

RIVERSTONE NETWORKS INC
Form 10-Q
January 14, 2003
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SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

QUARTERLY REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the Quarter Ended November 30, 2002

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

Commission File Number 0-32269

RIVERSTONE NETWORKS, INC.

(Exact name of registrant as specified in its charter)

Delaware
(State or other jurisdiction of
incorporation or organization)

95-4596178
(I.R.S. Employer
Identification no.)

5200 Great America Parkway, Santa Clara, CA 95054
(Address of principal executive offices and zip code)

(408) 878-6500
(Registrant's telephone number, including area code)

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

Yes No

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

Yes No

As of January 9, 2003, there were 130,605,751 shares of the Registrant's common stock outstanding.

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Table of Contents**PART I. FINANCIAL INFORMATION****Item 1. Financial Statements (unaudited)**

RIVERSTONE NETWORKS, INC.
CONDENSED CONSOLIDATED BALANCE SHEETS
(in thousands)

| | Nov 30, 2002 | Mar 2, 2002 |
|--|-----------------|----------------|
| | (unaudited) | (1) |
| ASSETS | | |
| Current Assets: | | |
| Cash and cash equivalents | \$ 186,840 | \$ 123,095 |
| Short-term investments | 83,610 | 160,779 |
| Accounts receivable, net | 10,785 | 42,535 |
| Inventories | 19,005 | 20,155 |
| Prepaid expenses and other current assets | 6,935 | 13,173 |
| | <u>307,175</u> | <u>359,737</u> |
| Total current assets | | |
| Property and equipment, net | 15,591 | 22,508 |
| Intangible and other long-term assets, net | 23,895 | 27,414 |
| Long-term investments | 112,742 | 201,962 |
| | <u>152,228</u> | <u>251,884</u> |
| Total assets | \$ 459,403 | \$ 611,621 |
| | <u>459,403</u> | <u>611,621</u> |
| LIABILITIES AND STOCKHOLDERS EQUITY | | |
| Current Liabilities: | | |
| Accounts payable | \$ 11,983 | \$ 34,873 |
| Deferred revenue | 9,903 | 9,012 |
| Accrued compensation | 8,191 | 9,166 |
| Other accrued liabilities | 8,711 | 8,475 |
| | <u>38,788</u> | <u>61,526</u> |
| Total current liabilities | | |
| Long-Term Liabilities: | | |
| Convertible subordinated notes | 147,000 | 175,000 |
| Commitments and contingencies | | |
| Stockholders' equity: | | |
| Common stock | 1,233 | 1,224 |
| Additional paid-in capital | 449,032 | 451,645 |
| Accumulated deficit | (173,998) | (72,175) |
| Unearned stock-based compensation | (2,864) | (6,543) |
| Accumulated other comprehensive income | 212 | 944 |
| | <u>273,615</u> | <u>375,095</u> |
| Total stockholders' equity | | |
| Total liabilities and stockholders' equity | \$ 459,403 | \$ 611,621 |
| | <u>459,403</u> | <u>611,621</u> |

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- (1) The balance sheet at March 2, 2002 has been derived from the audited consolidated financial statements at that date, but does not include all the information and footnotes required by generally accepted accounting principles for the complete financial statements.

See accompanying notes to the condensed consolidated financial statements

Table of Contents**RIVERSTONE NETWORKS, INC.****CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS**
(in thousands, except per share amounts)
(unaudited)

| | Three months ended | | Nine months ended | |
|--|--------------------|----------------|-------------------|----------------|
| | Nov 30, 2002 | Dec 1, 2001 | Nov 30, 2002 | Dec 1, 2001 |
| Net revenues | \$ 13,765 | \$ 60,056 | \$ 54,538 | \$ 159,473 |
| Cost of revenues | 8,867 | 25,822 | 31,241 | 68,813 |
| Gross margin | 4,898 | 34,234 | 23,297 | 90,660 |
| Operating expenses: | | | | |
| Research and development | 9,295 | 11,864 | 34,461 | 39,354 |
| Sales and marketing | 10,446 | 14,671 | 38,052 | 41,790 |
| General and administrative | 12,402 | 6,655 | 34,484 | 18,144 |
| Restructuring charge | | | 8,294 | |
| Total operating expenses | 32,143 | 33,190 | 115,291 | 99,288 |
| Operating income (loss) | (27,245) | 1,044 | (91,994) | (8,628) |
| Interest and other income, net | 4,602 | 1,719 | 10,796 | 6,772 |
| Interest expense | (2,241) | (397) | (6,312) | (423) |
| Loss on investments | (24,333) | | (35,010) | |
| Gain on settlement of litigation | 11,507 | | 11,507 | |
| Income (loss) before income taxes | (37,710) | 2,366 | (111,013) | (2,279) |
| Income tax provision (benefit) | (3,602) | 210 | (2,914) | 210 |
| Income (loss) before extraordinary gain | (34,108) | 2,156 | (108,099) | (2,489) |
| Extraordinary gain on repurchase of convertible notes payable, net of tax of \$4,184 | 6,276 | | 6,276 | |
| Net income (loss) | \$ (27,832) | \$ 2,156 | \$ (101,823) | \$ (2,489) |
| Basic per share data: | | | | |
| Net income (loss) before extraordinary gain | \$ (0.28) | \$ 0.02 | \$ (0.88) | \$ (0.02) |
| Extraordinary gain | \$ 0.05 | \$ 0.00 | \$ 0.05 | \$ 0.00 |
| Net income (loss) | \$ (0.23) | \$ 0.02 | \$ (0.83) | \$ (0.02) |
| Shares used in per-share calculation basic | 123,051 | 117,634 | 122,779 | 112,014 |
| Diluted per share data: | | | | |
| Net income (loss) before extraordinary gain | \$ (0.28) | \$ 0.02 | \$ (0.88) | \$ (0.02) |
| Extraordinary gain | \$ 0.05 | \$ | \$ 0.05 | \$ |
| Net income (loss) | \$ (0.23) | \$ 0.02 | \$ (0.83) | \$ (0.02) |

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| | | | | |
|--|---------|---------|---------|---------|
| Shares used in per-share calculation diluted | 123,051 | 136,055 | 122,779 | 112,014 |
|--|---------|---------|---------|---------|

See accompanying notes to the condensed consolidated financial statements

Table of Contents**RIVERSTONE NETWORKS, INC.****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS****(in thousands)****(unaudited)**

| | Nine months ended | |
|---|--------------------------|------------------------|
| | Nov 30, 2002 | Dec 1, 2001 |
| Cash flows from operating activities: | | |
| Net loss | \$ (101,823) | \$ (2,489) |
| Adjustments to reconcile net loss to net cash used in operating activities: | | |
| Depreciation and amortization | 8,821 | 7,928 |
| Provision for losses on accounts receivable | 24,518 | 5,025 |
| Stock-based compensation | 1,850 | 2,821 |
| Loss on investments | 35,010 | |
| Extraordinary gain on repurchase of convertible notes | (10,460) | |
| Realized gains on short-term investments | (2,334) | |
| Non-cash restructuring costs | 3,795 | |
| Other non-cash items | 741 | (2,500) |
| Changes in assets and liabilities: | | |
| Accounts receivable | 7,232 | (21,862) |
| Inventories | 533 | (3,378) |
| Prepaid expenses and other current assets | 6,238 | (4,276) |
| Accrued expenses and accounts payable | (24,005) | 16,483 |
| Long-term assets | 1,884 | |
| Deferred revenue | 891 | (22) |
| Net cash used in operating activities | (47,109) | (2,270) |
| Cash flows from investing activities: | | |
| Capital expenditures | (4,462) | (10,847) |
| Proceeds from sales of investments | 280,159 | |
| Proceeds from matured investments | 275,004 | 346,786 |
| Purchases of short-term, long-term and other long-term investments, net | (422,346) | (661,879) |
| Net cash provided by (used in) investing activities | 128,355 | (325,940) |
| Cash flows from financing activities: | | |
| Proceeds from issuance of common stock | 1,725 | 149,459 |
| Adjustment to transfer from former parent | (2,500) | 2,799 |
| Net proceeds from issuance of convertible subordinated notes | | 170,540 |
| Repurchases of convertible notes subordinated notes | (16,890) | |
| Net cash provided by (used in) financing activities | (17,665) | 322,798 |
| Effect of foreign exchange rate changes on cash | 164 | |
| Net increase (decrease) in cash and cash equivalents | 63,745 | (5,412) |
| Cash and cash equivalents, at beginning of period | 123,095 | 167,949 |

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| | | |
|---|-------------------|-------------------|
| Cash and cash equivalents, at end of period | \$ 186,840 | \$ 162,537 |
| | <u> </u> | <u> </u> |
| Other cash flow information: | | |
| Cash paid for interest | \$ 3,721 | \$ 280 |
| | <u> </u> | <u> </u> |
| Cash paid for taxes | \$ 682 | \$ |
| | <u> </u> | <u> </u> |
| Non-cash investing and financing activities: | | |
| Issuance of common stock for long-term investments | \$ | \$ 13,000 |
| | <u> </u> | <u> </u> |
| Assets acquired from and liabilities transferred to former parent | \$ | \$ 8,640 |
| | <u> </u> | <u> </u> |

See accompanying notes to the condensed consolidated financial statements

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RIVERSTONE NETWORKS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Note (1) Business Operations

Riverstone Networks designs and manufactures routers and switches that enable national carriers, service providers, governments and large corporations to convert network bandwidth into differentiated services over legacy and next-generation infrastructures. The Company was created by the combination of two businesses previously acquired by Cabletron: Zeitnet, Inc. (Zeitnet), which Cabletron acquired in 1996 and Yago Systems, Inc. (Yago), which Cabletron acquired in 1998.

On February 10, 2000, Cabletron Systems, Inc. (Cabletron) announced its plan to create an independent publicly-traded company, Riverstone Networks, Inc. (Riverstone or the Company), comprised of Cabletron s Internet infrastructure solutions business for Internet service providers and other service providers. After completion of Riverstone s initial public offering on February 22, 2001, Cabletron owned 92,088,235 shares of common stock, representing approximately 86% of Riverstone s outstanding common stock. On July 24, 2001, Riverstone issued 7,117,757 shares of common stock to Cabletron in exchange for approximately \$122.2 million in cash and certain strategic investments, with a historic cost of approximately \$13.0 million. On August 6, 2001, (the Distribution Date), Cabletron distributed all of its shares of Riverstone s common stock to its stockholders and Riverstone ceased to be a subsidiary of Cabletron. In connection with Cabletron s distribution of the Company s common stock to its stockholders, Riverstone was required to issue warrants to certain of Cabletron s investors to purchase 230,364 shares of its common stock. Additionally, Riverstone was obligated to grant supplemental options under its 2000 Equity Incentive Plan to acquire 3,146,272 shares of its common stock to those persons who held compensatory Cabletron stock options.

On the Distribution Date, Cabletron merged its subsidiary Enterasys Networks, Inc. into itself and renamed itself Enterasys Networks, Inc. The terms Cabletron and Enterasys included hereafter refer to Enterasys Networks, Inc. (formerly known as Cabletron Systems, Inc.) and Old Enterasys refers to the Enterasys Networks, Inc. that existed as a subsidiary of Cabletron prior to its merger into Cabletron.

Note (2) Summary of Significant Accounting Policies

Basis of Presentation

The accompanying consolidated financial statements have been prepared by Riverstone pursuant to the rules and regulations of the Securities and Exchange Commission and include the accounts of Riverstone and its wholly-owned subsidiaries. Certain information and footnote disclosures, normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States, have been condensed or omitted pursuant to such rules and regulations. While in the opinion of the Company, the unaudited financial statements reflect all adjustments (consisting only of normal recurring accruals) necessary for a fair presentation of the financial position at November 30, 2002 and the operating results and cash flows for the nine months ended November 30, 2002 and December 1, 2001, these financial statements and notes should be read in conjunction with the Company s audited consolidated financial statements and notes for the year ended March 2, 2002 included in the Company s Annual Report on Form 10-K filed with the Securities and Exchange Commission. The condensed consolidated balance sheet at March 2, 2002 has been derived from audited financial statements as of that date. Operating results for the nine months ended November 30, 2002 are not necessarily indicative of the results that may be expected for the fiscal year ending March 1, 2003.

The consolidated financial information for the period prior to the Distribution Date includes allocations of certain Cabletron expenses, including centralized legal, accounting, treasury, real estate, information technology, and other Cabletron corporate services and infrastructure costs. All of the allocations and estimates in the financial statements are based upon assumptions that the Company s and Cabletron s management believed to be reasonable reflections of the cost of services provided or benefit received by Riverstone. However, these financial statements do not necessarily indicate the financial position or results of operations that would have occurred if the Company had been a stand-alone entity during the applicable periods.

Note (3) Reclassifications

Effective in the first quarter of fiscal 2003, the Company began reporting convertible debt securities in privately held companies in long-term investments on its balance sheet. Revenues from certain geographic regions have also been grouped differently in the accompanying Note 9, *Segment Reporting*. Convertible debt securities and revenues by geographic region for all previous periods have been reclassified to conform to the November 30, 2002 presentation. These reclassifications had no impact on working capital or results of operations.

Table of Contents**Note (4) Strategic Investments**

The Company has certain strategic investments in private and public debt and equity securities. These investments are accounted for using the cost method as Riverstone holds less than 20% of the equity of each of these companies and does not have the ability to exercise significant influence over their operations. These investments are inherently risky as the Company's ability to recover its investments in these companies is largely dependent on equity market conditions and the occurrence of liquidity events, such as initial public offerings, mergers and private sales. Riverstone could lose its entire investment in these companies. The Company reviews the carrying value of these investments at the end of each reporting period to assess whether any investments are impaired. This review includes an evaluation of historical and projected financial performance, expected cash needs and recent funding events for each of the investees. Other-than-temporary impairments are recognized in earnings if the market value of the investment is below its current carrying value or the issuer has experienced significant financial declines or difficulties in raising capital to continue operations. The Company also assesses possible impairment of its investment portfolio based on the general financial performance of the telecommunications industry and general economic conditions. During the three months ended November 30, 2002, certain private companies in which the Company held investments continued to experience financial declines and therefore might not be able to raise sufficient funding to operate in the next six to twelve months. In addition, the prolonged economic downturn continued to negatively affect the financial performance of companies in the telecommunications sector. As a result, the Company determined that its investment portfolio had declined in fair value on an other-than-temporary basis and accordingly recorded impairment write-downs of \$24.3 million during the three months ended November 30, 2002. For the first nine months of fiscal 2003, impairment write-downs for equity investments totaled \$35.0 million. During the three and nine months ended December 1, 2001, the Company recognized no impairment write-downs. As of November 30, 2002, the Company's strategic investment portfolio totaling \$18.5 million was included in long-term investments. Accounts receivable from these investees totaled \$4.5 million as of November 30, 2002. During the three and nine months ended November 30, 2002, sales to strategic investee companies represented approximately 1% and 5% of net revenues, respectively, with sales to no one investee company exceeding 1% and 2% of net revenues, respectively.

Note (5) Inventories

Inventories consist of the following at November 30, 2002 and March 2, 2002 (in thousands):

| | Nov 30, 2002 | Mar 2, 2002 |
|-------------------------------|------------------|------------------|
| Raw materials | \$ 3,589 | \$ 1,918 |
| Finished goods | 7,199 | 6,800 |
| Consignment | 8,217 | 11,437 |
| Total inventories, net | \$ 19,005 | \$ 20,155 |

Note (6) Goodwill and Purchased Intangible Assets

In July 2001, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 142, *Goodwill and Other Intangible Assets* (SFAS 142). SFAS 142 prohibits the amortization of goodwill and intangible assets with indefinite useful lives. SFAS 142 requires that goodwill be reviewed for impairment on an annual basis and between annual tests in certain circumstances, and written down when impaired, rather than amortized as required by previous standards. Intangible assets with finite lives will continue to be amortized over their estimated useful lives. The Company adopted this statement beginning March 3, 2002. Goodwill at March 3, 2002 was \$6.3 million.

A reconciliation of previously reported net loss per share to the amounts adjusted for the exclusion of goodwill amortization is as follows (in thousands, except per share data):

| | Three months ended | | Nine months ended | |
|-----------------------------------|--------------------|-----------------|---------------------|-------------------|
| | Nov 30, 2002 | Dec 1, 2001 | Nov 30, 2002 | Dec 1, 2001 |
| Reported net income (loss) | \$ (27,832) | \$ 2,156 | \$ (101,823) | \$ (2,489) |
| Goodwill amortization | | 388 | | 1,164 |
| Adjusted net income (loss) | \$ (27,832) | \$ 2,544 | \$ (101,823) | \$ (1,325) |

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| | | | | |
|---|-----------|---------|-----------|-----------|
| Reported basic and diluted net loss per share | \$ (0.23) | \$ 0.02 | \$ (0.83) | \$ (0.02) |
| Goodwill amortization | | | | 0.01 |
| Adjusted basic and diluted net loss per share | \$ (0.23) | \$ 0.02 | \$ (0.83) | \$ (0.01) |

| | Fiscal year ended | | |
|---|-------------------|----------------|-----------------|
| | Mar 2, 2002 | Mar 1, 2001 | Feb 29, 2000 |
| Reported net income (loss) | \$ (30,687) | \$ (65,776) | \$ (37,431) |
| Goodwill amortization | 1,552 | 1,679 | 2,035 |
| Adjusted net income (loss) | \$ (29,135) | \$ (64,097) | \$ (35,396) |
| Reported basic and diluted net loss per share | \$ (0.27) | \$ (13.96) | \$ (374,310) |
| Goodwill amortization | 0.02 | 0.36 | 20,350 |
| Adjusted basic and diluted net loss per share | \$ (0.25) | \$ (13.60) | \$ (353,960) |

Table of Contents**Note (7) Customer Concentration**

During the three months ended November 30, 2002, two customers individually accounted for 19% and 12% of net revenues and one reseller customer accounted for 14% of net revenues, compared to no customer accounting for more than 10% of net revenues in the three months ended December 1, 2001. During the three months ended November 30, 2002 and December 1, 2001, sales to strategic investee companies represented approximately 1% and 20% of net revenues, respectively, with sales to no one investee company exceeding 1% and 7% of net revenues, respectively. For the nine months ended November 30, 2002 and December 1, 2001, sales to strategic investee companies represented approximately 5% and 14% of net revenues, respectively, with sales to no one investee company exceeding 2% and 6% of net revenues, respectively.

Note (8) Net Income (Loss) Per Share

The following table presents the calculation of basic and diluted net income (loss) per share (in thousands, except per share amounts):

| | Three months ended | | Nine months ended | |
|--|--------------------|----------------|-------------------|----------------|
| | Nov 30, 2002 | Dec 1, 2001 | Nov 30, 2002 | Dec 1, 2001 |
| Basic income (loss) per share computation: | | | | |
| Income (loss) before extraordinary gain | \$ (34,108) | \$ 2,156 | \$ (108,099) | \$ (2,489) |
| Extraordinary gain on repurchase of convertible notes payable, net of tax of \$4,184 | 6,276 | | 6,276 | |
| Net income (loss) | \$ (27,832) | \$ 2,156 | \$ (101,823) | \$ (2,489) |
| Weighted average shares of common stock outstanding used in computing basic net income (loss) per common share | | | | |
| | 123,051 | 117,634 | 122,779 | 112,014 |
| Income (loss) before extraordinary gain per share | | | | |
| | \$ (0.28) | \$ 0.02 | \$ (0.88) | \$ (0.02) |
| Extraordinary gain per share | 0.05 | | 0.05 | |
| Net income (loss) per share | \$ (0.23) | \$ 0.02 | \$ (0.83) | \$ (0.02) |
| Diluted income (loss) per share computation: | | | | |
| Income (loss) before extraordinary gain | \$ (34,108) | \$ 2,156 | \$ (108,099) | \$ (2,489) |
| Extraordinary gain on repurchase of convertible notes payable, net of tax of \$4,184 | 6,276 | | 6,276 | |
| Net income (loss) | \$ (27,832) | \$ 2,156 | \$ (101,823) | \$ (2,489) |
| Weighted average shares of common stock outstanding used in computing diluted net income (loss) per common share | | | | |
| | 123,051 | 136,055 | 122,779 | 112,014 |
| Income (loss) before extraordinary gain per share | | | | |
| | \$ (0.28) | \$ 0.02 | \$ (0.88) | \$ (0.02) |
| Extraordinary gain per share | 0.05 | | 0.05 | |
| Net income (loss) per share | \$ (0.23) | \$ 0.02 | \$ (0.83) | \$ (0.02) |

The diluted net loss per share is equivalent to the basic net loss per share during the three months ended November 30, 2002 and nine months ended November 30, 2002 and December 1, 2001 because the Company has experienced losses in these periods and thus no potential common shares from the exercise of stock options or warrants have been included in the net loss per share calculation. Common stock equivalents of 33,077 shares at a weighted-average price of \$0.56, 344,491 shares at a weighted-average price of \$2.30 and 21.8 million shares

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at a weighted-average price of \$5.43 were excluded from the calculation of diluted net loss per share for the three months ended November 30, 2002, and the nine months ended November 30, 2002 and December 1, 2001, respectively, because their effect would have been anti-dilutive. For the three months ended November 30, 2002, an additional 8,094,717 shares from the assumed conversion of the convertible subordinated notes were excluded from the computation of diluted net loss per share because their effect on earnings per share was anti-dilutive. For the nine months ended November 30, 2002 and December 1, 2001, an additional 8,094,717 and 9,636,567 shares, respectively, from the assumed conversion of the convertible subordinated notes were excluded from the computation of diluted net loss per share because their effect on earnings per share was also anti-dilutive.

Table of Contents**Note (9) Segment Reporting**

Revenues based on product shipment destination from unaffiliated customers by geographic region are as follows (in thousands):

| | Three months ended | | Nine months ended | |
|----------------------------------|--------------------|----------------|-------------------|----------------|
| | Nov 30, 2002 | Dec 1, 2001 | Nov 30, 2002 | Dec 1, 2001 |
| Sales to unaffiliated customers: | | | | |
| United States | \$ 3,028 | \$ 21,070 | \$ 19,939 | \$ 76,183 |
| Korea | 3,164 | 5,484 | 13,164 | 7,483 |
| China | 3,012 | 13,586 | 10,351 | 28,752 |
| Japan | 1,361 | 4,153 | 5,277 | 12,003 |
| Other | 3,200 | 15,763 | 5,807 | 34,655 |
| Total trades sales | 13,765 | 60,056 | 54,538 | 159,076 |
| Sales to related parties | | | | 397 |
| Total sales | \$ 13,765 | \$ 60,056 | \$ 54,538 | \$ 159,473 |

Note (10) Other Comprehensive Income

The components of comprehensive income (loss), net of tax, were as follows (in thousands):

| | Three months ended | | Nine months ended | |
|--|--------------------|----------------|-------------------|----------------|
| | Nov 30, 2002 | Dec 1, 2001 | Nov 30, 2002 | Dec 1, 2001 |
| Net income (loss) | \$ (27,832) | \$ 2,156 | \$ (101,823) | \$ (2,489) |
| Other comprehensive income: | | | | |
| Change in net unrealized gain on investments, net of tax | (2,374) | 980 | (1,169) | 1,557 |
| Foreign currency translation adjustment | 328 | 293 | 437 | 412 |
| Total comprehensive income (loss) | \$ (29,878) | \$ 3,429 | \$ (102,555) | \$ (520) |

The components of accumulated comprehensive income (loss), net of tax, were as follows (in thousands):

| | Nov 30, 2002 | Mar 2, 2002 |
|---|-----------------|----------------|
| Other comprehensive income: | | |
| Accumulated net unrealized gain on available-for-sale investments, net of tax | \$ 152 | \$ 1,048 |
| Accumulated foreign currency translation adjustment | 60 | (104) |
| Total accumulated other comprehensive income | \$ 212 | \$ 944 |

Note (11) Restructuring Charges

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In the fourth quarter of the Company's fiscal year 2002, the Company announced a restructuring (Q4 2002 Restructuring) in an effort to align the Company's business operations with the current market as well as service provider and carrier industry conditions. The Q4 2002 Restructuring included a worldwide workforce reduction, discontinuance of a product line and asset write-offs related to the workforce reduction. The Q4 2002 Restructuring resulted in the reduction of approximately 50 employees across all business functions and geographic locations. For the year ended March 2, 2002, the Company recorded charges of approximately \$0.5 million, \$0.9 million and \$1.9 million relating to severance, discontinued product line and asset write-offs, respectively.

In the second quarter of fiscal year 2003, the Company's management approved restructuring actions (Q2 2003 Restructuring) to respond to the continuing global economic downturn and to attempt to reduce the Company's cost structure by streamlining operations and prioritizing resources in strategic areas of its business. For the quarter ended August 31, 2002, the Company recorded a restructuring charge of \$8.3 million to reflect the Q2 2003 Restructuring actions. This charge consisted of severance and other employee costs resulting from a reduction in force of approximately 125 employees, across all geographic locations, business functions and job classes, as well as costs related to discontinuance of another product line and asset write-offs. The Company paid out the employee-related severance during the third quarter of fiscal year 2003. The Company discontinued a product line due to a shift in focus on product offerings resulting from the Q2 2003 Restructuring.

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The following table sets forth the restructuring activities during the nine months ended November 30, 2002 and the balance of the accrued restructuring charges as of November 30, 2002, which is included in Other Accrued Liabilities in the Condensed Consolidated Balance Sheet (in thousands):

| | Employee Severance and Other Related Benefits | Non-Cash Charges Relating to Discontinued Product Line and Assets Write-Offs | Total |
|---------------------------------|--|---|--------------|
| Balance as of March 2, 2002 | \$ 457 | \$ | \$ 457 |
| Restructuring charges | 4,499 | 3,795 | 8,294 |
| Cash payments | (2,949) | | (2,949) |
| Non-cash charges | | (3,795) | (3,795) |
| Balance as of November 30, 2002 | \$ 2,007 | \$ | \$ 2,007 |

Note (12) Convertible Notes

During the three months ended November 30, 2002, the Company repurchased a total of \$28.0 million in principal amount of its 3.75% convertible subordinated notes due December 1, 2006 (the Notes) for a price of \$16.9 million, plus accrued interest thereon of \$440,000. Concurrently with the repurchases of the Notes, the Company wrote off \$650,000 of debt issuance costs from other long-term assets. As a result of the repurchases and write-off, the Company recorded an extraordinary gain of approximately \$6.3 million, net of income taxes of \$4.2 million, in the third quarter of fiscal 2003.

Note (13) Litigation Settlement

On October 25, 2002, Riverstone and Tellabs Operations, Inc. (Tellabs) entered into a Settlement Agreement and Mutual General Release (Settlement Agreement). Under the terms of the Settlement Agreement, the parties agreed to a dismissal of all pending claims in the suit brought by Tellabs against Riverstone on August 28, 2001 in the Chancery Division of the Circuit Court of Cook County, Illinois, as well as the counterclaims against Tellabs by Riverstone. Tellabs further agreed to pay Riverstone \$12.0 million, approximately \$493,000 of which was designated as payment for outstanding invoices of past sales from Riverstone to Tellabs and recorded as revenue in the quarter ended November 30, 2002. The remaining balance was recorded as a gain on settlement of litigation in the same quarter.

Note (14) Recently Issued Accounting Standards

In July 2002, the FASB issued SFAS 146, *Accounting for Costs Associated with Exit or Disposal Activities*, which requires that a liability for costs associated with an exit or disposal activity be recognized and measured initially at fair value only when the liability is incurred. SFAS 146 is effective for exit or disposal activities that are initiated after December 31, 2002. SFAS 146 addresses costs associated with restructuring activities that are currently accounted for under Emerging Issues Task Force (EITF) Issue No. 94-3, *Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (Including Certain Costs Incurred in a Restructuring)*. The scope of SFAS 146 also covers termination benefits that employees who are involuntarily terminated received under the terms of a one-time benefit arrangement, costs related to terminating a contract that is not a capital lease and costs to consolidate facilities. The Company does not expect the adoption of SFAS 146 to have a material impact on its operating results or financial position.

Note (15) Stockholder's Equity

On October 15, 2002, the Company filed a Tender Offer Statement on Schedule TO (the Offer) with the Securities and Exchange Commission relating to a stock option exchange program offered to the Company's employees, other than the Company's executive officers and directors. Under the Offer, the Company offered to exchange outstanding unexercised vested and unvested stock options held by eligible employees for replacement stock options. Depending upon the exercise price per

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share underlying the employee's tendered stock option, the number of shares of common stock underlying the replacement stock option will equal 0.25 to 1.0 times the number of shares underlying the tendered option. Alternatively, eligible employees holding a stock option with an exercise price per share greater than or equal to \$10.00 were entitled to tender such option for either a replacement option or a cash payment equal to \$0.50 multiplied by ¼ of the aggregate number of shares underlying the tendered option (rounded down to the nearest whole share), less any applicable withholding taxes or charges. Under the terms of the Offer, an eligible employee who elected to tender any option was also required to exchange any other options granted to such employee in the six months prior to October 15, 2002, regardless of the exercise price per share underlying such options, and all options with an exercise price per share greater than or equal to \$5.00.

On November 14, 2002, employees eligible to participate in the Offer tendered an aggregate of 5,569,975 shares of Riverstone's common stock underlying options and, subject to the terms and conditions of the Offer, will receive replacement options to purchase an aggregate of 3,097,990 shares of Riverstone's common stock on or about May 21, 2003 in exchange for the cancellation of such tendered options. Certain employees eligible to participate in the Offer tendered an aggregate of 304,800 shares of Riverstone's common stock underlying options and, subject to the terms and conditions of the Offer, will receive cash payments in the aggregate amount of \$38,100 (which amount includes applicable withholding taxes) in exchange for the cancellation of such tendered options. In order to receive the replacement stock option grant or the alternative cash payment, an employee must remain employed with the Company or one of its subsidiaries until the date when the replacement stock options are granted. The replacement option will be vested at the time of grant to the same extent that the tendered option would have been vested had it not been tendered for exchange and will continue to vest on the same schedule as the tendered option.

Note (16) Contingencies

A consolidated class action lawsuit raising claims against Cabletron and some officers and directors of Cabletron was filed in the United States District Court for the District of New Hampshire and, following transfer, is pending in the District of Rhode Island. The complaint alleges that Cabletron and several of its officers and directors made materially false and misleading statements about Cabletron's operations and acted in violation of Section 10(b) of and Rule 10b-5 under the Securities Exchange Act of 1934 during the period between March 3, 1997 and December 2, 1997. The complaint also alleges that Cabletron's accounting practices resulted in the disclosure of materially misleading financial results during the same period. More specifically, the complaint challenged Cabletron's revenue recognition policies, accounting for product returns, and the validity of some sales. The complaint does not specify the amount of damages sought on behalf of the class. The plaintiffs served a second consolidated class action complaint and Cabletron filed a motion to dismiss this complaint. In a ruling dated May 23, 2001, the District Court dismissed this complaint with prejudice. The plaintiffs appealed this ruling to the First Circuit Court of Appeals and in a ruling issued November 12, 2002, the Court of Appeals reversed and remanded the case to the District Court for further proceedings. If the plaintiffs were to ultimately prevail on the merits of the case, Enterasys (formerly known as Cabletron) could be required to pay substantial damages.

Riverstone has not assumed any liability from Enterasys for this litigation. Riverstone has not been named as a defendant in this litigation. However, the plaintiffs might attempt to involve Riverstone in this litigation or might seek to have Riverstone pay damages if Enterasys has insufficient assets to cover any resulting damages. Any involvement in this litigation could be protracted and may result in a diversion of management and other resources. The payment of substantial legal costs or damages, or the diversion of the Company's management and other resources, could have a material adverse effect on Riverstone's business, financial condition or results of operations.

The Company has granted options to purchase shares of its common stock under its 2000 Equity Incentive Plan to its employees and employees of Cabletron and Cabletron's affiliates and to the Company's advisors and consultants. As a result of the nature of the persons who received these options and the vesting provisions of these options granted prior to February 22, 2001, the Company may have violated the California state securities laws. Because these option grants may not have been qualified or exempt from qualification under California state securities laws, certain persons residing in California who received these options may have a claim against the Company. Costs associated with these option grants could be significant. The Company has determined not to offer to repurchase the options.

On January 31, 2002, the Securities and Exchange Commission notified Enterasys that it had commenced an Order of Investigation into Enterasys and certain of its affiliates' accounting practices. The Company has responded to a subpoena seeking certain documents and information in connection with the Enterasys investigation that the Company received on June 24, 2002 from the SEC. As of the date of this Report, the Company is unable to predict what, if any, impact the SEC investigation into Enterasys' prior accounting practices may have on Riverstone. The Company could be required to take actions not presently contemplated, which could be expensive, divert management's attention from other business concerns and harm its business. In addition, the ongoing SEC inquiry into Enterasys may contribute to volatility in the price of the Company's common stock.

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Beginning in July 2002, several complaints were filed in the U.S. District Court for the Northern District of California, on behalf of purported classes of persons who purchased Riverstone's securities at various times between August 10, 2001 and June 19, 2002. The complaints name as defendants the Company and certain of its officers and directors, allege that they violated federal securities laws by making false and misleading statements about the Company's business and seek unspecified compensatory damages and other relief. On September 25, 2002, these actions were consolidated under the caption *In re Riverstone Networks, Inc. Securities Litigation*, Case No. C-02-3581 PJH. On October 28, 2002, the Court entered an order appointing a lead plaintiff and lead plaintiff's counsel. Neither the Company nor its officers or directors have responded to this action. In addition, in August 2002, a shareholder derivative lawsuit, captioned *Bruhn v. Pereira, et al.*, No. CV810290, was filed in California Superior Court. The complaint alleges that the Company's directors and officers made misrepresentations and/or omissions and breached their fiduciary duties to the Company in connection with the disclosure of the Company's publicly reported financial results and guidance and seeks unspecified damages as well as equitable and/or injunctive and other relief. On December 20, 2002, the defendants filed a demurrer to the complaint. A hearing on the demurrer is scheduled for February 25, 2003. The Company intends to vigorously defend these proceedings.

Riverstone is not aware of any other legal proceedings against it that, individually or in the aggregate, would have a material adverse effect on Riverstone's business, operating results or financial condition. Riverstone may in the future be party to litigation arising in the course of its business, including claims that Riverstone allegedly infringes third-party patents, trademarks and other intellectual property rights. These claims, even if not meritorious, could result in the expenditure of significant financial and managerial resources.

Note (17) Subsequent Events

In January 2003, the Company completed the acquisition of Pipal Systems, Inc. (Pipal), which will be accounted for as a purchase of a group of net assets rather than a business combination in accordance with EITF Issue No. 98-3 *Determining Whether a Nonmonetary Transaction Involves Receipt of Productive Assets or of a Business*. The Company issued approximately 7.3 million shares of common stock and agreed to pay approximately \$4.1 million in cash in exchange for all of Pipal's outstanding capital stock. In addition, with respect to Pipal's outstanding stock options, the Company settled for approximately \$367,000 cash, in part, and issued stock options in substitution for the remainder, which, if fully vested and exercised, would amount to approximately 700,000 shares of common stock. The common stock issued in exchange for Pipal common stock is subject to the Company's right to repurchase in accordance with individual vesting schedules. The Company will pay the cash payable for Pipal common stock and options as they vest with dates generally ranging from the closing of the transaction to four years. Any remaining cash which has not vested will be paid on January 2, 2013. The Company also assumed debt totaling approximately \$6.5 million and entered into bonus and compensatory arrangements tied to milestones for employees and consultants totaling approximately \$4.6 million. In connection with the acquisition of Pipal, the Company had made loans to Pipal in the amount of \$965,000, which were forgiven and became an element of the purchase price. Pipal is developing a new generation of advanced Ethernet and MPLS technologies that are expected to bring enhanced network functionality and service creation capabilities to carrier, campus metro and other mission critical networks.

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

The following discussion and analysis of our financial condition and results of operations should be read together with our condensed consolidated financial statements and related notes appearing elsewhere in this Form 10-Q, and our Annual Report on Form 10-K filed on May 31, 2002 with the Securities and Exchange Commission.

When used in the discussion below, the words expect, anticipate, estimate, plan, believe, intend and similar expressions are intended to identify forward-looking statements. These statements, which include statements as to our expectations regarding net income or losses, trends in average selling prices, gross margins and revenues, expected cost of revenues and sources of revenues, changes in product mix, inventory levels and accruals for inventory reserves, the adequacy of allowances for doubtful accounts and accruals for warranty costs, expectations regarding interest and other income, expectations regarding expenses, including investments in product development, expected cost structure reductions as a result of restructuring programs, statements regarding our critical accounting policies, the adequacy and use of capital resources and expected variations in capital requirements, expectations regarding capital expenditures and infrastructure, strategic investments, strategic and operational alternatives, plans to maintain sales, support, marketing and product development organizations, the features and benefits of our current and future products, expected benefits of our acquisition of Pipal Systems, expectations regarding the development and maintenance of strategic distribution relationships, the volatility of our stock price and our foreign currency risk management strategy, are subject to risks and uncertainties that could cause actual results to differ materially from those projected. These risks and uncertainties include, but are not limited to, those risks discussed below, as well as our ability to successfully bring future products to market, gain market share and compete against established companies in our market, the impact of alternative technological advances and competitive products, our ability to develop and maintain strategic relationships, and the matters discussed in Factors That May Affect Future Results and Market Price of Our Stock. These forward-looking statements speak only as of the date thereof. We expressly disclaim any obligation or undertaking to release publicly any updates or revisions to any forward-looking statements contained herein to reflect any change in our expectations with regard thereto or any change in events, conditions or circumstances on which any such statement is based.

Overview

We are a leading provider of networking solutions that enable national carriers, service providers, governments and large corporations to convert raw bandwidth into profitable services over legacy and next-generation infrastructures. Our products consist of advanced routers and switches that feature a broad range of service-enabling and security technologies with switching and routing software designed to bring increased reliability, control and performance to mission critical networks.

Riverstone was created by the combination of two businesses previously acquired by Cabletron. These businesses are Zeitnet, which Cabletron acquired in 1996, and Yago Systems, which Cabletron acquired in 1998. The majority of our net revenues come from sales of our routers.

Our industry has experienced an erosion of average selling prices. We anticipate that the average selling prices of our products will decrease in the future in response to competitive pricing pressures, which may reduce our gross margins or revenues. We expect our quarterly gross margins to fluctuate with changes in our product mix. Most of our sales within the United States have been through direct sales channels. We intend to add and maintain a limited number of strategic distribution relationships that complement our direct sales efforts. International sales are made through a combination of direct and indirect sales efforts. Starting in fiscal 2002, we initiated sales and marketing efforts internationally, focusing initially on Europe and Asia. As part of this effort, we have negotiated separate reseller agreements with various network integrators in Europe and Asia. We began shipping products outside the United States in fiscal year 2000, and these shipments accounted for 78% of our net revenues during the quarter ended November 30, 2002 compared to 65% during the quarter ended December 1, 2001. For the nine months ended November 30, 2002 and December 1, 2001, international sales were 63% and 48% of net revenues, respectively.

In January 2003, we completed the acquisition of Pipal Systems, Inc., which will be accounted for as a purchase of a group of net assets rather than a business combination in accordance with EITF Issue No. 98-3 *Determining Whether a Nonmonetary Transaction Involves Receipt of Productive Assets or of a Business*. We issued approximately 7.3 million shares of common stock and agreed to pay approximately \$4.1 million in cash in exchange for all of Pipal's outstanding capital stock. In addition, with respect to Pipal's outstanding stock options, we settled for approximately \$367,000 cash, in part, and issued stock options in substitution for the remainder, which, if fully vested and exercised, would amount to approximately 700,000 shares of common stock. The common stock issued in exchange for Pipal common stock is subject to the Company's right to repurchase in accordance with individual vesting schedules. The Company will pay the cash payable for Pipal common stock and options as they vest with dates generally ranging from the closing of the transaction to four years. Any remaining cash which has not vested will be paid on January 2, 2013. We also assumed debt totaling approximately \$6.5 million and entered into bonus and compensatory arrangements tied to milestones for employees and consultants totaling approximately \$4.6 million. In connection with the acquisition of Pipal, we had made loans to Pipal in the amount of \$965,000, which were forgiven and became an element of the purchase price.

Table of Contents**Critical Accounting Policies and Estimates**

The preparation of financial statements and related disclosures in conformity with accounting principles generally accepted in the United States requires management to make judgments, assumptions and estimates that affect the amounts reported in the consolidated financial statements and accompanying notes. Our most important accounting policies often require us to make estimates and judgments of uncertain matters that could have a material effect on our results of operations during the period reported and the reported amounts of assets and liabilities and disclosure of contingent liabilities at the date of the consolidated financial statements. Management bases its estimates and judgments on historical experience, market trends and other factors that are believed to be reasonable under the circumstances. Actual results could differ from these estimates. The following critical accounting policies are impacted significantly by judgments, assumptions and estimates used in the preparation of the consolidated financial statements.

Revenue Recognition and Related Warranty Accounting. We generally recognize revenue upon shipment of products provided that there are no uncertainties regarding customer acceptance, persuasive evidence of an arrangement exists, the sales price is fixed and determinable and collectibility is deemed probable. If uncertainties exist, revenue is recognized when these uncertainties are resolved. Revenues from service and maintenance contracts are deferred and recognized ratably over the period the services are performed, typically twelve months or less. When we make sales to international network integrators and value added resellers, in some cases they are given privileges to return a portion of inventory up to a maximum amount with placement of new orders for an equivalent amount of product. We accrue estimated warranty costs and sales returns and allowances at the time of shipment based on contractual rights and historical experience. If the historical data we use to calculate the estimated sales returns and allowances do not properly reflect future returns, a change in accruals for sales returns and allowances would be made in the period in which such a determination was made and our revenues could be adversely affected. Additionally, if we experience an increase in warranty claims, which are higher than our historical experience, our gross margin could be adversely affected.

Lease Financing. We may enter into transactions in which customers receive financing for the purchase of our equipment from third party leasing organizations, who in turn remit payment to us. In certain transactions during the second quarter of fiscal year 2002, we guaranteed a portion of the customer's lease payments to be made to the lessor. We record these transactions consistent with Statement of Financial Accounting Standards No. 13, *Accounting for Leases* (SFAS 13) and related interpretations. Substantially all of our customer leasing transactions involve capital leases. When we provide a financing guarantee, we record revenue at the time of shipment, subject to a sales reserve. We base the amount of the reserve on a percentage of the guaranteed lease payments, based on specific customer analysis supplemented with industry experience. Accordingly, we have deferred revenue subject to this reserve that will be recognized by the end of the respective lease terms if all lease payments are made by end users. As of November 30 and March 2, 2002, we had guaranteed payments associated with lease transactions of approximately \$8.3 million and \$9.4 million, respectively. If customer defaults are higher than our historical experience, an increase in sales reserves would be made in the period in which such a determination was made and our revenues could be adversely affected. We have not entered into any lease financing transactions since September 2001.

Inventories. The networking industry is characterized by rapid technological change, frequent new product introductions, changes in customer requirements, and evolving industry standards. We regularly monitor inventory quantities on hand and record a provision for excess and obsolete inventories based primarily on our estimated forecast of product demand and production requirements. While we believe that our provision for excess and obsolete inventory is adequate, if there is a sudden and significant decrease in demand for our products or there is a higher risk of inventory obsolescence due to rapidly changing technology, we may be required to write-down our inventory and our gross margin could be adversely affected.

Accounts receivable. We continually monitor and evaluate the collectibility of our trade receivables based on a combination of factors. We record specific allowances for bad debts when we become aware of a specific customer's inability to meet its financial obligation to us such as in the case of bankruptcy filings or deterioration of financial position. Estimates are used in determining our allowances for all other customers based on factors such as current trends, the length of time the receivables are past due and historical collection experiences. During the three and nine months ended November 30, 2002, we recorded a charge for doubtful accounts of approximately \$9.8 million and \$24.5 million, respectively, as a result of the lengthening economic downturn and continued poor results experienced by telecommunications service providers including a decline in the financial condition of some of our customers. While we believe that our allowance for doubtful accounts receivable is adequate and that the judgment applied is appropriate, such amounts estimated could differ materially from what actually occurs in the future.

Strategic Investments. As part of our long-term strategy, we have made investments in equity and convertible debt of public and private companies. We hold less than 20% of the equity of each of these companies and we do not have the ability to exercise significant influence over their operations. Accordingly, these investments are accounted for using the cost method. We use independent valuations or recent third party investments of cash for equity to support the initial carrying value of the investments. We review the carrying value of these investments at the end of each reporting period to assess whether any investments are impaired. This review includes an evaluation of historical and projected financial performance, expected cash

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needs and recent funding events for each of the investees. Other-than-temporary impairments are recognized in earnings if the market value of the investment is below its current carrying value for more than six months or the issuer has experienced significant financial declines or difficulties in raising capital to continue operations. The Company also assesses possible impairment of its investment portfolio based on the general financial performance of the telecommunications industry and general economic conditions. During the three months ended November 30, 2002, certain of these investees were experiencing financial declines and therefore, might not be able to raise sufficient funding to operate in the next six to twelve months. In addition, the prolonged economic downturn has further negatively affected the financial performance of companies in the telecommunications sector. As a result, we determined that our investment portfolio had declined in fair value on an other-than-temporary basis and accordingly recorded impairment write-downs of \$24.3 million. For the first nine months of fiscal 2003, impairment write-downs for equity investments totaled \$35.0 million. Our ability to recover investments from these investees is largely dependent on equity market conditions and the occurrence of liquidity events, such as initial public offerings, mergers, and private sales. All of these factors are difficult to predict, particularly in the current economic environment and our net income in the future could be adversely affected by additional investment impairment charges. If one or more of our investees experience a significant financial decline, our estimates of the recoverability of our investments, and proceeds from return on investments, if any, from these investees could be adversely affected.

Results of Operations

The following table sets forth for the periods indicated certain financial data as a percentage of net revenues:

| | Three months ended | | Nine months ended | |
|---|--------------------|----------------|-------------------|----------------|
| | Nov 30, 2002 | Dec 1, 2001 | Nov 30, 2002 | Dec 1, 2001 |
| Net revenues | 100 % | 100 % | 100 % | 100 % |
| Cost of revenues | 64 | 43 | 57 | 43 |
| Gross margin | 36 | 57 | 43 | 57 |
| Operating expenses: | | | | |
| Research and development | 68 | 20 | 63 | 25 |
| Sales and marketing | 76 | 24 | 70 | 27 |
| General and administrative | 90 | 11 | 63 | 11 |
| Restructuring expenses | | | 15 | |
| Total operating expenses | 234 | 55 | 211 | 63 |
| Operating income (loss) | (198) | 2 | (168) | (6) |
| Interest and other income, net | 33 | 3 | 20 | 4 |
| Interest expense | (16) | (1) | (12) | |
| Loss on investments | (177) | | (64) | |
| Gain on settlement of litigation | 84 | | 21 | |
| Income (loss) before income taxes | (274) | 4 | (203) | (2) |
| Income tax provision (benefit) | (26) | | (5) | |
| Income (loss) before extraordinary gain | (248) | 4 | (198) | (2) |
| Extraordinary gain on repurchase of convertible notes payable | 46 | | 11 | |
| Net income (loss) | (202)% | 4 % | (187)% | (2)% |

Net Revenues. Net revenues were \$13.8 million for the three months ended November 30, 2002, a \$46.3 million or 77% decrease as compared with net revenues of \$60.1 million for the three months ended December 1, 2001. Net revenues were \$54.5 million for the nine months ended November 30, 2002, a \$104.9 million or 66% decrease as compared to \$159.5 million for the nine months ended December 1, 2001. The decrease in net revenues was primarily attributable to lower unit sales of our routers due to unfavorable economic conditions and weaker capital spending compared to the same periods in the prior year. We market and sell our products primarily through resellers and distributors. For the three months ended November 30, 2002 and December 1, 2001, our international revenues accounted for 78% and 65% of net revenues, respectively. For the nine months ended November 30, 2002 and December 1, 2001, international revenues were 63% and 52% of net revenues, respectively. We expect that sales outside of the United States will continue to represent a significant portion of net revenues for the foreseeable

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future, although international sales as a percentage of net revenues may fluctuate from quarter to quarter.

The continued economic downturn and the reduction in capital spending by our existing and potential customers have adversely impacted the demand for our products and have made it increasingly difficult to accurately forecast our future revenues, as evidenced by declining quarterly revenues during the periods presented. Our sales cycle typically spans over several months as it involves a lengthy product evaluation and qualification process, and a significant commitment of resources from customers. Even after making the decision to purchase our products, customers may deploy the products slowly or delay implementation altogether. The current economic conditions may cause future revenues and operating results to vary significantly and unexpectedly from quarter to quarter.

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In order to establish relationships with companies in markets consistent with our long-term strategic direction, we have invested in equity and convertible debt of private and public companies. During the three and nine months ended November 30, 2002, sales to these strategic investee companies represented approximately 1% and 5% of net revenues, respectively, with sales to no one investee company exceeding 1% and 2% of net revenues, respectively.

Cost of Revenues. Cost of revenues includes costs of raw materials, direct labor, manufacturing overhead and amounts paid to third-party contract manufacturers, and other costs related to warranty, contractual obligations, customer service and support. Cost of revenues for the three months ended November 30, 2002 were \$8.9 million with a gross margin of 35.6%, compared with cost of revenues of \$25.8 million for the three months ended December 1, 2001 and a gross margin of 57.0%. Cost of revenues for the nine months ended November 30, 2002 were \$31.2 million with a gross margin of 42.7% compared to cost of revenues of \$68.8 million and a gross margin of 56.8% for the nine months ended December 1, 2001. The decrease in cost of revenues is primarily related to the decrease in our sales volume. The decrease in gross margin is primarily attributable to lower shipment volumes and the impact of certain fixed costs as well as a change in product mix.

Our gross margins are highly variable due to many factors such as our and our competitors' pricing policies and new product introductions by us or by our competitors. We have outsourced our manufacturing and repair operations. Our contract manufacturer manufactures our products using quality assurance standards that we established. We have potential exposure to the contract manufacturer, such as carrying costs and excess material, if it procures components and builds products based on forecasts we provide it and the actual component usage and product sales are significantly lower than we had forecast. Gross margin may be adversely affected in the future by increases in material or labor costs, excess and obsolete inventory, changes in shipment volume, increased price competition, geographic mix and changes in channel of distribution or in the mix of products sold. We provide reserves for excess and obsolete inventory based on our estimates of future sales. We believe the provisions we have made for inventory are adequate; however, if the demand for our products differs significantly from our estimates, our provisions may need to increase, which could adversely affect our gross margin. We accrue estimated costs for warranty obligations based on our historical experience and our expectation of future warranty costs for delivered products. We believe the accruals we have made for warranty costs are adequate to address known warranty issues, however, if actual warranty costs are significantly different from the estimates, we may need to revise our warranty accrual and the impact could adversely affect the gross margin for a given period.

Research and Development. Research and development expenses consist primarily of salaries and related personnel expenses, consultants and outside service provider fees, non-recurring engineering charges and prototype costs related to the development, testing and enhancement of our application specific integrated circuits, or ASICs, and software, and the depreciation of property and equipment related to these activities. Our research and development efforts can require significant expenditures, the timing of which can cause quarterly variability in our expenses.

Research and development expenses were \$9.3 million for the three months ended November 30, 2002, a decrease of approximately \$2.6 million over the comparable quarter in fiscal year 2002. Research and development expenses were \$34.5 million for the nine months ended November 30, 2002, a decrease of approximately \$4.9 million over the comparable period in fiscal year 2002. Research and development expenses as a percentage of net revenues were 68% and 20% in the three months ended November 30, 2002 and December 1, 2001, respectively. For the first nine months of fiscal 2003 and 2002, research and development expenses as a percentage of net revenues were 63% and 25%, respectively. The increase in research and development expenses as a percentage of revenues for the three and nine months ended November 30, 2002 compared with the three and nine months ended December 1, 2001, was primarily due to the decrease in revenues. The decrease in absolute dollars was primarily due to cost cutting measures including the restructuring programs that were initiated in the fourth quarter of fiscal year 2002 and second quarter of fiscal year 2003 and reductions in product development expenses such as non-recurring engineering costs and prototype expenses. Research and development is essential to our future success and we expect our research and development expenses to increase in absolute dollars and vary as a percentage of revenues in the foreseeable future.

Sales and Marketing. Sales and marketing expenses consist primarily of salaries, commissions and related expenses for personnel engaged in marketing, sales and customer support functions, and trade shows, advertising and promotional expenses. Sales and marketing expenses were \$10.4 million for the three months ended November 30, 2002, a decrease of \$4.2 million over the comparable quarter in fiscal year 2002. Sales and marketing expenses were \$38.1 million for the nine months ended November 30, 2002, a decrease of \$3.7 million over the comparable period in fiscal year 2002. Sales and marketing expenses as a percentage of net revenues were 76% and 24% in the three months ended November 30, 2002 and December 1, 2001, respectively. For the first nine months of fiscal 2003 and 2002, sales and marketing expenses as a percentage of net revenues were 70% and 27%, respectively. The increase in sales and marketing expenses as a percentage of net revenues for the three and nine months ended November 30, 2002 compared with the three and nine months ended December 1, 2001 was primarily attributable to the decrease in revenues. The decrease in absolute dollars in sales and marketing expenses was primarily

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due to cost savings from the restructuring programs that were initiated in the fourth quarter of fiscal year 2002 and second quarter of fiscal year 2003, as well as reductions in advertising and general expenses. We expect that quarterly sales and marketing expenses will not vary significantly in the near future as we continue to support our products and market segments.

General and Administrative. General and administrative expenses consist primarily of employee compensation and related expenses, professional and contractor fees, finance, legal, facilities, human resources, amortization of goodwill and intangibles and provisions for doubtful accounts. Through August 6, 2001, included in general and administrative expenses are expenses for services provided by Cabletron under our services agreement with them.

General and administrative expenses were \$12.4 million for the three months ended November 30, 2002, an increase of \$5.7 million over the comparable quarter in fiscal year 2002. General and administrative expenses were \$34.5 million for the nine months ended November 30, 2002, an increase of \$16.3 million over the comparable period in fiscal year 2002. General and administrative expenses as a percentage of net revenues were 90% and 11% in the three months ended November 30, 2002 and December 1, 2001, respectively. For the first nine months of fiscal 2003 and 2002, general and administrative expenses as a percentage of net revenues were 63% and 11%, respectively. The increase in general and administrative expenses as a percentage of net revenues for the three and nine months ended November 30, 2002 compared to the three and nine months ended December 1, 2001 was primarily due to a decrease in net revenues and an increase in provisions for doubtful accounts. The increase in absolute dollars for the three and nine months ended November 30, 2002 included provisions for doubtful accounts of \$9.8 million and \$24.5 million, respectively, to reflect a lengthening economic downturn, poor financial results experienced by telecommunications service providers and a general decline in the financial condition of some of our customers. We expect that quarterly general and administrative expenses, excluding reserves for doubtful accounts, will decrease slightly in the near term as a result of the restructuring programs.

Goodwill. In conjunction with the implementation of FAS 142, *Accounting for Goodwill and Intangibles*, we completed a goodwill impairment review as of March 2, 2002, and found no impairment. According to our accounting policy under FAS 142, we will perform a similar review annually, or earlier if indicators of potential impairment exist. Our impairment review is based on a discounted cash flow approach that uses our estimates of future market share and earnings as well as appropriate discount rates. The estimates we have used are consistent with the plans and estimates that we are using to manage the underlying business. If we fail to deliver new products, if the products fail to gain expected market acceptance, or if market conditions in our business fail to improve, our revenue and cost forecasts may not be achieved and we may incur charges for impairment of goodwill. Goodwill totaled \$6.3 million at November 30, 2002.

Restructuring Charges. In the second quarter of fiscal year 2003, we announced restructuring actions to respond to the continuing global economic downturn and to attempt to reduce our cost structure by streamlining operations and prioritizing resources in strategic areas of our business. For the nine months ended November 30, 2002, restructuring charges were approximately \$8.3 million, all of which was recorded in August 2002. Restructuring charges included \$4.5 million of severance and other employee costs resulting from a reduction in force of approximately 125 employees across all geographic locations, business functions and job classes, and \$3.8 million related to a discontinued product line and asset write-offs. Employee-related severance was paid out during the three months ended November 30, 2002.

We expect that the restructuring programs initiated in the fourth quarter of fiscal 2002 and the second quarter of fiscal 2003 will result in an approximately \$7.0 million reduction in salary and payroll-related costs, depreciation and other general operating expenses on a quarterly basis.

Interest and Other Income, Net. Interest and other income primarily consist of income on available-for-sale investments. Interest income was \$4.6 million for the three months ended November 30, 2002, compared with \$1.7 million for the three months ended December 1, 2001. For the nine months ended November 30, 2002 the interest income on available-for-sale investments was \$10.8 million compared to \$6.8 million in the nine months ended December 1, 2001. The increase in interest income is a direct result of increased cash and investment balance, resulting from the proceeds from the issuance of common stock to Cabletron in July 2001, stock option exercises, and net proceeds from the issuance of convertible subordinated notes in November 2001. We expect that interest and other income will decrease in the future if interest rates continue to decline and as we continue to consume cash for our operations.

Interest expense. Interest expense for the three months ended November 30, 2002 was \$2.2 million compared to \$397,000 for the three months ended December 1, 2001. Interest expense for the nine months ended November 30, 2002 was \$6.3 million compared to \$423,000 for the nine months ended December 1, 2001. Interest expense consists primarily of accrued interest and amortization of debt issuance costs, both attributable to the issuance of the 3.75% convertible subordinated notes in November 2001, and interest on trade accounts receivable that were sold to an unrelated financial institution. Interest expense for the three and nine months ended November 30, 2002 also included \$644,000 owed to holders of our convertible subordinated notes as liquidated damages for our failure to cause to be declared effective within 180 days of the issuance of such notes a shelf registration statement for the resale of such notes and the underlying common stock. We expect interest cost savings from the

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repurchases of convertible subordinated notes to be \$263,000 on a quarterly basis, offset by liquidated damages relating to the outstanding convertible subordinated notes of approximately \$184,000 quarterly until the resale registration statement relating to these notes is declared effective, the notes are sold under Rule 144 or the holding period under Rule 144(k) expires, whichever is earlier.

Loss on investments. We have invested in equity and convertible debt of certain public and privately held companies. These investments have been made to establish relationships with companies in markets that we believe are consistent with our long-term strategic direction. We review the carrying value of these investments at the end of each reporting period to assess whether any impairment has occurred, based on an evaluation of historical and projected financial performance, expected cash flows and recent funding events for each of the investees. We also assess possible impairment of our investment portfolio based on the general financial performance of the telecommunications industry and general economic conditions. During the three months ended November 30, 2002, certain private companies in which we held investments continued to experience financial declines and might not be able to raise sufficient funding to operate in the next six to twelve months. In addition, the prolonged economic downturn continued to negatively affect the financial performance of companies in the telecommunications sector. As a result, we determined that our investment portfolio had declined in fair value on an other-than-temporary basis and accordingly recorded impairment write-downs of \$24.3 million during the three months ended November 30, 2002. For the first nine months of fiscal 2003, impairment write-downs for our equity investments totaled \$35.0 million. Our ability to recover our investments in these companies and to earn a return on these investments largely depends on equity market conditions and the occurrence of liquidity events, such as initial public offerings, mergers, and private sales. These factors are difficult to predict, particularly in the current economic environment. Continued downturns in the equity market and/or failures of the investees to achieve business objectives could further impair our investments in the future.

Gain on settlement of litigation. On October 25, 2002, Riverstone and Tellabs Operations, Inc. entered into a Settlement Agreement and Mutual General Release. Under the terms of the agreement, the parties agreed to a dismissal of all pending claims in the suit brought by Tellabs against Riverstone on August 28, 2001 in the Chancery Division of the Circuit Court of Cook County, Illinois, as well as the counterclaims against Tellabs by Riverstone. Tellabs further agreed to pay Riverstone \$12.0 million, approximately \$493,000 of which was designated as payment for outstanding invoices of past sales from Riverstone to Tellabs and recorded as revenue in the quarter ended November 30, 2002. The remaining balance was recorded as a gain on settlement of litigation in the same quarter.

Extraordinary gain on repurchase of convertible notes. During the three months ended November 30, 2002, we repurchased a total of \$28.0 million in principal amount of our 3.75% convertible subordinated notes due December 1, 2006 for a price of \$16.9 million, plus accrued interest thereon of \$440,000. Concurrently with the repurchases of the Notes, we wrote off \$650,000 of debt issuance costs from other long-term assets. As a result of the repurchases and write-off, we recorded an extraordinary gain of approximately \$6.3 million, net of income taxes of \$4.2 million, in the third quarter of fiscal 2003.

Income taxes. We recorded an income tax benefit of \$3.6 million for the three months ended November 30, 2002, compared to a \$210,000 provision for income taxes for the three months ended December 1, 2001. The income tax benefit recorded consisted of a \$4.2 million tax benefit resulting from the extraordinary gain on repurchases of our convertible subordinated notes, offset by a tax provision of \$582,000 for certain foreign and minimum tax liabilities. For the nine months ended November 30, 2002, we recorded an income tax benefit of \$2.9 million compared to a \$210,000 provision for income taxes for the nine months ended December 1, 2001. The income tax benefit recorded included the \$4.2 million tax benefit from the extraordinary gain on repurchases of our convertible subordinated notes, offset by \$1.3 million of income tax provisions for certain foreign and minimum tax liabilities arising in jurisdictions in which we operate. Due to our history of cumulative operating losses, we recorded an increase in our valuation allowance for deferred tax assets for the three months ended November 30, 2002 that eliminated the income tax benefit that would otherwise be derived by applying the U.S. federal statutory rate to the amount of the net loss before income taxes we sustained during the period in excess of the \$10.5 million extraordinary gain on the repurchases of our convertible subordinated notes.

Liquidity and Capital Resources

At November 30, 2002, we had cash and cash equivalents of approximately \$186.8 million, short-term investments of \$83.6 million and marketable long-term investments of \$94.3 million. We regularly invest excess funds in money market funds, commercial paper and government and non-government debt securities.

We also have a \$15.0 million credit facility available under a revolving line of credit. This borrowing facility does not require compliance with any financial covenants and can be withdrawn by the financial institution at any time. At November 30, 2002 there was no indebtedness outstanding under this credit facility.

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Net cash used in operating activities for the nine months ended November 30, 2002 and December 1, 2001 was \$47.1 million and \$2.3 million, respectively. Cash used by operating activities in the first nine months of fiscal 2003 was primarily attributable to our net loss, a decrease in accounts payable and accrued liabilities and a non-cash gain on repurchases of our convertible subordinated notes, partially offset by a decrease in accounts receivable and prepaid assets, non-cash charges for depreciation and amortization, provision for losses on accounts receivable and loss on investments. Cash used by operating activities in the first nine months of fiscal 2002 was primarily due to our net loss, increases in accounts receivable, inventories and other working capital items offset by increases in accounts payable and other accrued expenses.

Net cash provided by investing activities for the nine months ended November 30, 2002 was \$128.4 million, consisting primarily of proceeds from maturities and sales of marketable investments, partially offset by purchases of short-term and long-term investments and capital equipment. Net cash used in investing activities for the nine months ended December 1, 2001 was \$325.9 million and consisted of capital expenditures, and purchases of short-term and long-term investments, partially offset by proceeds from maturities and sales of investments. Capital expenditures during both periods were for the procurement of production equipment, research and development equipment, computers, enterprise resource planning software applications and facilities-related improvements.

Net cash used in financing activities for the nine months ended November 30, 2002 was \$17.7 million, consisting of proceeds from issuance of common stock pursuant to our employee stock purchase plan, offset by an adjustment to equity relating to the spin off from Cabletron in August 2001 and repurchases of the convertible subordinated notes. During the three months ended November 30, 2002, we repurchased a total of \$28.0 million in principal amount of the convertible subordinated notes, for an aggregate price of \$16.9 million, plus accrued interest thereon of \$440,000. Concurrently with the repurchases of the convertible subordinated notes, we wrote off \$650,000 of debt issuance costs from other long-term assets. As a result of the repurchases and write-off, we recorded an extraordinary gain of approximately \$6.3 million, net of income tax of \$4.2 million, in the third quarter of fiscal 2003. Cash provided by financing activities was \$322.8 million for the nine months ended December 1, 2001, consisting of proceeds from issuance of common stock, exercise of stock options, net transfers from Cabletron under our agreement with them and net proceeds from issuance of convertible subordinated notes in November 2001.

Beginning in fiscal 2002, we initiated a program to sell, from time to time, trade accounts receivables to an unrelated finance entity, with limited recourse. We account for the transfer of accounts receivable in accordance with SFAS No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities A Replacement of FASB Statement No. 125*. According to the accounts receivable sale agreements, we maintain the servicing of these receivables. During the nine months ended November 30, 2002, we sold approximately \$13.8 million in receivables. The difference between the receivables face amount and net cash flow from the sale of receivables in any given period represents the discount on sales and is recorded as interest expense. The discount was approximately \$882,000 in the first nine months of fiscal year 2003. At November 30, 2002, \$5.1 million in sold trade accounts receivable remained outstanding. For the nine months ended December 1, 2001, we sold \$9.0 million in trade accounts receivable with a discount of approximately \$343,000.

We currently have operating lease commitments of approximately \$13.7 million, outstanding convertible subordinated notes of \$147.0 million due December 2006 and standby letters of credit relating to lease guarantees of \$8.3 million. In January 2003, we completed the acquisition of Pipal Systems, Inc., which will be accounted for as a purchase of a group of net assets rather than a business combination in accordance with EITF Issue No. 98-3 *Determining Whether a Nonmonetary Transaction Involves Receipt of Productive Assets or of a Business*. We issued approximately 7.3 million shares of common stock and agreed to pay approximately \$4.1 million in cash in exchange for all of Pipal's outstanding capital stock. In addition, with respect to Pipal's outstanding stock options, we settled for approximately \$367,000 cash, in part, and issued stock options in substitution for the remainder, which, if fully vested and exercised, would amount to approximately 700,000 shares of common stock. The common stock issued in exchange for Pipal common stock is subject to the Company's right to repurchase in accordance with individual vesting schedules. The Company will pay the cash payable for Pipal common stock and options as they vest with dates generally ranging from the closing of the transaction to four years. Any remaining cash which has not vested will be paid on January 2, 2013. We also assumed debt totaling approximately \$6.5 million and entered into bonus and compensatory arrangements tied to milestones for employees and consultants totaling approximately \$4.6 million. In connection with the acquisition of Pipal, we had made loans to Pipal in the amount of \$965,000, which were forgiven and became an element of the purchase price. Our future capital requirements will depend on a number of factors, including the timing and rate of the expansion of our business, resources we devote to developing our products and market acceptance of our products. We anticipate devoting substantial capital resources to continue our research and development efforts, to maintain our sales, support, marketing and product development organizations, and for other general corporate activities and infrastructure. We may periodically review strategic and operational alternatives to improve our operating results and financial position. In this regard, we may consider, among other things, changes in our capital structure, including repurchases of our common stock or our convertible notes, adjustments to our capital expenditures and overall spending, the restructuring of our operations and the disposition of assets. We may also consider the acquisition of products and businesses complementary to our business. Any acquisition or investments may require additional capital. We cannot assure you that we will be successful in implementing any new strategic or operational initiatives or, if implemented, that they will have the effect of improving our operating results and financial position. Although it is difficult for us to predict future liquidity requirements with certainty, we believe that our existing cash, cash equivalents and marketable short-and long-term investments together with our existing credit facility will be sufficient to meet our anticipated cash needs for working capital and capital expenditures over the next 12 months.

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Risk Factors that May Affect Our Future Results and the Market Price of Our Stock

Factors Related to Our Business

We have a general history of losses and cannot assure you that we will operate profitably in the future.

We have not yet achieved profitability on an annual basis, and we cannot be certain that we will realize sufficient revenue to achieve profitability in the future. We incurred net losses of \$30.7 million, \$65.8 million and \$37.4 million during fiscal years 2002, 2001 and 2000, respectively and \$101.8 million during the nine months ended November 30, 2002. Portions of our financial data for fiscal 2002 and earlier periods were based on Cabletron's financial statements. We anticipate incurring significant sales and marketing, product development and general and administrative expenses, which will require us to realize significantly higher revenue in order to achieve profitability.

Because the United States, Europe and Asia-Pacific are experiencing an economic slowdown, our ability to increase or sustain our revenues may be limited. The events on September 11, 2001 and other terrorist attacks, as well as concerns regarding any related conflicts or similar events worldwide, have increased economic uncertainty in the U.S. These events have decreased our ability to project our revenue in future quarters and may decrease the amount of funds our customers commit to information technology infrastructure spending. Any reduction in or delay of capital spending by our customers due to the events of September 11, 2001 and subsequent economic, political and social turmoil will reduce our future revenue and profitability.

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

Our customers include local exchange carriers, long distance carriers, Internet service providers, metropolitan service providers, content hosting providers and cable operators whose businesses depend on the continuing demand for differentiated services by their customers. Service provider companies generally have been adversely impacted by the current global economic slowdown. The developing service provider market has become very competitive and price sensitive. Poor conditions in the service provider market have caused service providers to reduce capital expenditures on technology infrastructure. We have experienced reductions and order delays from our service provider customers. Our exposure to these risks is greater than it is for vendors who sell to a more diversified customer base. We believe that there are risks arising from doing business with service providers in these markets that may not be faced by our competitors in their relationships with corporate and other customers, including:

service providers that are heavily dependent upon financing, particularly from the high yield debt market, may decrease their infrastructure purchases as a result of limited financing availability or interest rates increases;

weak economic conditions may cause service providers to postpone or reduce capital expenditures;

the introduction, or the planned introduction, of new products and product enhancements, which could cause service providers to cancel, reduce or delay existing orders;

any failure of a service provider's service to its customers that it attributes to our products, whether or not our products actually failed, which could lead to substantial negative publicity and undermine our sales; and

the low level of brand loyalty demonstrated by service providers, which may cause them to switch to another supplier that provides, or that they believe provides, superior performance or cost-effectiveness.

The occurrence of these events may lead to our customers delaying orders, delivery times or payments for our products, or require us to increase the time and cost associated with our sales efforts.

Our quarterly revenue and operating results are likely to fluctuate which could cause us to miss quarterly revenue targets and results in a decline in our stock price.

We base our operating expenses on anticipated revenue trends. A high percentage of our expenses remain relatively fixed despite changes in revenue, including marketing, research and development and general administrative expenses and expenses for employee compensation other than sales commissions. This means that any failure to achieve anticipated revenues could cause our quarterly operating results to fall below the expectations of public market analysts or investors, which could cause the price of our common stock to fall. For example, during the three months ended November 30, 2002, while our operating expenses decreased by approximately \$1.0 million or 3% compared to the three months ended December 1, 2001, net revenues declined by 77% compared to the same period a year ago. As a result, operating expenses accounted for 234% of net revenues for the three months ended November 30, 2002 compared to 55% of net revenues for the same period a year ago.

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

fluctuations in demand for our products and services;

unexpected product returns or the cancellation or rescheduling of significant orders;

our ability to develop, introduce, ship and support new products and product enhancements and manage product transitions;

the linearity of our sales within a quarter, which can fluctuate widely and subject us to risks such as unexpected disruptions in component availability, manufacturing capacity, order management, and shipping as well as cause our reseller customers to delay placing new orders until later in the following quarter when they have reduced their inventory levels;

the timing and amount of non-cash stock-based compensation charges;

our ability and our suppliers' abilities to attain and maintain production volumes and quality levels for our products; and

write-downs resulting from other-than-temporary declines in value of our investments in equity and convertible debt investees.

Due to these factors, we believe that you should not rely on period-to-period comparisons of our operating results as an indicator of our future performance.

We generally do not have binding commitments from our customers and if significant customers cancel, reduce or delay a large purchase, our revenues may decline and the price of our stock may fall.

Historically, a limited number of customers have accounted for a significant portion of our revenues. Customers making large purchases from us are likely to vary over time, due to changes in our product cycles, customer needs, competition or economic circumstances. Some of our former significant customers have filed for bankruptcy and ceased operations. Although our largest customers may vary from period to period, we anticipate that our operating results for any given period will continue to depend significantly on large orders from a small number of customers. We generally do not have binding commitments from our customers. If any of our large customers cancels, reduces or delays purchases, our revenues and profitability would be harmed.

Because the purchase of our products often represents a significant decision on the part of potential customers, we may expend significant resources on potential customers without achieving actual sales.

Purchases of our products often represent a significant strategic decision and capital investment by our customers related to their communications infrastructure and typically involve significant internal procedures involving the evaluation, testing, implementation and acceptance of new technologies. This evaluation process frequently results in a lengthy sales process, often ranging from one month to longer than a year, and purchases of our products are subject to a number of significant risks, including customer budgetary constraints and internal acceptance reviews. During this time we may incur substantial sales and marketing expenses and expend significant management effort. The length of the sales cycle, and the magnitude of our investment in the sales process, is more substantial for our service provider customers than it would typically be with corporate customers. If sales forecasts from a specific customer for a particular quarter are not realized in that quarter, we may be unable to compensate for the shortfall, which could harm our operating results.

We may be unable to expand our sales and direct and indirect distribution channels, which may hinder our ability to target multiple levels of a prospective customer's organization, to address markets adjacent to the service provider market and to increase sales and revenues.

Our products and services require a sophisticated sales and marketing effort targeted at several levels within a prospective customer's organization. Unless we expand our sales force and maintain high levels of marketing activity, we will be unable to increase revenues. Although we plan to continue to dedicate sales personnel to our target customers, competition for qualified sales personnel is intense, and we may be unable to hire or retain the sales personnel we require.

Our sales and distribution strategy relies on value-added resellers, original equipment manufacturers, or OEMs, our direct and indirect international sales efforts and our ability to package our products into a complete network infrastructure solution by working with other technology vendors. If we are unable to establish new value-added reseller or OEM relationships, or if our OEMs and value-added resellers are unsuccessful in distributing our products, our sales could suffer. Because we are not a vertically integrated network infrastructure provider, if we fail to maintain existing technology vendor relationships or to establish new ones, we will be unable to satisfy our customers' need for complete, fully-integrated solutions and our business could suffer.

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We continue to expand our international sales effort, and marketing and distributing our products outside of the United States may require increased expenses and greater exposure to risks that we may not be able to successfully address.

Our growth strategy depends in part on the expansion of our international sales and operations. International sales increased to 32% in fiscal 2001 and 52% in fiscal 2002. During the nine months ended November 30, 2002, international sales accounted for 63% of net revenues. The international market for our products is less mature than the market in the United States, and our strategy of selling to service providers that operate in the metropolitan area network may be unsuccessful on an international basis. Operating internationally exposes us to risks such as longer accounts receivable collection cycles, difficulties in staffing and managing operations across disparate geographic areas, tariffs, export controls and other trade barriers, less effective protection of intellectual property and potentially negative consequences from changes in tax laws. We conduct our international sales in either U.S. dollars or local currencies and a change in the value of the U.S. dollar relative to foreign currencies could make our products less competitive in international markets. We are also subject to fluctuations in exchange rates between the U.S. dollar and the particular local currency. We may engage in hedging transactions to minimize the risk of fluctuations, and if we are not successful in managing hedging transactions, we could incur losses.

Certain of our customers rely on us to arrange financing for our products, which subjects us to credit and market risks.

Certain of our customers do not have or do not wish to commit the financial resources necessary to purchase our products without financing, and these customers may expect us to arrange their financing. These financing arrangements can expose us to our customers' credit risks and in the past we have experienced customer defaults. Due to continuing public market volatility, a number of our current or prospective customers may be unable to raise funding through the issuance of their securities or the borrowing of money. This difficulty could result in an increased need for financing provided either by us or with our assistance and an increased risk of customer default. At November 30, 2002, our guaranteed lease payments amounted to \$8.3 million. In the past, we benefited from Cabletron's resources and credit in arranging financing for our customers. As a result of our separation from Cabletron, we are a much smaller, stand-alone company, which could impair our ability to provide or arrange and support customer financing. If third party financing were to become less available due to credit market factors, our ability to arrange third party financing for our customers could be significantly limited, potentially resulting in reduced revenues. We have not entered into any lease financing transactions since September 2001.

Some of our customers may not have the resources to pay for our products as a result of the current economic environment.

With the continued economic slowdown, some of our customers are forecasting that their revenue for the foreseeable future will generally be lower than anticipated. Some of these customers are experiencing, or are likely to experience, serious cash flow problems and as a result, may find it increasingly difficult to obtain financing on attractive terms, if at all. If some of these customers are not successful in generating sufficient revenue or securing alternate financing arrangements, they may not be able to pay, or may delay payment for the amounts that they owe us. Furthermore, they may not order as many products from us as originally forecast or cancel orders with us entirely. The inability of some of our potential customers to pay us for our products may adversely affect our cash flow, the timing of our revenue recognition and amount of revenue, which may cause our stock price to decline.

We face litigation risks that could negatively impact our business.

We are currently a defendant in a consolidated securities class action lawsuit and a derivative lawsuit, which seek damages of indeterminate amounts. We are and may in the future be subject to other litigation arising in the normal course of our business. We also face risks associated with certain option grants made to our employees and employees of Cabletron and Cabletron's affiliates and to our advisors and consultants because, as a result of the nature of the persons who received these options and the vesting provisions of these options granted prior to February 22, 2001, we may have violated the California state securities laws. Costs associated with these option grants could be significant.

Litigation may be time-consuming, expensive and disruptive to normal business operations, and the outcome of litigation is difficult to predict. An unfavorable resolution of any specific lawsuit could have a material adverse effect on our business, results of operations and financial condition.

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

We purchase several key components used in the manufacturing of our products from single or limited sources and are dependent upon supply from these sources to meet our needs. We have worked with NEC, Agere and LSI Logic to develop several of our key proprietary application specific integrated circuits, or ASICs. These proprietary ASICs are very complex, and NEC, Agere and LSI Logic are our sole source suppliers for the specific types of ASICs that they supply to us. We do not have a long-term fixed price or minimum volume agreement with any of these suppliers. Should we encounter problems with NEC, Agere or LSI Logic, we may not be able to develop an alternate source in a timely manner, which could hurt our ability to deliver our routers.

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We depend on a single contract manufacturer for all of our manufacturing requirements, and a failure by this contract manufacturer would impair our ability to deliver products.

We outsource all of our manufacturing to one company, Flextronics International, Ltd., which manufactures our products in San Jose, California. If the demand for our products grows, we will need to increase our material purchases and our contract manufacturing capacity with Flextronics or add additional contract manufacturers. Our existing and future contract manufacturers may not meet our future requirements. We have experienced a delay in product shipments from our contract manufacturer in the past, which in turn delayed product shipments to our customers. We may in the future experience similar and other problems, such as insufficient quantity of product, which could materially harm our business and operating results. The inability of our contract manufacturer to provide us with adequate supplies of high-quality products or the loss of our contract manufacturer would cause a delay in our ability to fulfill orders while we obtain a replacement manufacturer and would have a significant negative effect on our business, operating results and financial condition.

We base our purchasing decisions on a forecast of anticipated orders of our products, and if we miscalculate our needs or are not able to obtain necessary components, our business could be harmed.

We use a forward-looking forecast of anticipated product orders to determine our material requirements, and if customer orders do not match forecasts, we may have excess or inadequate inventory of materials and components. In the past, we have experienced shortages of some components, resulting in delays in filling orders. We have also experienced delays in the prototyping of our ASICs during initial product development, which in turn has led to delays in product introductions. If we cannot obtain necessary components, we may not be able to meet customer orders and our business and results of operations could suffer.

Our contract manufacturer manufactures our products using quality assurance standards that we established. We have potential exposure to the contract manufacturer, such as carrying costs and excess material, if it procures components and builds products based on forecasts we provide it and the actual component usage and product sales are significantly lower than we had forecast. We provide reserves for excess and obsolete inventory based on our expectation of future sales. We believe the provisions we have made for inventory are adequate; however, if the demand for our products differs significantly from our estimates, our provisions may need to increase which could adversely affect our gross margin for a given period.

Substantially all of our revenues come from sales of our RS router family, making us dependent on widespread market acceptance of these products.

Substantially all of our revenues result from sales of our RS router family. Continuing market acceptance of our products is critical to our future success, and we are more dependent on the market acceptance of a single product family, our RS router family, than competitors with broader product offerings. Factors that may affect the market acceptance of our RS router family include:

- adoption of advanced routing and switching products and technologies;
- the performance, price and total cost of ownership of our products;
- the availability and price of competing products and technologies;
- brand recognition of the Riverstone name; and
- the success and development of our sales and marketing organizations and resellers.

If we fail to achieve and maintain market acceptance for our RS router family, our revenues may be harmed.

The market for network equipment is subject to rapid technological change, and if we fail to accurately predict and respond to market developments or demands, we will be unable to compete successfully.

The market for network equipment is characterized by rapid technological change, frequent new product introductions, changes in customer requirements and evolving industry standards. Our future performance will depend on our successful development and introduction and the market acceptance of new and enhanced products that address customer requirements in a cost-effective manner. We may be unsuccessful in completing the development or introduction of these product enhancements or new products on a timely basis or at all. The failure of these enhancements or new products to operate as expected could delay or prevent future sales. Developments in routers and routing software could also significantly reduce demand for our product. Alternative technologies and customer requirements could achieve widespread market acceptance and displace the technologies, protocols and service requirements on which our product lines are based. Our technological approach may not achieve broad market acceptance, and other technologies or devices may supplant our approach.

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If we are unable to deliver the high level of customer service and support demanded by our customers, we may lose customers and our operating results will suffer.

Our customers demand a high level of customer service and support. Our customer service and support functions are provided by our internal product support groups. We have transitioned all of these functions from a combination of internal and external support to our internal customer service group, RTAC group, and field technical support group. If we are unable to manage these functions internally and satisfy our customers with a high level of service and support, any resulting customer dissatisfaction could impair our ability to retain customers and make future sales. We have also considered, and could consider in the future, using other third parties to provide certain customer support services. We may be unable to manage effectively those third parties who may provide support services for us and they may provide inadequate levels of customer support.

Our products are very complex and undetected defects may increase our costs and harm our reputation with our customers.

Networking products are extremely complex and must operate successfully with equally complex products of other vendors. These products frequently contain undetected software or hardware errors when first introduced or as new upgrades are released. Additionally, the pressures we face to be the first to market new products increases the possibility that we will offer products in which we or our customers later discover errors. We have experienced new product and product upgrade errors in the past and may experience similar problems in the future. These problems could result in our incurring significant warranty and repair costs, divert the attention of our engineering personnel from our product development efforts and cause significant customer relations problems and our stock price to fall.

We face risks associated with our strategic investments and may not realize the anticipated benefits of such investments.

We may make strategic investments in the future. We may not realize the anticipated benefits of our current and future strategic investments. Some of our current investments have resulted in and may continue to result in losses. The companies in which we invest may not make, may reduce or may terminate product purchases from us. We may lose all or a portion of the amount invested. Our ability to recover investments from these investees is largely dependent on equity market conditions and the occurrence of liquidity events, such as initial public offerings, mergers and private sales. All of these factors are difficult to predict, particularly in the current economic environment. We assess the fair value of our strategic investments quarterly and may be required to record impairment charges against our strategic investments. We also assess possible impairment for our investment portfolio based on the general financial performance of the telecommunications industry and general economic conditions. During the fourth quarter of the fiscal year ended March 2, 2002, and the nine months ended November 30, 2002, certain private companies in which we held investments were experiencing financial declines and were not likely to be able to raise capital to continue operations. In addition, the prolonged economic downturn has further negatively affected the financial performance of companies in the telecommunications sector. As a result, we determined that investments in these investees had declined in fair market value on an other-than-temporary basis and accordingly recorded impairment charges of \$22.1 million and \$35.0 million for the fiscal year ended March 2, 2002 and the nine months ended November 30, 2002, respectively, against strategic investments. Factors we consider important that could trigger an impairment charge include the likelihood that the related company would have insufficient cash flows to operate for the next six to twelve months, significant changes in the operating performance or operating model, and/or changes in market conditions. If we determine to reduce the carrying value of one of our investments, such a reduction could adversely affect our financial condition and results of operations.

A substantial portion of our strategic investments is and may continue to be in companies located outside of the United States. We face additional risks associated with these international investments, including political or social unrest or economic instability in the specific country or region, as well as the ability to enforce our contract rights, if necessary, in a foreign jurisdiction.

The issuance of shares of our common stock in our recent acquisition of Pipal Systems, Inc. and the recognition of Pipal's operating losses will have the effect of increasing our net loss per share, which could reduce the market price of our stock. If we are unable to achieve certain business synergies following the acquisition, we may not achieve results of operations and financial conditions superior to what the two companies could achieve independently.

The issuance of our common stock in connection with our recent acquisition of Pipal Systems and the recognition of Pipal's operating losses will have the effect of increasing our net loss per share and could reduce the market price of our common stock unless and until revenue growth or cost savings and other business synergies sufficient to offset the effect of such issuance can be achieved. There can be no assurance that such growth, savings or synergies will be achieved. In addition, in the event that investors view the acquisition negatively, the market price of our common stock could be adversely affected. Although we believe that beneficial synergies will result from the acquisition, there can be no assurance that the combining of the two companies' businesses, even if achieved in an efficient, effective and timely manner, will result in combined results of operations and financial condition superior to what would have been achieved by each company independently, or as to the period of time required to achieve such result.

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If customers do not perceive benefits from integrating Pipal's intellectual property and product design into our product offerings or we experience problems integrating Pipal's business with ours, our revenues following the acquisition may fail to grow or may decline, our expenses could increase, our business could be adversely affected and our stock price could decline.

The success of the acquisition of Pipal depends on market acceptance of our strategic initiative to integrate Pipal's intellectual property and product design into our product offerings. If customers do not perceive benefits from these combined product offerings, we will not realize the principal strategic benefits that we currently anticipate from the acquisition. As a result, we would not realize increased revenues and could experience decreased revenues as a result of the acquisition and could simultaneously be required to expend additional amounts to develop products or remedy unanticipated problems, any of which could harm our operating results and our earnings per share. If we fail to integrate Pipal's business with ours successfully, we will incur substantial costs which will increase our expenses and operating losses, and we will fail to achieve the expected synergies of the acquisition. In addition, integration problems could divert management's attention from regular business concerns and other business opportunities, which could result in slower revenue growth than anticipated or in declines in revenue. To the extent the acquisition and related integration do not proceed as beneficially as anticipated, our revenues could decline or grow at a slower rate, our expenses could increase and our stock price could decline.

We have limited ability to engage in acquisitions and other strategic transactions using our equity because of the federal income tax requirements for a tax-free distribution.

For the distribution of our stock by Cabletron (now known as Enterasys) to qualify as tax-free to Enterasys there must not be a change in ownership of 50% or greater in either the voting power or value of either our stock or Cabletron's stock that is considered to be part of a plan or series of transactions related to the distribution. If there is a direct or indirect acquisition of our or Enterasys' stock by one or more persons during the four-year period beginning two years before and ending two years after the distribution, it will be presumed to be part of a plan or series of related transactions related to Enterasys' intended distribution of our stock. Unless this presumption is successfully rebutted, the distribution will be taxable to Enterasys.

We have entered into a tax sharing agreement with Enterasys and Aprisma. This agreement requires us to indemnify the other parties if the distribution by Cabletron of its Riverstone shares does not qualify as tax-free due to actions we take or that otherwise relate to us, including any change of ownership of us. The process for determining whether a change of ownership has occurred under the tax rules is complex. If we do not carefully monitor our compliance with these rules, we might inadvertently cause a change of ownership to occur, triggering our obligation to indemnify Enterasys and the other parties to the tax sharing agreement. Our obligation to indemnify these parties if a change of ownership causes the distribution not to be tax-free could discourage or prevent a third party from making a proposal to acquire us. The amount of any such indemnification would be substantial.

For the reasons described above, our ability to use our stock for acquisitions and other similar strategic transactions or for compensation for employees and others is restricted. Many of our competitors use their equity to complete acquisitions, to expand their product offerings and speed the development of new technology and to attract and retain employees and other key personnel, giving them a potentially significant competitive advantage over us.

We jointly own with Enterasys some of our intellectual property, and our business could be harmed if Enterasys uses this intellectual property to compete with us.

Intellectual property that relates to a family of ASICs used in both our RS router family and Enterasys' Smart Switch Router product family is owned jointly by Enterasys and us. Enterasys is primarily a provider of local area network products for the enterprise market. There are no contractual provisions that prohibit Enterasys from developing products that are competitive with our products, including products based upon the jointly owned intellectual property. If Enterasys is acquired by one of our competitors, there are no contractual provisions that would prohibit the combined company from developing products competitive with our products.

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

We rely on a combination of patent, copyright, trademark and trade secret laws, licensing agreements and restrictions on disclosure of confidential information to protect our intellectual property rights. We cannot assure you that any patents that we hold will protect our intellectual property or provide any significant competitive advantage or will not be challenged by third parties. Other parties may also independently develop similar or competing products that do not infringe upon our patents. We may be required to spend significant resources to monitor and police our intellectual property rights. We may not be able to detect infringement and may lose our competitive position in the market before we do so. Although we attempt to protect our intellectual property rights, we may be unable to prevent the misappropriation of our intellectual property, particularly in foreign countries where the laws may not protect our proprietary rights as fully as in the United States. If we fail to protect or to enforce our intellectual property rights successfully, our competitive position could suffer, which could harm our operating results.

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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.

In the course of our business, we may receive claims of infringement or otherwise become aware of potentially relevant patents or other intellectual property rights held by other parties. We evaluate the validity and applicability of these intellectual property rights, and determine in each case whether we must negotiate licenses or cross-licenses to incorporate or use the proprietary technologies in our products. Third parties may claim that we or our customers, manufacturers or suppliers are infringing or contributing to the infringement of their intellectual property rights, and we may be found to infringe or contribute to the infringement of those intellectual property rights and require a license to use those rights or indemnify our customers, manufacturers or suppliers. However, we may not be able to obtain royalty or license agreements on terms acceptable to us, or at all. We may be unaware of intellectual property rights of others that may cover some of our technology, product or services. Any litigation regarding patents or other intellectual property could be costly and time-consuming and could divert our management and key personnel from our business operations. The complexity of the technology involved and the uncertainty of intellectual property litigation increase these risks. We also may be subject to significant damages or injunctions against development and sale of our products.

If we are unable to attract, integrate, manage and retain qualified personnel, we may not be able to achieve our objectives and our business could be harmed.

Our success depends to a significant degree upon the continued contributions of our key management, engineering, sales and marketing, customer support and manufacturing personnel, many of whom would be difficult to replace. In particular, we believe that our future success is highly dependent on Romulus Pereira, our president and chief executive officer.

We believe our future success also depends on our ability to attract, integrate, manage and retain highly skilled managerial, engineering, sales and marketing, finance, customer support and manufacturing personnel. Competition for these personnel is intense, and in the past, we have had difficulty hiring employees in our desired time frame, particularly software and hardware engineers. We may be unsuccessful in attracting and retaining personnel. The loss of the services of any of our key personnel, the inability to attract or retain qualified personnel in the future or delays in hiring required personnel, particularly engineers and sales personnel, could make it difficult for us to manage our business and meet key objectives, such as timely product introductions.

In recent quarters, we initiated reductions in our workforce of both employees and contractors. These reductions have resulted in reallocations of employee duties which could result in employee and contractor uncertainty. Reductions in our workforce could make it difficult to motivate and retain the remaining employees and contractors, which would affect our ability to deliver our products in a timely fashion and otherwise negatively affect our business. Further, our common stock price per share has been, and may continue to be, extremely volatile. When our common stock price is less than the exercise price of stock options granted to employees, turnover may increase, which could harm our results of operations or financial condition.

We rely on independent service providers to supply certain of our back-office functions, and if they fail to deliver adequate services, our business will suffer.

We rely on service providers to supply us with many of our operational and back-office functions, including human resources applications, enterprise resource management applications and customer relationship management applications. Although these functions are critical to our business, we neither own the software that performs these functions nor, in some cases, the hardware on which these programs and our data reside. If there is a significant degradation or failure in service, we may be unable to quickly and cost-effectively transition to other service providers or provide the necessary functionality ourselves and our business could be disrupted.

Factors Related to Our Industry

Intense competition in the market for network equipment could prevent us from increasing revenues and sustaining profitability.

The market for network equipment is very competitive and has historically been dominated by Cisco Systems. Other principal competitors include established companies such as Extreme Networks, Inc., Foundry Networks, Inc., Juniper Networks, Inc., Nortel Networks Corporation and other smaller public and private companies. These competitors may have developed or could in the future develop new technologies that compete with our products or even make our products obsolete. Consolidation in our industry is occurring and is likely to continue. Future acquisitions by, and mergers among, our competitors and potential competitors could expand their product offerings and accelerate their development of new technologies, providing them with a competitive advantage.

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Many of our competitors have significantly more established customer support and professional services organizations and substantially greater financial resources than we do. Many of our competitors also have much greater name recognition and have a more extensive customer base and broader customer relationships and product offerings than we do. These companies can rely on their customer bases and broader product offerings and adopt aggressive pricing policies to gain market share. We expect that competitive pressures may result in price reductions, reduced margins and loss of market share, which would materially harm our business, results of operations and financial condition.

We expect the average selling prices of our products to decrease rapidly, which may reduce our gross margins or revenues.

Our industry has experienced rapid erosion of average selling prices. We anticipate that the average selling prices of our products will decrease in the future in response to competitive pricing pressures, increased sales discounts, new product introductions by us or our competitors and increasing availability of relatively inexpensive standard microprocessors that can perform some of our products' functionality. If we are unable to achieve sufficient cost reductions and increases in sales volumes, this decline in average selling prices will reduce our revenues and gross margins.

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 equipment products is characterized by the need to support industry standards as different standards emerge, evolve and achieve acceptance. To be competitive, we must continually introduce new products and product enhancements that meet these emerging standards. 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 issues that arise from technological changes and evolving industry standards. 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 NEBS. Internationally, products that we develop may be 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 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 or maintaining profitability.

Factors Related to Our Separation from Cabletron

We cannot rely on Cabletron to fund our future capital requirements, and financing from other sources may not be available on favorable terms or at all.

In the past, our capital needs were satisfied by Cabletron. However, following our separation, Cabletron is no longer a source of funds to finance our working capital or other cash requirements. Financing or financial support from other sources, if needed, may not be available on favorable terms or at all.

We believe our capital requirements will vary greatly from quarter to quarter. Capital expenditures, fluctuations in our operating results, financing activities, acquisitions, investments and inventory and receivables management may contribute to these fluctuations. We believe that the proceeds from our initial public offering, our sale of common stock to Cabletron in July 2001, our issuance of convertible subordinated notes in November 2001 and our future cash flow from operations, will be sufficient to satisfy our working capital, capital expenditure and research and development requirements for at least the next twelve months. However, we may require or choose to obtain additional debt or equity financing to finance acquisitions or other investments in our business. Future equity financings may be dilutive to the existing holders of our common stock. Future debt financings could involve restrictive covenants. We will likely not be able to obtain debt financing with interest rates and other terms as favorable as those that Cabletron could obtain.

The plaintiffs in Cabletron's outstanding class action suit might seek to add us to this litigation or seek payment of any related damages.

Since December 1997, Cabletron has been party to an outstanding class action suit alleging that during the period from March 3, 1997 through December 2, 1997, Cabletron released false and misleading information about its operations and that Cabletron's accounting practices resulted in the disclosure of materially misleading financial results. The plaintiffs' complaint does not specify the amount of damages, but if the plaintiffs prevail Enterasys (formerly Cabletron) could be required to pay substantial damages. The plaintiffs in this matter might seek to involve us in this litigation or, if they prevail in this litigation, might seek to recover damages from us, particularly if Enterasys has insufficient assets.

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We face risks related to the pending formal SEC investigation of Enterasys and certain of its affiliates.

On January 31, 2002, the Securities and Exchange Commission notified Enterasys that it had commenced an Order of Investigation into Enterasys and certain of its affiliates' accounting practices. We have responded to a subpoena seeking certain documents and information in connection with the Enterasys investigation that we received on June 24, 2002 from the SEC. As of the date of this Report, we are unable to predict what, if any, impact the SEC investigation into Enterasys' prior accounting practices may have on us. We could be required to take actions not presently contemplated, which could be expensive, divert management's attention from other business concerns and harm our business. In addition, the ongoing SEC inquiry into Enterasys may contribute to volatility in the price of our common stock.

Conflicts of interest may arise because our directors and executive officers have ownership interests in Enterasys.

Many of our directors and executive officers have a substantial amount of their personal financial portfolios in Enterasys common stock and options to purchase Enterasys common stock. Conflicts of interest may arise between Enterasys and us in a number of areas relating to our past and ongoing relationships, including tax, indemnification, intellectual property and other matters arising from our separation from Cabletron, which is now Enterasys. These factors could create, or appear to create, potential conflicts of interest when directors and officers are faced with decisions that could have different implications for Enterasys and us. In our certificate of incorporation we have renounced any interest in business opportunities that are presented to Cabletron (now known as Enterasys), its subsidiaries, or our officers or directors who are employees of Enterasys or its subsidiaries at the time the opportunity is presented.

We could incur significant tax liability if the distribution does not qualify for tax-free treatment, which could require us to pay Enterasys a substantial amount of money.

In addition to our liability under the tax sharing agreement with Enterasys and Aprisma under United States Federal income tax laws, we would be jointly and severally liable for the Federal income taxes of Cabletron resulting from the distribution being taxable. This means that even if we do not have to indemnify Enterasys under the tax sharing agreement because we did not take any specific action to cause the distribution to fail as a tax-free event, we may still be liable for any part of, including the whole amount of, these liabilities and expenses if Enterasys fails to pay them.

Factors Related to Our Stock

Our stock price has been and may continue to be volatile, which could result in substantial losses for individual stockholders.

The stock markets in general, and the markets for high technology stocks in particular, have experienced extreme volatility that has often been unrelated to the operating performance of particular companies. The market price of our common stock has been volatile, and we expect that it will continue to be volatile. This volatility could result in substantial losses to individual stockholders and holders of our convertible subordinated notes.

We may not be able to maintain our listing on The Nasdaq National Market and if we fail to do so, the price and liquidity of our common stock may decline.

The Nasdaq Stock Market has quantitative maintenance criteria for the continued listing of common stock on The Nasdaq National Market, including maintaining a minimum closing bid of \$1.00 per share and a minimum of \$10.0 million in stockholders' equity. There have been periods in the second and third quarters of fiscal year 2003 when the closing bid price per share for our common stock was below \$1.00. If the closing bid price of our common stock remains below \$1.00 per share for 30 consecutive trading days, Nasdaq will provide a notice indicating that we are not in compliance with the minimum bid requirement, and we will be provided 90 calendar days to regain compliance. If, at any time within that 90-day period, the bid price of our common stock closes at \$1.00 or more for a minimum of 10 consecutive trading days, Nasdaq will provide written notification that we comply with the minimum bid requirement. If compliance with the requirement cannot be demonstrated by the end of the 90-day period, Nasdaq will provide written notification that our common stock will be delisted from The Nasdaq National Market, at which time we may appeal Nasdaq's determination. On October 7, 2002, we received notification from Nasdaq that for 30 consecutive trading days our common stock had closed below the minimum \$1.00 per share requirement. On November 18, 2002, we received notification from Nasdaq that we had regained compliance with the minimum bid requirement for continued listing. There can be no assurance that we will be able to comply with the quantitative maintenance criteria or any of The Nasdaq National Market's rules in the future. If we fail to maintain continued listing on The Nasdaq National Market and must move to a market with less liquidity, our financial condition could be harmed and our stock price would likely decline. If we are delisted, it could have a material adverse effect on the market price of, and the liquidity of the trading market for, our common stock.

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Anti-takeover provisions could make it more difficult for a third party to acquire us.

We have adopted a stockholder rights plan and declared a dividend distribution of one right for each outstanding share of common stock to stockholders of record as of July 26, 2001. Each right entitles the holder to purchase upon certain events one one-thousandth of a share of our Series A Preferred Stock for \$115. Under certain circumstances, if a person or group acquire 15% or more of our outstanding common stock, holders of the rights (other than the person or group triggering their exercise) will be able to purchase, in exchange for the exercise price, shares of our common stock, and in certain cases, shares of stock of a company into which we are merged, having a value of double the exercise price. Because the rights may substantially dilute the stock ownership of a person or group attempting to take us over without the approval of our board of directors, our rights plan could make it more difficult for a third party to acquire us, or a significant percentage of our outstanding capital stock, without first negotiating with our board of directors regarding such acquisition.

In addition, our board of directors has the authority to issue up to 2,000,000 shares of preferred stock (of which 200,000 shares have been designated as Series A Preferred Stock) and to determine the price, rights, preferences, privileges and restrictions, including voting rights, of those shares without any further vote or action by the stockholders. The rights of the holders of common stock may be subject to, and may be adversely affected by, the rights of holders of any preferred stock that may be issued in the future. The issuance of preferred stock may have the effect of delaying, deferring or preventing a change of control of us without further action by the stockholders and may adversely affect the voting and other rights of the holders of common stock. Further, certain provisions of our charter documents may have the effect of delaying or preventing changes in control or management of Riverstone.

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

We have no material changes to the disclosure on this matter made in our report on Form 10-K for the fiscal year ended March 2, 2002.

Item 4. *Controls and Procedures*

(a) *Evaluation of disclosure controls and procedures.* The Company's chief executive officer and chief financial officer have reviewed and evaluated the effectiveness of the Company's disclosure controls and procedures (as defined in Exchange Act Rules 240.13a-14(c) and 15d-14(c)) as of a date within ninety days before the filing date of this quarterly report. Based on that evaluation, the chief executive officer and chief financial officer have concluded that the Company's current disclosure controls and procedures are effective in timely providing them with material information relating to the Company required to be disclosed in the reports the Company files or submits under the Exchange Act.

(b) *Changes in internal controls.* There have not been any significant changes in the Company's internal controls or in other factors that could significantly affect these controls subsequent to the date of their evaluation. There were no significant deficiencies or material weakness, and therefore no corrective actions were taken.

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PART II. OTHER INFORMATION

Item 1. *Legal Proceedings*

Information with respect to this item is incorporated by reference to Note (12) of the Notes to the Condensed Consolidated Financial Statements included herein on page 9 of this Report on Form 10-Q.

Item 5. *Other Information*

In accordance with Section 10A(i)(2) of the Securities Exchange Act of 1934, as added by Section 202 of the Sarbanes-Oxley Act of 2002, the Company is responsible for listing the non-audit services approved in the third quarter of fiscal year 2003 by the Company's Audit Committee to be performed by Ernst & Young, the Company's external auditor. Non-audit services are defined in the law as services other than those provided in connection with an audit or a review of the financial statements of the Company. The non-audit services approved by the Audit Committee in the second quarter are each considered by the Company to be audit-related services, which are closely related to the financial audit process. Each of the services has been approved in accordance with a pre-approval from the Audit Committee.

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

- (a) *Exhibits:* None
- (b) *Reports on Form 8-K:*

On October 23, 2002, the Company filed a current report on Form 8-K reporting under items 5 and 7 that Mr. William J. Weyand and Ms. Sylvia Summers had been elected to the board of directors and that the Company had received notification from Nasdaq that for 30 consecutive trading days the Company's common stock had closed below the minimum \$1.00 per share requirement for continued listing on The Nasdaq National Market.

On November 18, 2002, the Company filed a current report on Form 8-K reporting under item 5 that the Company had received notification from Nasdaq that the Company had regained compliance with the minimum bid requirement for continued listing on The Nasdaq National Market.

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SIGNATURES

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

RIVERSTONE NETWORKS, INC.
(Registrant)

/s/ ROMULUS S. PEREIRA

Romulus S. Pereira
President, Chief Executive Officer and Director
(Duly Authorized Officer)

Dated: January 14, 2003

/s/ ROBERT STANTON

Robert Stanton
Executive Vice President of Finance and
Chief Financial Officer
(Principal Financial Officer)

Dated: January 14, 2003

The certifications by the Company's chief executive officer and chief financial officer of this report on Form 10-Q, as required by Section 906 of the Sarbanes-Oxley Act of 2002 (18 U.S.C. §1350), have been submitted to the Securities and Exchange Commission as additional correspondence accompanying this report.

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CERTIFICATIONS

I, Romulus S. Pereira, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Riverstone Networks, Inc.;
2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;
3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report;
4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and we have:
 - (a) designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;
 - (b) evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this quarterly report (the Evaluation Date); and
 - (c) presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;
5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent function):
 - (a) all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and
 - (b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and
6. The registrant's other certifying officers and I have indicated in this quarterly report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

/s/ ROMULUS S. PEREIRA

Romulus S. Pereira
President, Chief Executive Officer and Director

Dated: January 14, 2003

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I, Robert Stanton, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Riverstone Networks, Inc.;
2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;
3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report;
4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and we have:
 - (a) designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;
 - (b) evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this quarterly report (the "Evaluation Date"); and
 - (c) presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;
5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent function):
 - (a) all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and
 - (b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and
6. The registrant's other certifying officers and I have indicated in this quarterly report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

/s/ ROBERT STANTON

Robert Stanton
Executive Vice President of Finance and
Chief Financial Officer

Dated: January 14, 2003