior pronouncement applicable to the disposal. However, SFAS No. 144 requires a company to reclassify previously issued statements of financial position presented for comparative purposes if a company presented as a single net line item the asses and liabilities of a disposal group. As a result, we continue to account for and present in our consolidated statements of operations, the Riverstone, Aprisma and GNTS discontinued operations in accordance with Accounting Principles Board Opinion No. 30, “Reporting the Results of Operations — Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions,” and has reclassified the assets and liabilities of Aprisma on the consolidated balance sheets to conform to the presentation required by SFAS

No. 144. See Note 4 to our consolidated financial statements included in Part 1 Item 1 of this quarterly report on Form 10-Q for a discussion of our discontinued operations. The adoption of SFAS No. 144 did not have any impact on the book value of our long-lived assets.

In April 2002, the FASB issued SFAS No. 145, “Rescission of FASB Statements No. 4, 44 and 64, Amendment of FASB Statement No. 13, and Technical Corrections.” SFAS No. 145, among other things, rescinds SFAS No. 4, which required all gains and losses from the extinguishment of debt to be classified as an extraordinary item and amends SFAS No. 13 to require that certain lease modifications that have economic effects similar to sale-leaseback transactions be accounted for in the same manner as sale-leaseback transactions. This statement was issued effective for fiscal years beginning May 15, 2002 or later. We do not expect this statement will have an impact on our consolidated financial statements.

In July 2002, the FASB issued SFAS No. 146, “Accounting for Costs Associated with Exit or Disposal Activities,” which requires companies to recognize costs associated with exit or disposal activities when a liability is incurred rather than at the date of a commitment to an exit or disposal plan. This statement is effective for fiscal years beginning after December 31, 2002. We are currently evaluating the impact that the adoption will have on the consolidated financial statements.

CAUTIONARY STATEMENTS

We may occasionally make forward-looking statements and estimates such as forecasts and projections of our future performance or statements of our plans and objectives. These forward-looking statements may be contained in, among other things, SEC filings, including this quarterly report on Form 10-Q, and press releases made by us and in oral statements made by our officers. Actual results could differ materially from those contained in such forward-looking statements. Important factors that could cause our actual results to differ from those contained in such forward-looking statement include, among other things, the risks described below and the risks described below in our Form 10-K for the transition period ended December 29, 2002 filed with the SEC on November 26, 2002.

Risks Related to our Financial Results and Condition

The SEC investigation and our accounting restatements could materially harm our business, operating results and financial condition

The uncertainty associated with the SEC investigation into our accounting practices and the restatement of our financial statements could seriously harm our business, financial condition and reputation. In particular, this uncertainty could harm our relationships with existing customers and has impaired and could continue to impair our ability to attract new customers. Purchasing decisions by potential and existing customers have been and may continue to be postponed, we believe in part due to the SEC investigation. If potential and existing customers lose confidence in us, our competitive position in the networking industry may be seriously harmed and our revenues could decline. In addition, we believe this uncertainty has caused significant declines in our stock price, and continued uncertainty or negative developments could cause the price of our common stock to decline further.

We are the defendant in a number of class action lawsuits alleging violations of the securities laws against us, as well as derivative actions against our Board of Directors. The restatement of our financial statements may lead to new litigation, may strengthen and expand the claims and the class period in pending litigation, and may increase the cost of defending or resolving current litigation. We expect that resolution of these lawsuits will continue to involve significant management time and attention and significant expenses for professional fees, and could lead to the payment of significant damages, any of which could materially harm our financial condition and results of operations.

As a result of the findings of the internal review initiated by our Board of Directors, individuals identified as having participated in, or who reasonably should have known about conduct contrary to our internal policies, have left our organization, have been terminated or have otherwise been disciplined. We have also instituted new policies and procedures designed to enhance our ability to monitor and enforce our revenue recognition policies worldwide. In addition, between March and October of 2002, several of our executive officers resigned and were replaced with new management. In October 2002, our Vice President of Finance was promoted to the position of Chief Financial Officer. We also hired new managers in several senior finance and operations capacities and bolstered our finance staff in several key areas. In addition, we added an internal audit director who reports directly to the Audit Committee of our Board of Directors as well as to our Chief Financial Officer. However, our new management team has limited experience working together, and they, and our new policies and procedures, may not enable us to prevent or timely identify future accounting irregularities.

The SEC investigation remains pending and continues to require significant management attention and resources. An adverse finding by the SEC may lead to significant fines and penalties, as well as limitations on our activities and our inability to rely on certain securities law safe harbors available to other companies. The filing of our restated financial statements to correct the discovered accounting irregularities will not necessarily resolve the pending SEC investigation into our accounting practices. The resolution of the SEC investigation could require the filing of additional restatements of our prior financial statements, and/or our restated financial statements, or require that we take other actions not presently contemplated.

Worldwide economic weakness, deteriorating market conditions and recent political and social turmoil have and may continue to negatively affect our business and revenues and make forecasting more difficult, which could harm our financial condition

Our business is subject to the effects of general worldwide economic conditions, particularly in the United States and EMEA, and market conditions in the networking industry, which have been particularly unfavorable. Recent political and social turmoil, such as terrorist and military actions as well as the effects of any hostilities involving the U.S. in the Middle East or anywhere else in the world and any continuation or repercussions thereof or responses thereto may put further pressure on worldwide economic conditions. If economic or market conditions fail to improve or worsen, our business, revenues, and forecasting ability will continue to be negatively affected, which could harm our results of operations and financial condition.

Market conditions in the networking industry have been particularly unfavorable over the past two years, as companies have been reluctant to invest in their network infrastructures in light of continued economic uncertainty. In recent quarters, our product revenues have declined as a result of reduced capital spending and a lengthened sales cycle attributable to unfavorable economic and market conditions as well as other factors. Continued economic weakness could result in increased price competition in our industry and could further reduce demand for our products, either of which could harm our revenues and reduce our gross margin.

These unfavorable political, social and economic conditions and uncertainties also make it extremely difficult for us, our customers and our vendors to accurately forecast and plan future business activities. In particular, it is difficult for us to develop and implement strategies, forecast demand for our products, and effectively manage contract manufacturing and supply chain relationships. This reduced predictability challenges our ability to operate profitably and to grow our business.

We have a history of losses in recent years and may not operate profitably in the future

We have experienced losses in recent years and may not achieve or sustain profitability in the future. We will need to generate higher revenues and reduce our costs to achieve and maintain consistent profitability. We may not be able to generate higher revenues or reduce our costs, and if we do achieve consistent profitability, we may not be able to sustain or increase our profitability over subsequent periods. Our revenues have been negatively affected by weaker economic conditions worldwide, which have reduced demand and increased price competition for most of our products, as well as resulted in longer selling cycles. If weaker worldwide economic conditions continue for an extended period of time, our ability to maintain and increase our revenues may be significantly limited. In addition, while we recently implemented a cost reduction plan designed to decrease our expenses, which included a significant reduction in the size of our workforce and the sale of our operating subsidiary, Aprisma, we will continue to have large fixed expenses and expect to continue to incur significant sales and marketing, product development, customer support and service and other expenses. We continue to assess whether additional cost-cutting efforts may be required. Additional cost-cutting efforts may result in the recording of additional charges, such as workforce reduction costs, facilities reduction costs, asset write downs and contractual settlements. Further, our workforce reductions may impair our ability to realize our current or future business objectives, and costs incurred in connection with our cost-cutting efforts may be higher than the estimated costs of such actions and may not lead to anticipated cost savings. As a result, our cost-cutting efforts may not result in a return to profitability.

Our quarterly operating results are likely to fluctuate, which could cause us to fail to meet quarterly operating targets and result in a decline in our stock price

Our operating expenses are largely based on anticipated organizational size and revenue trends, and a high percentage of these expenses are, and will continue to be, fixed in the short term. As a result, if our revenue for a particular quarter is below our expectations, we will be unable to proportionately reduce our operating expenses for that quarter. Any revenue shortfall in a quarter may thus cause our financial results for that quarter to fall below the expectations of public market analysts or investors, which could cause the price of our common stock to fall. Any increase in our fixed expenses will increase the magnitude of this risk. In addition, the unpredictability of our operating results from quarter to quarter could cause our stock to trade at lower prices than it would if our results were consistent from quarter to quarter.

Our quarterly operating results may vary significantly from quarter to quarter in the future due to a number of factors, including:

- fluctuations in the demand for our products and services;
- the timing and size of sales of our products or the cancellation or rescheduling of significant orders;
- the length and variability of the sales cycle for our products;
- the timing of implementation and product acceptance by our customers and by customers of our distribution partners;
- the timing and success of new product introductions;
- the timing and level of non-cash, stock-based compensation charges;
- increases in the prices or decreases in the availability of the components we purchase;
- price and product competition in the networking industry;
- our ability to source and receive from third party sources appropriate product volumes and quality;
- manufacturing lead times and our ability to maintain appropriate inventory levels;
- the timing and level of research, development and prototype expenses;
- the mix of products and services sold;
- changes in the distribution channels through which we sell our products and the loss of distribution partners;
- the uncertainties inherent in our accounting estimates and assumptions and the impact of changes in accounting principles;
- our ability to achieve targeted cost reductions;
- the outcome of pending securities litigation and the pending SEC investigation into our accounting practices; and
- general economic conditions as well as those specific to the networking industry.

Due to these and other factors, you should not rely on quarter-to-quarter comparisons of our operating results as an indicator of our future performance.

We earn a substantial portion of our revenue for each quarter in the last month of each quarter, which reduces our ability to accurately forecast our quarterly results and increases the risk that we will be unable to achieve previously forecasted results

We have derived and expect to continue to derive a substantial portion of our revenues in the last month of each quarter, with such revenues frequently concentrated in the last two weeks of the quarter. Because we rely on the generation of a large portion of revenues at the end of the quarter, we traditionally have not been able, and in the future do not expect to be able, to predict our financial results for any quarter until very late in the quarter. Due to this end-of-quarter buying pattern, we may not achieve our financial forecasts, either because expected sales do not occur in the anticipated quarter or because they occur at lower prices or on terms that are less favorable to us than anticipated.

We may need additional capital to fund our future operations, commitments and contingencies and, if it is not available when needed, our business may be harmed

We believe our existing working capital, cash available from operations and anticipated tax refunds will enable us to meet our working capital requirements for at least the next twelve months. Our working capital requirements and cash flows historically have been, and are expected to continue to be, subject to quarterly and yearly fluctuations, depending on such factors as capital expenditures, sales levels, collection of receivables, inventory levels, supplier terms and obligations, and other factors impacting our financial performance and condition. Also, in February 2003, the holders of our Series D and E preferred stock have the right to redeem these shares from us for cash. This redemption could require that we pay them up to $99 million in cash for their shares. Our inability to manage cash flow fluctuations resulting from these and other factors could impair our ability to fund our working capital requirements from operating cash flows and other sources of liquidity or to achieve our business objectives in a timely manner. We have not established any borrowing relationships with financial institutions and are primarily reliant on cash generated from operations to meet our cash requirements. If cash from future operations is insufficient, or if cash must be used for currently unanticipated uses, we may need to raise additional capital or reduce our expenses.

We cannot assure you that additional capital, if required, will be available on acceptable terms, or at all. As a result of the current unfavorable market environment, as well as the SEC investigation into our accounting practices and related litigation, our ability to access the capital markets and establish borrowing relationships with financial institutions has been impaired and may continue to be impaired for the foreseeable future. If we are unable to obtain additional capital when needed or must reduce our expenses, it is likely that our product development and marketing efforts will be restricted, which would harm our ability to develop new and enhanced products, expand our distribution relationships and customer base, and establish our brand name. This could adversely impact our competitive position and cause our revenues to decline. To the extent that we raise additional capital through the sale of equity or convertible debt securities, existing stockholders may suffer dilution. Also, these securities may provide the holders with certain rights, privileges and preferences senior to those of common stockholders. If we raise additional capital through the sale of debt securities, the terms of such debt could impose restrictions on our operations.

In February 2003, the holders of our Series D and E preferred stock may require redemption of their shares for cash, which could impair our cash position, or request the conversion of their shares into shares of our common stock, which would dilute our existing stockholders

In February 2003, the holders of our Series D and E preferred stock have the right to redeem these shares for cash. This redemption could require us to pay them up to approximately $99 million in cash for their shares less proceeds from the sale of the Riverstone shares they received in the Riverstone spin-off, which could impair our cash position. If we fail to redeem the Series D and E shares, pursuant to the terms of our Certificate of Incorporation the Series D and E Preferred stock will become convertible into a much larger number of shares of our common stock than it is currently convertible into, which would dilute the ownership interest of our existing common stockholders. Upon our failure to redeem, these shares would be convertible into approximately 58 million shares of our common stock, resulting in these holders holding 29% of our outstanding common stock, based on the closing price of our common stock of $1.68 per share and approximately 202.0 million shares outstanding on January 13, 2003. It is also possible that, as an alternative to the foregoing, we may renegotiate the terms of the Series D and E preferred stock with the holders. We cannot assure you that we will be successful in renegotiating the terms. Any renegotiations will likely result in terms less favorable to us than the current terms.

Pending and future litigation could materially harm our business, operating results and financial condition

Several lawsuits have been filed against us and our directors in recent years, including nine shareholder class action lawsuits filed between October 24, 1997 and March 2, 1998, and, more recently, six shareholder class action lawsuits filed between February 7, 2002 and April 9, 2002, as well as shareholder derivative actions filed in the State of New Hampshire on February 22, 2002 and in the State of Delaware on April 16, 2002. See *"Part II, Item 1 - Legal Proceedings"* of this report for a more detailed discussion of pending litigation. We may be required to pay significant damages as a result of these lawsuits. We are and may in the future be subject to other litigation arising in the normal course of our business or in connection with the recent restatement of our financial statements.

The uncertainty associated with these lawsuits could seriously harm our business, financial condition and reputation by, among other things, harming our relationships with existing customers and impairing our ability to attract new customers. In addition, the continued defense of these lawsuits will result in significant expense and the continued diversion of our management's time and attention from the operation of our business, which could impede our ability to achieve our business objectives. The unfavorable resolution of any specific lawsuit could materially harm our business, operating results and financial condition, and could cause the price of our common stock to decline significantly.

The limitations of our director and officer liability insurance may materially harm our financial condition

Our director and officer liability insurance for the period during which events related to securities class action lawsuits against us and certain of our current and former officers and directors are alleged to have occurred provides only limited liability protection. If these policies do not adequately cover expenses and certain liabilities relating to these lawsuits, our financial condition could be materially harmed. Our certificate of incorporation provides that we will indemnify and advance expenses to our directors and officers to the maximum extent permitted by Delaware law. The indemnification covers any expenses and liabilities reasonably incurred by a person, by reason of the fact that such person is or was or has agreed to be a director or officer, in connection with the investigation, defense and settlement of any threatened, pending or completed action, suit, proceeding or claim.

The facts underlying the SEC investigation and shareholder lawsuits will likely increase the premiums we must pay for director and officer liability insurance in the future, and may make this insurance coverage prohibitively expensive or unavailable. Increased premiums for this insurance could materially harm our financial results in future periods. The inability to obtain this coverage due to its unavailability or prohibitively expensive premiums would make it more difficult for us to retain and attract officers and directors.

Our failure to improve our management information systems and internal controls could harm our business

We currently use three disparate information systems in our domestic and international operations, resulting in delays in obtaining consistent and timely information on a worldwide basis and use of extensive manual procedures to generate our consolidated financial results. Further, our systems do not provide all of the information that we believe is necessary to successfully operate our business, and we have identified weaknesses in our internal controls and accounting procedures. We have implemented a number of changes designed to improve our information systems and controls, including organizational changes, communication of revenue recognition and other accounting policies to all of our employees, implementation of an internal audit function, new approval procedures and various other initiatives. We are evaluating additional changes which may require us to make investments in our systems and controls, which could result in higher future operating expenses and capital expenditures. If we fail to strengthen our management information systems and internal controls, our ability to manage our business and implement our strategies may be impaired and our financial condition could be harmed. In addition, even if we are successful in strengthening these systems and controls, they may not sufficiently improve our ability to manage our business and implement our strategies, or be adequate to prevent or identify irregularities.

We have experienced significant turnover of senior management and our current management team has been together for only a limited time, which could harm our business and operations

In connection with the merger of Enterasys Subsidiary into us in August 2001, our management team was restructured to include several senior Enterasys Subsidiary executives. In April 2002, we announced the departure of several of these senior executives, including our President and Chief Executive Officer. In October 2002, our Vice President of Finance was promoted to the position of Chief Financial Officer. Because of these recent changes and their recent recruitment, our current management team has not worked together for a significant length of time and may not be able to work together effectively to successfully develop and implement business strategies. In addition, as a result of these management changes, management will need to devote significant attention and resources to preserve and strengthen relationships with employees and customers. If our new management team is unable to develop successful business strategies, achieve our business objectives, or maintain positive relationships with employees and customers, our ability to grow our business and successfully meet operational challenges could be impaired.

Retaining key management and employees is critical to our success

Our future success depends to a significant extent on the continued services of our key employees, many of whom have significant experience with the network communications market, as well as relationships with many of our existing and potential enterprise customers and business partners. The loss of several of our key employees or any significant portion of them could have a significant detrimental effect on our ability to execute our business strategy. Our future success also depends on our continuing ability to identify, hire, train, assimilate and retain large numbers of highly qualified engineering, sales, marketing, and managerial and support personnel. If we cannot successfully recruit and retain such persons, particularly in our engineering and sales departments, our development and introduction of new products could be delayed and our ability to compete successfully could be impaired.

Despite the current economic downturn, the competition for qualified employees in our industry is particularly intense in the New England area, where our principal operations are located, and it can be difficult to attract and retain quality employees at reasonable cost. We have from time to time experienced, and we expect to continue to experience in the future, difficulty in hiring and retaining highly skilled employees with appropriate qualifications. In addition, the significant downturn in our business environment has caused us to significantly reduce our workforce and implement other cost-containment activities, including consolidating our operating

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locations and relocating some of our personnel to Rochester, New Hampshire and Andover, Massachusetts. These actions, as well as the pending SEC investigation of our accounting practices and shareholder litigation, may lead to disruptions in our business, reduced employee morale and productivity, increased attrition and difficulty retaining existing employees and recruiting future employees, any of which could harm our business and operating results.

We maintain strategic investments in early stage, privately held technology companies to establish relationships that we believe may benefit us as we execute our business strategy, but these relationships may not prove helpful to us, and we could lose our entire investment in these companies

We have made strategic investments in privately-held technology companies and value-added resellers, many of which are in the start-up or development stage. The benefits we expected to achieve by investing in these companies may not be realized. Moreover, investments in these companies are inherently risky as the technologies or products they have under development, or the services they propose to provide, are often in early stages of development and may never materialize. We may never realize any benefits or financial returns from these investments, and, if these companies are not successful, we could lose our entire investment. The concentration of our investments in a small number of related industries, primarily telecommunications, exposes our investments to increased risk, particularly if these industries continue to be adversely affected by the worldwide economic slowdown. At March 30, 2002, these investments totaled approximately $64.0 million. During the three-month period ended March 30, 2002, we recorded impairment losses of $0.4 million relating to these investments.

Risks Related to the Markets for our Products

There is intense competition in the market for enterprise network equipment, which could prevent us from increasing our revenue and achieving profitability

The network communications market is dominated by a small number of competitors, some of which, Cisco Systems in particular, have substantially greater resources and market share than other participants in that market, including us. In addition, this market is intensely competitive, subject to rapid technological change and significantly affected by new product introductions and other market activities of industry participants. Competitive pressures could result in price reductions, reduced margins or loss of market share, which would materially harm our ability to increase revenues and profitability.

Our principal competitors include Alcatel; Avaya, formerly part of Lucent; Cisco Systems; Extreme Networks; Foundry Networks; Hewlett-Packard; Nortel Networks; and 3Com. We also experience competition from a number of other smaller public and private companies. We may experience reluctance by our prospective customers to replace or expand their current infrastructure solutions, which may be supplied by one or more of these competitors, with our products. There has also been a trend toward consolidation in our industry for several years, and we expect this trend will continue as companies attempt to strengthen or maintain their market share positions. Consolidation among our competitors and potential competitors may result in stronger competitors with expanded product offerings and a greater ability to accelerate their development of new technologies.

Some of our competitors have significantly more established customer support and professional services organizations and substantially greater selling and marketing, technical, manufacturing, financial and other resources than we do. Many of our competitors also have more customers, greater market recognition and more established relationships and alliances in the industry. As a result, these competitors may be able to develop, enhance and expand their product offerings more quickly, adapt more swiftly to new or emerging technologies and changes in customer demands, devote greater resources to the marketing and sale of their products, pursue acquisitions and other opportunities more readily and adopt more aggressive pricing policies. Additional competitors with significant market presence and financial resources may enter our rapidly evolving market, thereby further intensifying competition.

We may be unable to expand our indirect distribution channels, which may hinder our ability to grow our customer base and increase our revenues

Our sales and distribution strategy relies heavily on our indirect sales efforts, including sales through distributors and channel partners, such as value-added resellers, systems integrators and telecommunications service providers. We believe that our future success will depend in part upon our ability to maintain and expand existing relationships, as well as establish successful new relationships, with a variety of these partners. If we are unable to expand our indirect distribution channels, we may be unable to increase or sustain market awareness or sales of our products and services, which may prevent us from maintaining or increasing our customer base and revenues.

Even if we are able to expand our indirect distribution channels, our revenues may not increase. Our distribution partners are not prohibited from selling products and services that compete with ours and may not devote adequate resources to selling our products and services. In addition, we may be unable to maintain our existing agreements or reach new agreements with distribution partners on a timely basis or at all.

We expect the average selling prices of our products to decrease over time, which may reduce our revenue and gross margins

Our industry has experienced erosion of average selling prices in recent years, particularly as products reach the end of their life cycles. We anticipate that the average selling prices of our products will decrease in the future in response to increased sales discounts and new product or technology introductions by us and our competitors. Our prices will also likely be adversely affected by downturns in regional or industry economies, such as the recent downturn in the United States economy. We also expect our gross margins may be adversely affected by increases in material or labor costs and an increasing reliance on third party distribution channels. If we are unable to achieve commensurate cost reductions and increases in sales volumes, any decline in average selling prices will reduce our revenues and gross margins.

If we do not anticipate and respond to technological developments and evolving customer requirements, we may not retain our current customers or attract new customers

The markets for our products are characterized by rapidly changing technologies and frequent new product introductions. The introduction by us or our competitors of new products and the emergence of new industry standards and practices can render existing products obsolete and unmarketable. Our success will depend upon our ability to enhance our existing products and to develop and introduce, on a timely and cost-effective basis, new products and functionality that keep pace with technological developments and emerging standards. Any failure to introduce new products and enhancements on a timely basis will harm our future revenue and prospects.

Our future success will also depend upon our ability to develop and manage customer relationships and to introduce a variety of new products and product enhancements that address the increasingly sophisticated needs of our customers. Our current and prospective customers may require product features and capabilities that our products do not have. We must anticipate and adapt to customer requirements and offer products that meet those demands in a timely manner. Our failure to develop products that satisfy evolving customer requirements could seriously harm our ability to achieve or maintain market acceptance for our products and prevent us from recovering our product development investments.

Our focus on sales to enterprise customers subjects us to risks that may be greater than those for providers with a more diverse customer base

We focus principally on sales of products and services to enterprises, such as large corporations and government agencies that rely on network communications for many important aspects of their operations. This focus subjects us to risks that are particular to this customer segment. For example, many of our current and potential customers are health care, education and governmental agencies, all of whom are generally slower to incorporate information technology into their business practices due to the regulatory and privacy issues that must be addressed with respect to the sharing of their information. In addition, the use and growth of the Internet is critical to enterprises, which often have electronic networks, applications and other mission-critical functions that use the Internet. To the extent that there is any decline in use of the Internet for electronic commerce or communications, for whatever reason, including performance, reliability or security concerns, we may experience decreased demand for our products and lower than expected revenue growth.

Many of our competitors sell their products to both enterprises and service providers, which are companies who provide Internet-based services to businesses and individuals. In the future, the demand for network communications products from enterprises may not grow as rapidly as the demand from service providers. Enterprises may turn to service providers to supply them with services that obviate the need for enterprises to implement many of our solutions. Because we sell our products primarily to enterprises, our exposure to these risks is greater than that of vendors that sell to a more diversified customer base.

Risks Related to our Products

Our products are very complex, and undetected defects may increase our costs, harm our reputation with our customers and lead to costly litigation

Our network communications products are extremely complex and must operate successfully with complex products of other vendors. Our products may contain undetected errors when first introduced or as we introduce product upgrades. The pressures we face to be the first to market new products or functionality increases the possibility that we will offer products in which we or our customers later discover problems. We have experienced new product and product upgrade errors in the past and expect similar problems in the future. These problems may cause us to incur significant warranty and other costs and divert the attention of our engineering personnel from our product development efforts. If we are unable to repair these problems in a timely manner, we may experience a loss of or delay in revenues and significant damage to our reputation and business prospects.

Many of our customers rely upon our products for business-critical applications. Because of this reliance, errors, defects or other performance problems in our products could result in significant financial and other damage to our customers. Our customers could attempt to recover these losses by pursuing product liability claims against us, which, even if unsuccessful, would likely be time-consuming and costly to defend and could adversely affect our reputation.

If our products do not comply with complex governmental regulations and evolving industry standards, our products may not be widely accepted, which may prevent us from sustaining our revenues or achieving profitability

The market for network communications equipment is characterized by the need to support industry standards as different standards emerge, evolve and achieve acceptance. In the past, we have had to delay the introduction of new products to comply with third party standards testing. We may be unable to address compatibility and interoperability problems that arise from technological changes and evolving industry standards. We also may devote significant resources developing products designed to meet standards that are not widely adopted. In the United States, our products must comply with various governmental regulations and industry regulations and standards, including those defined by the Federal Communications Commission, Underwriters Laboratories and Networking Equipment Building Standards. Internationally, our products are required to comply with standards or obtain certifications established by telecommunications authorities in various countries and with recommendations of the International Telecommunications Union. If we do not comply with existing or evolving industry standards, fail to anticipate correctly which standards will be widely adopted or fail to obtain timely domestic or foreign regulatory approvals or certificates, we will be unable to sell our products where these standards or regulations apply, which may prevent us from sustaining our revenues or achieving profitability.

The United States government may impose unique requirements on network equipment providers before they are permitted to sell to the government, such as that supplied products qualify as made in the United States. Such requirements may be imposed on some or all government procurements. We may not always satisfy all such requirements. Other governments or industries may establish similar performance requirements or tests that we may be unable to satisfy. If we are unable to satisfy the performance or other requirements of the United States government or other industries that establish them, our revenues growth may be lower than expected.

Because several of our significant competitors maintain dominant positions in selling network equipment products to enterprises and others, they may have the ability to establish de facto standards within the industry. Any actions by these competitors or other industry leaders that diminish compliance by our products with industry or de facto standards or the ability of our products to interoperate with other network communication products would be damaging to our reputation and our ability to generate revenue.

Our limited ability to protect our intellectual property may hinder our ability to compete

We regard our products and technology as proprietary. We attempt to protect them through a combination of patents, copyrights, trademarks, trade secret laws, contractual restrictions on disclosure and other methods. These methods may not be sufficient to protect our proprietary rights. We also generally enter into confidentiality agreements with our employees, consultants and customers, and generally control access to and distribution of our documentation and other proprietary information. Despite these precautions, it may be possible for a third party to copy or otherwise misappropriate and use our products or technology without authorization, particularly in foreign countries where the laws may not protect our proprietary rights to the same extent as do the laws of the United States, or to develop similar technology independently. We have resorted to litigation in the past and may need to resort to litigation in the future to enforce our intellectual property rights, to protect our trade secrets or to determine the validity and scope of the proprietary rights of others. Litigation of this type could result in substantial costs and diversion of resources and could harm our business.

We may be subject to claims that our intellectual property infringes upon the proprietary rights of others, and a successful claim could harm our ability to sell and develop our products

We license technology from third parties and are continuing to develop and acquire additional intellectual property. Although we have not been involved in any material litigation relating to our intellectual property, we expect that participants in our markets will be increasingly subject to infringement claims. Third parties may try to claim our products infringe their intellectual property, in which case we would be forced to defend ourselves or our customers, manufacturers and suppliers against those claims. Any claim, whether meritorious or not, could be time consuming, result in costly litigation and/or require us to enter into royalty or licensing agreements. Although we carry general liability insurance, our insurance may not cover potential claims of this type or may not be adequate to indemnify us for all liability that may be imposed. In addition, any royalty or licensing agreements might not be available on terms acceptable to us or at all, in which case we would have to cease selling, incorporating or using the products that incorporate the challenged intellectual property and expend substantial amounts of resources to redesign our products. If we are forced to enter into unacceptable royalty or licensing agreements or to redesign our products, our business and prospects would suffer.

Risks Related to our Manufacturing and Components

We use several key components for our products that we purchase from single or limited sources, and we could lose sales if these sources fail to fulfill our needs

We currently work with third parties to manufacture our key proprietary application-specific integrated circuits, which are custom designed circuits built to perform a specific function more rapidly than a general purpose microprocessor. These proprietary circuits are very complex, and these third parties are our sole source suppliers for the specific types of application specific integrated circuits that they supply to us. We also have limited sources for the semiconductor chips that we use in our wireless RoamAbout solution, as well as several other key components used in the manufacture of our products. We do not carry significant inventories of these components, and we do not have a long-term, fixed price or minimum volume agreements with these suppliers. If we encounter future problems with these vendors, we likely would not be able to develop an alternate source in a timely manner. We have encountered shortages and delays in obtaining these components in the past and may experience similar shortages and delays in the future. If we are unable to purchase our critical components, particularly our application-specific integrated circuits, at such times and in such volumes as our business requires, we may not be able to deliver our products to our customers in accordance with schedule requirements. In addition, any delay in obtaining key components for new products under development could cause a significant delay in the initial launch of these products. Any delay in the launch of new products could harm our reputation and operating results.

Even if we are able to obtain these components in sufficient volumes and on schedules that permit us to satisfy our delivery requirements, we have little control over their cost. Accordingly, the lack of alternative sources for these components may force us to pay higher prices for them. If we are unable to obtain these components from our current suppliers or others at economical prices, our margins could be adversely impacted unless we raise the prices of our products in a commensurate manner. The existing competitive conditions may not permit us to do so, in which case our operating results may suffer.

We depend upon a limited number of contract manufacturers for substantially all of our manufacturing requirements, and the loss of our primary contract manufacturer would impair our ability to meet the demands of our customers

We do not have internal manufacturing capabilities. We outsource most of our manufacturing to one company, Flextronics International, Ltd., which procures material on our behalf and provides comprehensive manufacturing services, including assembly, test, control and shipment to our customers. Our agreement with Flextronics expired in February 2002 and, since that time, we have been operating under an informal extension of the expired contract while negotiating a new agreement with Flextronics. Our secondary contract manufacturer is Accton Technology Corporation, which provides services similar to those of Flextronics. If we experience increased demand for our products, we will need to increase our manufacturing capacity with Flextronics and Accton or add additional contract manufacturers. Flextronics and Accton also build products for other companies, and we cannot be certain that they will always have sufficient quantities of inventory and capacity available or that they will allocate their internal resources to fulfill our requirements. Further, qualifying a new contract manufacturer and commencing volume production is expensive and time consuming. The loss of our existing contract manufacturers, the failure of our existing contract manufacturers to satisfy their contractual obligations to us or our failure to timely qualify a new contract manufacturer to meet anticipated demand increases could result in a significant interruption in the supply of our products. In this event, we could lose revenue and damage our customer relationships.

If we fail to accurately predict our manufacturing requirements, we could incur additional costs or experience manufacturing delays

We use a forward-looking forecast of anticipated product orders to determine our product requirements for our contract manufacturer. The lead times for materials and components we order vary significantly and depend on factors such as the specific supplier, contract terms and demand for each component at a given time. For example, some of our application-specific integrated circuits have a lead time of up to eight months. If we overestimate our requirements, our contract manufacturers may have excess inventory, which we may be obligated to pay for. If we underestimate our requirements, our contract manufacturers may have inadequate inventory, which could result in delays in delivery to our customers and our recognition of revenue.

In addition, because our contract manufacturers produce our products based on forward-looking demand projections that we supply to them, we may be unable to respond quickly to sudden changes in demand. For example, following the events of September 11, 2001, we experienced a sudden drop in demand for our products and were unable to reduce the amount of product manufactured by our contract manufacturers in the short term, which were based on demand forecasts provided prior to the sudden change in demand. This contributed to a $72.9 million charge for inventory obsolescence in transition 2001 of which $9.8 million was incurred in the quarter ended June 2, 2001. With respect to sudden increases in demand, we may be unable to satisfy this demand with our products, thereby forfeiting revenue opportunities and damaging our customer relationships, and with respect to sudden decreases in demand, we may find ourselves with excess finished goods inventory, which could expose us to high manufacturing costs compared to our revenue in a financial quarter and increased risks of inventory obsolescence.

Other Risks Related to our Business

Our significant sales outside the United States subject us to increasing foreign political and economic risks, including foreign currency fluctuations

Our sales to customers outside of the North America accounted for approximately 43.4% of our revenue in the three months ended March 30, 2002, and 46.5% of our revenue in the three months ended June 2, 2001. We are seeking to expand our international presence by establishing arrangements with distribution partners as well as through strategic relationships in international markets. Consequently, we anticipate that sales outside of the United States will continue to account for a significant portion of our revenues in future periods.

The sales of our products are denominated primarily in United States dollars. As a result, increases in the value of the United States dollar relative to foreign currencies could cause our products to become less competitive in international markets and could result in reductions in sales and profitability. To the extent our prices or expenses are denominated in foreign currencies, we will be exposed to increased risks of currency fluctuations.

Our international presence subjects us to risks, including:

- political and economic instability and changing regulatory environments in foreign countries;
- increased time to deliver solutions to customers due to the complexities associated with managing an international distribution system;
- increased time to collect receivables caused by slower payment practices in many international markets;
- managing export licenses, tariffs and other regulatory issues pertaining to international trade;
- increased effort and costs associated with the protection of our intellectual property in foreign countries;
- difficulties in hiring and managing employees in foreign countries; and
- political and economic instability.

The market price of our common stock has historically been volatile, and the recent decline in the market price of our common stock may negatively impact our ability to make future strategic acquisitions, raise capital, issue debt, and retain employees

Shares of our common stock have experienced, and may continue to experience, substantial price volatility, including significant recent decreases, particularly as a result of variations between our actual or anticipated financial results and the published expectations of analysts, announcements by our competitors and us, economic weakness and political instability, high turnover in our senior management, the pending SEC investigation of our accounting practices, and class action lawsuits recently filed against us. In addition, the stock markets have experienced extreme price fluctuations that have affected the market price of many technology companies. These price fluctuations have, in some cases, been unrelated to the operating performance of these companies. A major decline in capital markets generally, or in the market price of our shares of common stock, may negatively impact our ability to make future strategic acquisitions, raise capital, issue debt, or retain employees. These factors, as well as general economic and political conditions and the outcome of the pending SEC investigation and class action lawsuits, may in turn materially adversely affect the market price of our shares of common stock.

We may not be able to maintain our listing on the New York Stock Exchange, and if we fail to do so, the price and liquidity of our common stock may decline

The New York Stock Exchange has quantitative maintenance criteria for the continued listing of common stock on the exchange, including a requirement that we maintain a minimum 30-day average closing price per share of $1.00. Throughout much of 2002, our stock traded below $2.00 per share, at one point, falling below $1.00, and we received a notice from the New York Stock Exchange that our continued listing is under review. Although we are currently in compliance with the 30-day average closing price requirement, we must also meet this requirement on May 7, 2003.

The New York Stock Exchange recently proposed significant amendments to its rules relating to corporate governance. The proposed amendments to such rules, if adopted, will require us to make a number of changes in our business in order to remain in compliance. As a result, we are currently evaluating our compliance with the proposed rule changes to ensure our ability to comply with the proposed rules; however, we cannot assure you that, if the proposed rules are adopted, we will be able to achieve or maintain compliance with them.

If we fail to maintain the continued listing of our shares on the New York Stock Exchange, our stock price would likely decline, the ability of our stockholders to buy and sell shares of our common stock may be materially impaired and the efficiency of the trading market for our common stock would be adversely affected. In addition, delisting of our shares could harm our ability to recruit directors and employees, diminish customer confidence in us, harming our revenues and our financial condition, and would significantly impair our ability to raise capital in the public markets should we desire to do so in the future.

Item 3. *Quantitative and Qualitative Disclosures About Market Risk*

The following discussion about our market risk involves forward-looking statements. Actual results could differ materially from those projected in the forward-looking statements. We are exposed to market risk primarily related to changes in interest rates and foreign currency exchange rates. Our hedging activity is intended to offset the impact of currency fluctuations on certain nonfunctional currency assets and liabilities.

Interest Rate Sensitivity. We maintain an investment portfolio consisting partly of debt securities of various issuers, types and maturities. The securities that we classify as held-to-maturity are recorded on the balance sheet at amortized cost, which approximates market value. Unrealized gains or losses associated with these securities are not material. The securities that we classify as available-for-sale are recorded on the balance sheet at fair market value with unrealized gains or losses reported as part of accumulated other comprehensive income, net of tax as a component of stockholders’ equity. A hypothetical 10 percent increase in interest rates would not have a material impact on the fair market value of these securities at the March 30, 2002. We are able to hold our fixed income investments until maturity, and therefore we do not expect our operating results or cash flows to be affected to any significant degree by the effect of a sudden change in market interest rates on our securities portfolio, unless we are required to liquidate these securities earlier to satisfy immediate cash flow requirements.

Foreign Currency Exchange Risk. Due to our global operating and financial activities, we are exposed to changes in foreign currency exchange rates. At March 30, 2002, we had net asset exposures to the Australian Dollar, Eurodollar, Japanese Yen and Brazilian Real and a net liability exposure to the British Pound. We do not expect our operating results or cash flows to be affected to any significant degree by foreign currency exchange rate fluctuations.

To minimize the potential adverse impact of changes in foreign currency exchange rates, we, at times, have used foreign currency forward and option contracts to hedge the currency risk inherent in our global operations. We do not use financial instruments for trading or other speculative purposes, nor do we use leveraged financial instruments. Gains and losses on these contracts are largely offset by gains and losses on the underlying assets and liabilities. We had no foreign exchange forward or option contracts outstanding at March 30, 2002.

Equity Price Risk. We maintain a small amount of investments in marketable equity securities of publicly-traded companies. As of March 30, 2002, these investments were considered available-for-sale with any unrealized gains or losses deferred as a component of stockholders' equity. It is not customary for us to make investments in equity securities of publicly traded companies as part of our investment strategy. In the past, we have also made strategic equity and convertible debt investments in privately-held technology companies, many of which are in the start-up or development stage. Investments in these companies are highly illiquid and inherently risky as the technologies or products they have under development, or the services they propose to provide, are typically in early stages of development and may never materialize. If these companies are not successful, we could lose our entire investment. The concentration of our investments in a small number of related industries, primarily telecommunications, exposes our investments to increased risk, particularly if these industries continue to be adversely affected by the worldwide economic slowdown. At March 30, 2002, these investments totaled approximately $64.0 million. During the three months ended March 30, 2002, we recorded impairment losses of $0.4 million relating to these investments. While our operating results may be materially adversely affected by fluctuations in the value of these investments, we do not expect any material adverse impact in our cash flows.

Item 4. ***Controls and Procedures***

In January 2002, we discovered that a previously recognized $4 million sale in our Asia Pacific region did not qualify for revenue recognition during the period in which we had originally reported the revenue. We also learned that the SEC had opened a formal order of investigation relating to us and our affiliates. In response to these developments, our Board of Directors formed a Special Committee to oversee an internal review of our financial accounting and reporting for the fiscal year ended March 3, 2001 and the ten-month transition period ended December 29, 2001.

Our management has reassessed our internal controls in each of the regions in which we operate in connection with the audit of our financial statements for the ten-month transition period ended December 29, 2001. The Special Committee, management and KPMG have each advised the Audit Committee that during the course of the audit and the internal review, deficiencies in internal controls were identified relating to:

- accounting policies and procedures;
- inadequate systems integration and data reconciliation; and
- personnel and their roles and responsibilities.

KPMG has advised the Audit Committee that these internal control deficiencies constitute reportable conditions and, collectively, a material weakness as defined in Statement of Auditing Standards No. 60 ("SAS No. 60"). We have assigned the highest priority to the short-term and long-term correction of these internal control deficiencies and have implemented and continue to implement changes to our accounting policies and procedures, systems and personnel to address these issues.

We have also performed additional procedures designed to ensure that these internal control deficiencies do not lead to material misstatements in our consolidated financial statements and to enable the completion of KPMG's audit of our consolidated financial statements, notwithstanding the presence of the internal control weaknesses noted above.

Specifically, we have implemented the following corrective actions as well as additional procedures:

1. Review and revision of revenue recognition policies and contracting management policies and procedures, including more formalized training of finance, sales and other staffs;

2. Retention of new management in senior finance and operations positions, and in many staff positions;

3. Creation of an internal audit department and retention of an internal audit director;

4. Review and revision of our code of conduct;

5. Communication of a zero tolerance policy for employees who engage in violations of our accounting policies and procedures;

6. Establishment of an anonymous hotline for employees to report potential violations of our policies and procedures or of applicable laws or regulations;

7. Additional management oversight and detailed reviews of personnel, disclosures and reporting; and

8. Use of significant outside resources to supplement our employees in the preparation of the consolidated financial statements, as well as in evaluating and implementing the various internal control recommendations.

Additionally, feedback from KPMG's significantly expanded audit process was considered by management in its evaluation of controls and procedures and to help determine and implement appropriate corrective actions and additional policies and procedures.

Longer term corrective actions, some of which we have already begun to implement, will include:

1. Retention of additional personnel in key areas throughout our organization;

2. Improved financial and management reporting systems;

3. Development of additional financial, accounting and other policies and procedures;

4. Additional training of our personnel;

5. Certification by employees of their familiarity, and obligation to comply, with our policies and procedures; and

6. Periodic re-certification by employees of their continued compliance with our policies and procedures.

We continue to evaluate the effectiveness of our internal controls and procedures on an ongoing basis and will take further action as appropriate.

PART II. OTHER INFORMATION

Item 1. *Legal Proceedings*

In the normal course of our business, we are subject to proceedings, litigation and other claims. Litigation in general, and securities and intellectual property litigation in particular, can be expensive and disruptive to our normal business operations. Moreover, the results of litigation are difficult to predict. Described below are material legal proceedings in which we are involved. The uncertainty associated with these and other unresolved or threatened legal actions could adversely affect our relationships with existing customers and impair our ability to attract new customers. In addition, the defense of these actions may result in the diversion of management's resources from the operation of our business, which could impede our ability to achieve our business objectives. The unfavorable resolution of any specific action could materially harm our business, operating results and financial condition, and could cause the price of our common stock to decline significantly. See also *"Cautionary Statements — The pending SEC investigation and our accounting restatements could materially harm our business, operating results and financial condition"* and *"Cautionary Statements — Pending and future litigation could materially harm our business, operating results and financial condition."*

Securities Class Action in the District of Rhode Island. Between October 24, 1997 and March 2, 1998, nine shareholder class action lawsuits were filed against us and certain of our officers and directors in the United States District Court for the District of New Hampshire. By order dated March 3, 1998 these lawsuits, which are similar in material respects, were consolidated into one class action lawsuit, captioned *In re Cabletron Systems, Inc. Securities Litigation* (C.A. No. 97-542-SD). The case has been transferred to the District of Rhode Island. The complaint alleges that we and several of our officers and directors disseminated materially false and misleading information about our operations and acted in violation of Section 10(b) and Rule 10b-5 of the Exchange Act during the period between March 3, 1997 and December 2, 1997. The complaint further alleges that certain officers and directors profited from the dissemination of such misleading information by selling shares of our common stock during this period. The complaint does not specify the amount of damages sought on behalf of the class. In a ruling dated May 23, 2001, the district court dismissed this complaint with prejudice. The plaintiffs appealed that ruling to the First Circuit Court of Appeals, and, in a ruling issued on November 12, 2002, the Court of Appeals reversed and remanded the case to the District Court for further proceedings. If plaintiffs prevail on the merits of the case, we could be required to pay substantial damages.

Securities Class Action in the District of New Hampshire. Between February 7 and April 9, 2002, six class action lawsuits were filed in the United States District Court for the District of New Hampshire. Defendants are us, former chairman and chief executive officer Enrique Fiallo and former chief financial officer Robert Gagalis. By orders dated August 2, 2002 and September 25, 2002, these lawsuits, which are similar in material respects were consolidated into one class action lawsuit, captioned *In re Enterasys Networks, Inc. Securities Litigation (C.A. No. 02-CV-71)* . On December 9, 2002, the plaintiffs filed an amended consolidated complaint, adding two additional defendants, Piyush Patel, former chief executive officer of Cabletron Systems, Inc. (“Cabletron”) and David Kirkpatrick, former chief financial officer of Cabletron. The amended complaint alleges violations of Sections 10(b) and 20(a) of the Exchange Act and Rule 10b-5 there under. Specifically, plaintiffs allege that during periods spanning from June 28, 2000 and August 3, 2001 and in the period between August 6, 2001 and February 1, 2002 (together the “Class Period”), defendants issued materially false and misleading financial statements and press releases that overstated the Company’s revenues, income, and cash, and understated our net losses, because we purportedly recognized revenue in violation of Generally Accepted Accounting Principles (“GAAP”) and the Company’s own accounting policies in connection with various sales and/or investment transactions. The complaints seek unspecified compensatory damages in favor of the plaintiffs and the other members of the purported class against all of the defendants, jointly and severally as well as fees, costs and interest and unspecified equitable relief. By order of the court, the Company has not yet been required to file a responsive pleading. If plaintiffs prevail on the merits of the case, the Company could be required to pay substantial damages.

Shareholder Derivative Action in State of New Hampshire. On February 22, 2002, a shareholder derivative action was filed on our behalf in the Superior Court of Rockingham County, State of New Hampshire. The suit is captioned *Nemes v. Fiallo, et al.* Individual defendants are former chairman and chief executive officer Fiallo and certain members of our Board of Directors. Plaintiffs allege that the individual defendants breached their fiduciary duty to shareholders by causing or allowing us to conduct our business in an unsafe, imprudent, and unlawful manner and failing to implement and maintain an adequate internal accounting control system. Plaintiffs allege that this breach caused us to improperly recognize revenue in violation of GAAP and our own accounting policies in connection with transactions in our Asia Pacific region, and that this alleged wrongdoing resulted in damages to us. Plaintiffs seek unspecified compensatory damages. On October 7, 2002, the Superior Court approved the parties joint stipulation to stay proceedings.

Shareholder Derivative Action in State of Delaware. On April 16, 2002, a shareholder derivative action was filed in the Court of Chancery of the State of Delaware in and for New Castle County on behalf of us. It is captioned, *Meisner v. Enterasys Networks, Inc., et al.* Individual defendants are former chairman and chief executive officer Fiallo and members of our Board of Directors. Plaintiffs allege that the individual defendants permitted wrongful business practices to occur which had the effect of manipulating revenues and earnings, inadequately supervised our employees and managers, and failed to institute legal actions against those officers, directors and employees responsible for the alleged conduct. The complaint alleges counts for breach of fiduciary duty, misappropriation of confidential information for personal profit, and contribution and indemnification. Plaintiffs seek judgment directing defendants to account to us for all damages sustained by us by reason of the alleged conduct, return all compensation of whatever kind paid to them by us, pay interest on the damages as well as costs of the action. On July 11, 2002, the individual defendants filed a motion to dismiss the complaint. The plaintiff has not yet filed a responsive brief with respect to this motion.

Securities and Exchange Commission Investigation. After the close of business on January 31, 2002, the Securities and Exchange Commission, or SEC, notified us that it had commenced a “Formal Order of Private Investigation” into our financial accounting and reporting practices. This investigation remains ongoing and we are fully cooperating with the SEC. We cannot predict when this investigation will conclude or its outcome. The SEC has not commenced legal proceedings against us in connection with this investigation; however, if the SEC were to conclude that legal action were appropriate, we could be required to pay significant penalties and/or fines and could become subject to an administrative order and/or a cease and desist order.

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

(a) Exhibits

99.1 Certification of William K. O’Brien under Section 906 of the Sarbanes-Oxley Act.

99.2 Certification of Richard S. Haak, Jr. under Section 906 of the Sarbanes-Oxley Act.

(b) Reports on Form 8-K:

For the quarter ended March 30, 2002, we filed the following reports on Form 8-K:

1. *January 31, 2002:* On January 31, 2002, we filed a current report on Form 8-K, dated January 29, 2002 reporting under item 5 that on or about January 29, 2002, we issued an Information Statement about our proposed spin-off of Aprisma Management Technologies, Inc. and attaching the Information Statement as an Exhibit to the Form 8-K.

2. *February 15, 2002:* On February 15, 2002, we filed a current report on Form 8-K, dated February 4, 2002 reporting under Item 5 that on February 4, 2002, we determined not to proceed with the distribution of the common stock of Aprisma Management Technologies, Inc. to our stockholders on February 13, 2002 in a “spin-off” transaction and canceled the previously established February 5, 2002 record date for this transaction.

SIGNATURES

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

ENTERASYS NETWORKS, INC.

January 16, 2003	By: /s/ WILLIAM K. O'BRIEN
Date	William K. O'Brien *Chief Executive Officer and Director*

ENTERASYS NETWORKS, INC.

January 16, 2003	By: /s/ RICHARD S. HAAK, JR.
Date	Richard S. Haak, Jr. *Chief Financial Officer* (Principal Financial and Accounting Officer)

CERTIFICATIONS

I, William K. O'Brien, Chief Executive Officer of Enterasys Networks, Inc., certify that:

1. I have reviewed this quarterly report on Form 10-Q of Enterasys Networks, Inc.;

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

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

/s/ WILLIAM K. O'BRIEN

William K. O'Brien

Date: January 16, 2003

I, Richard S. Haak, Jr., Chief Financial Officer of Enterasys Networks, Inc., certify that:

1. I have reviewed this quarterly report on Form 10-Q of Enterasys Networks, Inc.;

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

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

/s/ RICHARD S. HAAK, JR.

Richard S. Haak, Jr.

Date: January 16, 2003