# UNITED STATES
# SECURITIES AND EXCHANGE COMMISSION
**Washington, DC 20549**

# Form 10-Q

**(Mark One)**

☒ **Quarterly report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**

**For the quarterly period ended March 31, 2003**

**OR**

☐ **Transition report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**

**Commission File Number: 000-25120**

# RSA Security Inc.
*(Exact Name of Registrant as Specified in Its Charter)*

| **Delaware** | **04-2916506** |
|---|---|
| *(State or Other Jurisdiction of Incorporation or Organization)* | *(I.R.S. Employer Identification No.)* |

**174 Middlesex Turnpike**
**Bedford, Massachusetts 01730**
*(Address of Principal Executive Offices)*

**Registrant's Telephone Number, Including Area Code: (781) 515-5000**

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 ☐

As of May 2, 2003, there were outstanding 58,048,581 shares of the Registrant's Common Stock, $0.01 par value per share.

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

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**RSA SECURITY INC.**
**FORM 10-Q**
**For the Quarter Ended March 31, 2003**

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# PART I. FINANCIAL INFORMATION

## Item 1. Financial Statements

### RSA SECURITY INC. AND SUBSIDIARIES
### CONDENSED CONSOLIDATED BALANCE SHEETS
### (Unaudited)
### (In thousands, except share data)

| | March 31, 2003 | December 31, 2002 |
|---|---|---|
| **ASSETS** | | |
| Current assets | | |
| Cash and cash equivalents | $ 115,416 | $ 103,030 |
| Accounts receivable (less allowance for doubtful accounts of $2,615 in 2003 and $2,494 in 2002) | 28,928 | 35,666 |
| Inventory | 1,953 | 2,334 |
| Prepaid expenses and other assets | 10,174 | 7,974 |
| Refundable income taxes | 57,621 | 57,643 |
| Deferred taxes | 3,829 | 3,829 |
| Total current assets | 217,921 | 210,476 |
| Property and equipment, net | 71,782 | 74,928 |
| Other assets | | |
| Goodwill, net | 188,372 | 191,742 |
| Investments | — | 1,400 |
| Other | 5,379 | 5,854 |
| Total other assets | 193,751 | 198,996 |
| | $ 483,454 | $ 484,400 |
| **LIABILITIES AND STOCKHOLDERS' EQUITY** | | |
| Current liabilities | | |
| Accounts payable | $ 10,202 | $ 6,966 |
| Accrued payroll and related benefits | 8,973 | 11,256 |
| Accrued expenses and other liabilities | 16,590 | 17,543 |
| Current portion of accrued restructurings | 11,409 | 12,163 |
| Income taxes accrued and payable | 34,092 | 33,484 |
| Deferred revenue | 31,129 | 33,170 |
| Total current liabilities | 112,395 | 114,582 |
| Deferred taxes, long-term | 1,592 | 1,592 |
| Accrued restructurings, long-term | 24,648 | 27,315 |
| Convertible debentures | 77,824 | 77,477 |
| Total liabilities | 216,459 | 220,966 |
| Commitments and Contingencies | | |
| Stockholders' equity | | |
| Common stock, $0.01 par value; authorized, 300,000,000 shares; issued, 62,144,158 shares; outstanding, 57,720,702 and 57,066,695 shares in 2003 and 2002, respectively | 621 | 621 |
| Additional paid-in capital | 77,213 | 100,824 |
| Retained earnings | 356,240 | 354,496 |
| Treasury stock, at cost; 4,423,456 and 5,077,463 shares in 2003 and 2002, respectively | (164,642) | (190,554) |
| Accumulated other comprehensive loss | (2,437) | (1,953) |
| Total stockholders' equity | 266,995 | 263,434 |
| | $ 483,454 | $ 484,400 |

See notes to condensed consolidated financial statements.

**RSA SECURITY INC. AND SUBSIDIARIES**
**CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS**
**(Unaudited)**
**(In thousands, except per share data)**

| | Three Months Ended March 31, 2003 | Three Months Ended March 31, 2002 |
|---|---|---|
| Revenue | | |
| Products | $45,512 | $ 39,268 |
| Maintenance and professional services | 15,752 | 16,237 |
| Total revenue | 61,264 | 55,505 |
| Cost of revenue | | |
| Products | 8,051 | 7,585 |
| Maintenance and professional services | 5,131 | 5,867 |
| Total cost of revenue | 13,182 | 13,452 |
| Gross profit | 48,082 | 42,053 |
| Costs and expenses | | |
| Research and development | 12,674 | 15,308 |
| Marketing and selling | 22,886 | 27,750 |
| General and administrative | 9,516 | 6,837 |
| Restructurings | — | 4,383 |
| Amortization of intangible assets | — | 2,312 |
| Total | 45,076 | 56,590 |
| Income (loss) from operations | 3,006 | (14,537) |
| Interest expense and other | (1,850) | (2,054) |
| Income (loss) from investing activities | 1,515 | (2,467) |
| Income (loss) before provision (benefit) for income taxes | 2,671 | (19,058) |
| Provision (benefit) for income taxes | 927 | (5,336) |
| Net income (loss) | $ 1,744 | $(13,722) |
| Basic earnings (loss) per share | | |
| Per share amount | $ 0.03 | $ (0.24) |
| Weighted average shares | 57,263 | 56,442 |
| Diluted earnings (loss) per share | | |
| Per share amount | $ 0.03 | $ (0.24) |
| Weighted average shares | 57,263 | 56,442 |
| Effect of dilutive equity instruments | 1,823 | — |
| Adjusted weighted average shares | 59,086 | 56,442 |

See notes to condensed consolidated financial statements.

**RSA SECURITY INC. AND SUBSIDIARIES**
**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**
**(Unaudited)**
**(In thousands)**

| | Three Months Ended March 31, 2003 | Three Months Ended March 31, 2002 |
|---|---|---|
| Cash flows from operating activities | | |
| Net income (loss) | $ 1,744 | $(13,722) |
| Adjustments to reconcile net income (loss) to net cash provided by operating activities: | | |
| Depreciation | 3,386 | 4,302 |
| Amortization of intangible assets | — | 2,312 |
| Amortization of convertible debentures deferred financing costs | 401 | 405 |
| Non cash warrant accretion | 348 | 342 |
| Income from investing activities | (1,508) | (677) |
| (Increase) decrease in Crosby Finance, LLC fair value | (7) | 3,144 |
| Deferred taxes | — | (915) |
| Increase (decrease) in cash from changes in: | | |
| Accounts receivable | 7,292 | 15,288 |
| Inventory | 424 | 1,094 |
| Prepaid expenses and other assets | (2,194) | 816 |
| Accounts payable | 3,237 | 418 |
| Accrued payroll and related benefits | (2,390) | (4,359) |
| Accrued expenses and other liabilities | (1,002) | (833) |
| Accrued restructurings | (3,293) | 1,739 |
| Refundable income taxes and income taxes accrued and payable | 611 | (54) |
| Deferred revenue | (2,654) | (1,045) |
| Net cash provided by operating activities | 4,395 | 8,255 |
| Cash flows from investing activities | | |
| Sales of marketable securities | — | 1,148 |
| Purchases of property and equipment | (518) | (2,628) |
| Sales of investments | 3,009 | — |
| Acquisitions and related proceeds (costs) | 3,370 | (1,922) |
| Other | 114 | 52 |
| Net cash provided by (used for) investing activities | 5,975 | (3,350) |
| Cash flows from financing activities | | |
| Proceeds from exercise of stock options and purchase plans | 2,303 | 2,709 |
| Other | — | (17) |
| Net cash provided by financing activities | 2,303 | 2,692 |
| Effect of exchange rate changes on cash and cash equivalents | (287) | (57) |
| Net increase in cash and cash equivalents | 12,386 | 7,540 |
| Cash and cash equivalents, beginning of period | 103,030 | 61,946 |
| Cash and cash equivalents, end of period | $115,416 | $ 69,486 |

Cash payments for income taxes were $316 and $150 for the three months ended March 31, 2003 and 2002, respectively.
Cash payments for interest expense were $2,873 and $1,122 for the three months ended March 31, 2003 and 2002, respectively.

See notes to condensed consolidated financial statements.

## 1. Basis of Presentation

The accompanying unaudited condensed consolidated financial statements include the accounts of RSA Security Inc. and its wholly owned subsidiaries (the "Company") and have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission regarding interim financial reporting. Accordingly, they do not include all of the information and notes required by accounting principles generally accepted in the United States for complete financial statements and should be read in conjunction with the audited consolidated financial statements included in the Company's Annual Report on Form 10-K filed for the year ended December 31, 2002.

In the opinion of management, the accompanying unaudited condensed consolidated financial statements have been prepared on the same basis as the audited consolidated financial statements, and reflect all adjustments of a normal recurring nature considered necessary to present fairly results of the interim periods presented. The operating results for the interim periods presented are not necessarily indicative of the results expected for the full year. Certain prior period amounts have been reclassified to conform to the current period presentation.

*Use of Estimates* — The preparation of the Company's condensed consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reporting periods. On an ongoing basis, the Company evaluates its estimates. The Company bases its estimates on historical experience and on various other assumptions that the Company believes are reasonable under the circumstances. Actual results could differ from those estimates.

*Revenue Recognition* — Revenue is recognized when earned. The Company's revenue recognition policies are in compliance with all applicable accounting principles generally accepted in the United States of America, including the American Institute of Certified Public Accountants Statement of Position ("SOP") 97-2, "Software Revenue Recognition," and SOP 98-9, "Modification of SOP 97-2 With Respect to Certain Transactions." The Company recognizes revenue from the sale of products when persuasive evidence of an arrangement exists, delivery has occurred, the fee is fixed or determinable, and collection is considered probable. The Company recognizes revenue from licensing other intellectual property when evidence of an arrangement exists, the fee is fixed or determinable and collection is considered probable. Revenue is reduced by provisions for estimated returns. When arrangements contain multiple elements and vendor specific objective evidence of fair value exists for all undelivered elements, the Company recognizes revenue for the delivered elements using the residual method. For arrangements containing multiple elements where vendor specific objective evidence of fair value does not exist for all undelivered elements, revenue for the delivered and undelivered elements is deferred until vendor specific objective evidence of fair value exists or all elements have been delivered. In accordance with Statement of Financial Accounting Standards ("SFAS") No. 48, "Revenue Recognition when Right of Return Exists," the Company recognizes revenue upon shipment of product to its stocking distributors, net of estimated returns. Maintenance services revenue, whether sold separately or as part of a multiple element arrangement, is deferred and recognized ratably over the term of the maintenance contract, generally twelve months. The Company recognizes professional service revenue as services are provided.

*Allowance for Sales Returns* – Allowances for estimated sales returns and allowances on products and maintenance and professional service revenue are recorded in the same period as the related revenue is recorded. The Company bases these estimates on historical sales returns, analysis of credit memo data, current economic trends, product line and customer industry and other known factors.

*Allowance for Doubtful Accounts* – The Company maintains allowances for doubtful accounts for estimated losses resulting from the inability of the Company's customers to make required payments. The Company utilizes accounts receivable and the composition of the accounts receivable aging, historical bad debts, customer creditworthiness, current economic trends, foreign currency exchange rate fluctuations, and changes in customer payment terms when evaluating the adequacy of the allowance for doubtful accounts. Bad debt expense of zero and $1,371 for the three months ended March 31, 2003 and 2002, respectively, has been included in marketing and selling expenses in the condensed consolidated statements of operations. Uncollectible accounts receivable written off were $469 and $2,186 for the three months ended March 31, 2003 and 2002, respectively. Recoveries of accounts previously written off as uncollectible were $590 and $326 for the three months ended March 31, 2003 and 2002, respectively.

*Warranty Policy* – The Company's standard practice is to provide a warranty on all RSA SecurID hardware authenticators for the customer selected programmed life of the authenticator (generally three to four years) and to replace any defective authenticators (other than authenticators damaged by a user's abuse or alteration) free of charge. The Company sells its other products to customers with a warranty for product defects for a specified period, generally ninety days. Reserves are provided for warranty expenses based upon historical experience and estimates of future liabilities.

Accrued warranty reserve is included in accrued expenses and other liabilities in the condensed consolidated balance sheet and was as follows for the three months ended March 31,:

| | 2003 | 2002 |
|---|---|---|
| Balance at January 1, 2003 | $1,566 | $124 |
| Provision for warranty expense | 948 | 785 |
| Deductions | 609 | 533 |
| Balance at March 31, 2003 | $1,905 | $376 |

*Goodwill and Intangible Assets* – Goodwill and other acquisition related identifiable intangible assets are stated at fair value as of the date acquired in a business acquisition accounted for as a purchase, net of accumulated amortization. The Company evaluates goodwill for impairment on November 30 of each year and at an interim date if events or circumstances occur that would more likely than not reduce the fair value of the goodwill below its carrying amount. The Company evaluates the carrying value of goodwill and other intangible assets against the estimated fair value of its assets and will record an impairment charge in the amount by which the carrying value of the assets exceed their estimated fair value. Estimated fair value is determined based on estimated discounted future cash flows or a market multiple valuation method.

*Financial Instruments* — The carrying amounts of cash and cash equivalents, marketable securities, accounts receivable and accounts payable approximate fair value due to the short-term nature of these instruments. The carrying value of the Company's convertible debentures is the principal balance of the debentures outstanding less the fair value of the warrants outstanding, net of accumulated accretion of the warrants' fair value. The Company believes the carrying value of the convertible debentures approximates the fair value.

The Company accounts for its investment in Crosby Finance, LLC ("Crosby") under Emerging Issues Task Force ("EITF") Issue No. 96-12, "Recognition of Interest Income and Balance Sheet Classification of Structured Notes." The Company is carrying its interest at fair value with all changes in fair value included in income from investing activities in the consolidated statements of operations. The Company determines the fair value based on the fair value of Crosby's right to potentially receive additional cash proceeds under a variable delivery forward contract that it holds.

*Impairment of Long-lived Assets* – The Company tests long-lived assets for recoverability whenever events or changes in circumstances indicate that their carrying amount may not be recoverable. The recoverability of long-lived assets is assessed by comparing the undiscounted cash flows expected to be generated to the carrying value of the assets. If the sum of the undiscounted cash flows is less than the carrying value of the assets, the Company recognizes an impairment charge. The amount of an impairment charge is determined by comparing the carrying amount of the long-lived asset to its fair value. Fair value is determined based on estimated discounted cash flows.

*Income Taxes* – The Company provides for income taxes for interim periods based on the estimated effective tax rate for the full year. The Company records cumulative adjustments to tax provisions in the interim period in which a change in the estimated annual effective rate is determined.

*Earnings (Loss) Per Share* — The Company computes basic earnings (loss) per share using the weighted average number of common shares outstanding. The Company computes diluted earnings per share using the weighted average number of common shares outstanding plus the effect of potential outstanding shares, including options and warrants, using the "treasury stock" method. Diluted loss per share excludes the effect of equity instruments including convertible debentures, options and warrants, as such instruments are antidilutive.

*Stock-Based Compensation Plans* – The Company accounts for stock-based compensation cost using the intrinsic value method in accordance with Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees." Accordingly, no accounting recognition is given to stock options granted at fair market value until they are exercised. Upon exercise, net proceeds, including the tax benefits realized, are credited to shareholders' equity.

Stock-Based Compensation Plans Pro Forma Disclosure — Had the Company recognized compensation expense for its stock option and purchase plans based on the fair value for awards under those plans in accordance with SFAS No. 123, "Accounting for Stock Based Compensation," pro forma net loss and pro forma net loss per share would have been as follows:

| | Three Months Ended March 31, | |
|---|---|---|
| | **2003** | **2002** |
| Net income (loss) as reported | $ 1,744 | $(13,722) |
| Less: stock based compensation expense determined under fair value method for all awards, net of related tax effects | 9,127 | 10,435 |
| Pro forma net loss | $(7,383) | $(24,157) |
| Net income (loss) per share: | | |
| Basic earnings (loss) per share – as reported | $ 0.03 | $ (0.24) |
| Basic loss per share – pro forma | $ (0.13) | $ (0.43) |
| Diluted earnings (loss) per share – as reported | $ 0.03 | $ (0.24) |
| Diluted loss per share – pro forma | $ (0.13) | $ (0.43) |

The Company estimated the fair values used to compute pro forma net loss and pro forma net loss per share as the fair value at grant date using the Black-Scholes option-pricing model with the following weighted average assumptions:

| | Three Months Ended March 31, | |
|---|---|---|
| | **2003** | **2002** |
| Stock Option Plans: | | |
| Risk-free interest rate | 2.5% | 3.8% |
| Expected life of option grants (years) | 4.0 | 4.4 |
| Expected volatility of underlying stock | 90.0% | 90.0% |
| Expected dividend payment rate | 0.0% | 0.0% |
| Expected forfeiture rate | 7.5% | 7.5% |
| Weighted average fair value of stock options granted | $ 3.31 | $ 3.11 |
| Employee Stock Purchase Plan: | | |
| Risk-free interest rate | 1.7% | 1.7% |
| Expected life of option grants (years) | 0.5 | 0.5 |
| Expected volatility of underlying stock | 112.0% | 112.0% |
| Expected dividend payment rate | 0.0% | 0.0% |
| Weighted average fair value of stock options granted | $ 2.14 | $ 2.14 |

*New Accounting Pronouncements* — Interpretation No. 46 – In January 2003, the Financial Accounting Standards Board ("FASB") issued Interpretation No. 46 ("FIN 46"), "Consolidation of Variable Interest Entities," which clarifies the application of Accounting Research Bulletin No. 51, "Consolidated Financial Statements," relating to consolidation of certain entities. First, FIN 46 will require identification of the Company's participation in variable interest entities ("VIE"), which are defined as entities with a level of invested equity that is not sufficient to fund future activities to permit them to operate on a stand alone basis, or whose equity holders lack certain characteristics of a controlling financial interest. For entities identified as VIE, FIN 46 sets forth a model to evaluate potential consolidation based on an assessment of which party to the VIE, if any, bears a majority of the exposure to its expected losses, or stands to gain from a majority of its expected returns. FIN 46 also sets forth certain disclosure requirements regarding interests in VIE that are deemed significant, even if consolidation is not required. For VIE created before February 1, 2003, FIN 46 applies to interim periods beginning after June 15, 2003. The Company believes the adoption of FIN 46 will not require the consolidation of the Company's investment in Crosby and therefore will not have a significant impact on its consolidated financial position or results of operations.

EITF No. 00-21 – In November 2002, the EITF issued EITF No. 00-21, "Revenue Arrangements with Multiple Deliverables," which provides guidance on the timing and method of revenue recognition for sales arrangements that include the delivery of more than one

product or service. EITF 00-21 is effective prospectively for arrangements entered into in fiscal periods beginning after June 15, 2003. The Company anticipates the adoption of EITF No. 00-21 will not have a significant impact on its consolidated financial position or results of operations.

## 2. Acquisitions

During 2001 the Company completed four acquisitions, which were accounted for as purchases including, Securant Technologies, Inc. ("Securant"), a privately held company that developed the ClearTrust Web access management solution; 3-G International, Inc. ("3GI"), a privately held company that developed smart card and biometric authentication products; Transindigo Inc ("Transindigo"), a privately held company that developed real time Web access management software products; and Xcert International, Inc. ("Xcert"), a privately held company that developed digital certificate-based products for securing e-business transactions.

Pursuant to two separate escrow agreements entered into in connection with the Securant acquisition, $21,000 of the cash purchase price otherwise payable to Securant's shareholders was placed in escrow, pending settlement of any claims for breach of representations, warranties or covenants in the merger agreement. One escrow agreement put $20,000 of the purchase price into an escrow fund. During March 2003, the Company received $3,300 from this Securant escrow fund in final settlement of outstanding escrow fund claims, which resulted in a decrease to goodwill of $3,300. The remainder of the escrow fund was released to the selling shareholders during March 2003. The second escrow agreement put $1,000 of the Securant purchase price into an escrow fund. The remaining unclaimed balance of the $1,000 Securant escrow fund not subject to a pending claim is scheduled to be released to the selling shareholders during 2005.

Pursuant to an escrow agreement, $3,000 of the cash purchase price otherwise payable to 3GI's stockholders was placed in escrow, pending settlement of any claims for breaches of representations, warranties or covenants in the merger agreement. The Company has submitted claims against the 3GI escrow totaling approximately $3,000 and received an aggregate of $2,637 from the 3GI escrow fund in settlement of these claims, of which $70 was received during the three months ended March 31, 2003, resulting in a decrease to goodwill of $70 during the first quarter of 2003. The remainder of the escrow fund was released to the selling stockholders during March 2003.

Pursuant to an escrow agreement, $10,500 of the cash purchase price otherwise payable to Xcert's stockholders was placed in escrow, pending settlement of any claims for breaches of representations, warranties or covenants in the merger agreement. The Company released all but $500 of the Xcert escrow fund to the selling stockholders in August 2002. The Company received approximately $64 from the escrow fund in settlement of certain tax issues, and the balance of the $500 was released to the selling stockholders during March 2003.

## 3. Investments and Financial Instruments

Income (loss) from investing activities includes the following gains (losses):

| | Three Months Ended March 31, | |
|---|---|---|
| | 2003 | 2002 |
| Gain on sale of marketable securities | — | $ 677 |
| Gain on sale of investments | $1,508 | — |
| Increase (decrease) in fair value of Crosby Finance, LLC | 7 | (3,144) |
| Total income (loss) from investing activities | $1,515 | $(2,467) |

The Company sold substantially all of its private equity investments, received cash proceeds of $3,009 and recognized a gain from the sales of $1,508 during the three months ended March 31, 2003.

The Company holds a 99% interest in Crosby Finance, LLC, a bankruptcy-remote, qualified special purpose entity, established specifically to securitize shares of VeriSign, Inc. ("VeriSign") common stock. At March 31, 2003, Crosby held 2,027,325 shares of VeriSign common stock and a variable delivery forward contract ("VDF"). The VDF contract entitles Crosby to receive cash proceeds of up to $35,336 if the market price of VeriSign common stock on January 3, 2006 is at least $87.16. The closing price of VeriSign's common stock on The NASDAQ National Market on March 31, 2003 was $8.74 per share.

The carrying amount of the Company's 99% interest in Crosby was $193 and $186 at March 31, 2003 and December 31, 2002, respectively, and is included in other assets on the consolidated balance sheets. The Company is carrying its interest at fair value with all changes in fair value reported in income from investing activities in the consolidated statements of operations. The Company determines the fair value of its interest in Crosby based on the fair value of Crosby's right to potentially receive additional cash proceeds upon maturity of the VDF. The increase in the fair value of the Company's interest in Crosby was $7 for the three months ended March 31, 2003.

Crosby has no liability or obligation to its members or to the counterparty to the VDF contract other than to deliver the shares of VeriSign common stock to the counterparty upon maturity of the VDF contract and to distribute the cash proceeds, if any, to its members. After settlement of the VDF in January 2006, Crosby will dissolve.

### 4. Line of Credit

The Company has a $10,000 line of credit agreement with a major financial institution that expires on June 30, 2003, and which contains annual extension provisions. Borrowing availability is reduced by letters of credit issued for purposes such as collateralizing real estate rental agreements. As of March 31, 2003, the Company had $7,921 of borrowing availability under this line of credit. The availability under this line of credit was reduced during the first quarter of 2003 due to a letter of credit issued during March 2003. Borrowings under this agreement will bear interest, at the Company's option, at either fixed or variable rates linked to either the London Interbank Offered Rate or the Prime Rate. Borrowings will be collateralized by cash deposits of the Company.

### 5. Comprehensive (Loss) Income

Comprehensive (loss) income was as follows:

| | Three Months Ended March 31, | |
|---|---|---|
| | **2003** | **2002** |
| Net income (loss) | $1,744 | $(13,722) |
| Decrease in net unrealized gains on marketable securities | — | (422) |
| Foreign currency translation adjustments | (484) | (950) |
| Comprehensive income (loss) | $1,260 | $(15,094) |

### 6. Earnings (Loss) Per Share

Equity instruments that were considered antidilutive and therefore were not included in the computation of diluted earnings or loss per share include the following shares of the Company's common stock:

| | Three Months Ended March 31, | |
|---|---|---|
| | **2003** | **2002** |
| Employee stock options | 8,685,887 | 11,419,421 |
| Convertible debentures | 5,820,298 | 5,820,298 |
| Common stock warrants | 873,045 | 873,045 |

### 7. Restructurings

During 2002 and 2001, the Company evaluated and initiated restructuring actions in order to consolidate some of its operations, enhance operational efficiency and reduce expenses. These actions resulted in total restructuring charges of $56,036 and $19,956 for the years ended December 31, 2002 and 2001, respectively. The Company continues to monitor and assess its facility obligations, the real estate market and its operating expenses. Restructuring charges were zero and $4,383 for the three months ended March 31, 2003 and 2002, respectively.

Restructuring charges recorded during 2002 and 2001 consist of facility exit costs, costs associated with the sale and liquidation of the Company's Swedish development operations, and severance and other costs associated with the reduction of employee headcount.

Restructuring charges accrued and unpaid at March 31, 2003 were as follows:

| | Facility Exit Costs & Related Asset Impairments | Severance Costs | Liquidation of Sweden Development Operations | Other Direct Costs | Total |
|---|---|---|---|---|---|
| Balance at January 1, 2003 | $36,811 | $1,397 | $ 618 | $652 | $39,478 |
| Payments and write offs | (2,669) | (370) | (382) | — | (3,421) |
| Balance at March 31, 2003 | $34,142 | $1,027 | $ 236 | $652 | $36,057 |

The Company expects to pay the remaining restructuring costs accrued at March 31, 2003 as follows:

| | |
|---|---|
| Nine months ending December 31, 2003 | $8,868 |
| Year ending December 31, 2004 | 9,637 |
| Year ending December 31, 2005 | 8,854 |
| Year ending December 31, 2006 | 5,762 |
| Year ending December 31, 2007 | 1,723 |
| Year ending December 31, 2008 and thereafter | 1,213 |

## 8. Segments

The Company has one reportable segment, e-Security Solutions. The operations of the e-Security Solutions segment consist of the sale of software licenses, hardware, maintenance and professional services through two product groups, Enterprise solutions and Developer solutions. Enterprise solutions include sales of RSA SecurID® authenticators, RSA ACE/Server® software, RSA Keon® software, RSA ClearTrust® software, and maintenance and professional services associated with these products. Developer solutions include sales of RSA BSAFE® encryption software and protocol products, RSA Keon components, and maintenance and professional services associated with these products. The segment was determined primarily on how management views and evaluates the Company's operations.

Prior to January 1, 2003, the Company reported two segments, e-Security Solutions and RSA Capital. The Company has modified its segment disclosure to reflect the divesture of substantially all of its investments held in RSA Capital and the reduction of resources allocated to RSA Capital. Accordingly, the Company will report one segment, the e-Security Solutions segment, after January 1, 2003. The Company's segment disclosure for the three months ended March 31, 2002 has been revised to conform to the current period presentation.

The Company's operations are conducted throughout the world. Operations in the United States represent more than 10% of revenue and loss from operations. The Company's operations in other countries have been grouped by regional area below. The following tables present information about e-Security Solutions revenue:

| | Three Months Ended March 31, | |
|---|---|---|
| | 2003 | 2002 |
| Product and service groups | | |
| Enterprise solutions | $55,412 | $48,834 |
| Developer solutions | 5,852 | 6,671 |
| | $61,264 | $55,505 |

| | Three Months Ended March 31, | |
|---|---|---|
| | 2003 | 2002 |
| Geographic areas | | |
| United States | $37,927 | $33,814 |
| Europe and other | 17,834 | 17,146 |
| Asia Pacific | 5,503 | 4,545 |
| | $61,264 | $55,505 |

No customer accounted for 10% or more of total revenue for the three months ended March 31, 2003 or 2002. During the second quarter of 2003, two of our distributors merged in a business combination, and based upon historical revenue, the Company expects the revenue generated by the merged company could potentially account for greater than 10% of total revenue in future periods.

The tables below present information about the Company's long lived assets by regional area:

| | At March 31, 2003 | | | |
|---|---|---|---|---|
| | Total | United States | Europe and Other | Asia Pacific |
| Property and equipment, net | $ 71,782 | $ 40,436 | $28,198 | $3,148 |
| Goodwill, net | 188,372 | 188,372 | — | — |
| Other assets | 5,379 | 3,494 | 150 | 1,735 |

| | At March 31, 2002 | | | |
|---|---|---|---|---|
| | Total | United States | Europe and Other | Asia Pacific |
| Property and equipment, net | $ 93,139 | $ 58,945 | $30,552 | $3,642 |
| Goodwill, net | 192,490 | 192,490 | — | — |
| Intangible assets, net | 26,757 | 26,757 | — | — |
| Other assets | 10,542 | 8,673 | 158 | 1,711 |

## 9. Litigation

By notice dated January 23, 2002, the Securities and Exchange Commission notified the Company that it is conducting a formal investigation of (1) the Company's disclosure of a change in its method for estimating its distributor revenue, and (2) certain trading in the Company's common stock. On or about July 11, 2002, the SEC staff notified the Company and some of its officers that the staff was considering seeking permission from the SEC to commence a civil injunctive proceeding against them, and that the Company and the officers could submit a written statement explaining why no such proceeding should be commenced. The Company and the officers submitted such a statement in August 2002 and are waiting for the SEC's response. The Company and the officers are continuing to cooperate with the SEC, but the Company cannot predict the ultimate outcome of this matter.

On or about February 2, 2001, Leon Stambler filed a complaint for patent infringement in U.S. District Court for the District of Delaware against the Company, VeriSign, Inc., First Data Corporation, Openwave Systems Inc., and Omnisky Corporation, Case Number 01-0065. In his complaint, Mr. Stambler alleged that certain products marketed by each of the defendants infringed various patents that he owns, and he sought unspecified damages as well as a preliminary and permanent injunction enjoining the defendants from infringing the claims asserted. The trial took place in March 2003, and the jury determined that the Company's products did not infringe Mr. Stambler's patents. On April 17, 2003, the court entered final judgment in the Company's favor on all claims of non-infringement. In May 2003, Mr. Stambler filed a motion asking the court to set aside the jury's verdict. The Company intends to oppose this motion. The Company believes that the final disposition of this matter will not have a material adverse effect on its continuing operations and consolidated financial position.

On or about December 20, 2001, France Telecom and Telediffusion de France ("FT") filed a Request for Arbitration with the International Court of Arbitration. FT claims that the Company breached a license agreement with FT and seeks unspecified damages including a payment in excess of $20,000 plus the legal fees and other costs associated with the arbitration. The arbitration is scheduled to take place in June 2003. The Company believes that FT's claims are without merit, and intends to defend the arbitration vigorously. In a related matter, FT has also filed a patent infringement suit in Delaware against Novell, Inc., one of the Company's licensees. In August 2002, the Company signed a letter agreement with Novell agreeing that if a court requires Novell to pay FT damages, the Company will reimburse Novell for 50% of the damages, up to a maximum payment of $2,500 by the Company. If the damages payable by Novell exceed $5,000, then the indemnification provisions of the Company's license agreement with Novell will govern the Company's indemnification obligations. Although the Company believes that FT's claims against Novell are without merit, it cannot predict the ultimate outcome of this matter. However, the Company believes that neither the disposition of its arbitration with FT nor the disposition of the litigation between Novell and FT will have a material adverse effect on its continuing operations and consolidated financial position.

From time to time, the Company has been named as a defendant in other legal actions arising from its normal business activities, which it believes will not have a material adverse effect on the Company or its business.

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

*This Report contains forward-looking statements within the meaning of Section 21E of the Securities Exchange Act of 1934, as amended, and Section 27A of the Securities Act of 1933, as amended. For purposes of these Acts, any statement that is not a statement of historical fact may be a forward-looking statement. For example, statements containing the words "believes," "anticipates," "plans," "expects," and similar expressions may be forward-looking statements. However, we caution investors not to place undue reliance on any forward-looking statements in this Report because these statements speak only as of the date when made. Furthermore, we are not obligated to publicly update any forward-looking statements, whether as a result of new information, future events or otherwise. There are a number of factors that could cause our actual results to differ materially from those indicated by these forward-looking statements, including without limitation the factors described below under the caption "Certain Factors That May Affect Future Results."*

**Overview**

RSA Security Inc. is a leading provider of e-security solutions. With thousands of customers around the globe, we provide interoperable solutions for establishing online identities, access rights and privileges for people, applications and devices. Built to work seamlessly and transparently in the complex environments of our customers, our comprehensive portfolio of identity and access management solutions — including authentication, Web access management and developer solutions – are designed to allow customers to confidently exploit new technologies for competitive advantage. We sell our two-factor user authentication, Web access management and encryption products and solutions to corporate enterprise users seeking turnkey security solutions, and to original equipment manufacturers and developers seeking software development components for embedding security in a range of software applications or hardware devices.

Through our e-Security Solutions segment we derive our operating revenue primarily from two distinct product groups: Enterprise solutions, which includes RSA SecurID® authenticators, RSA ACE/Server® software, RSA ClearTrust® software, RSA Keon® software, and maintenance and professional services associated with those products, and Developer solutions, which includes RSA BSAFE® encryption software and protocol products, RSA Keon components, and maintenance and professional services associated with those products.

We believe sales of our products will be driven by the trend of enterprises permitting remote access to internal resources and Web enabling of existing applications. Sales of our RSA SecurID authenticator products continue to generate substantial revenue for us, while our less mature Enterprise software products are building revenue and market share. We continue to see a decrease in sales to Developers, which we believe is primarily attributable to a decrease in the number of technology companies funding development and the availability of free, "open source" products that compete with our RSA BSAFE product line. We believe our product line synergies and strength of our customer base create opportunities to sell additional products to existing customers. However, information technology spending has sharply decreased in the past two years and information technology budgets remain constrained, which has had and could continue to have a direct affect on the sale of our products.

Our Enterprise solutions customers typically place an initial order for a limited number of users, for either our RSA SecurID authenticators or any of our software products, and deploy additional authenticators or software licenses as their need for our products within their enterprise increases. Authenticators have a programmed life of three to four years, and as they expire, our customers typically place additional orders for replacement authenticators. We typically base our RSA ACE/Server, RSA Keon and RSA ClearTrust software license fees on the number of users authorized under each customer's license. In most cases, customers will also enter into an annual customer support agreement for their software license at the time of initial purchase and renew this support agreement annually. Our support agreement entitles our customers to software license upgrades and telephone support.

Our Developer solutions software licensing terms vary by product and customer. Typical licensing terms may include an initial prepaid license fee and ongoing royalties paid as a percentage of the developer's product or service revenue, or payment of annual license fees, or a single fully paid-up license fee. Often, our existing developer customers go on to license new software or technology from us or wish to increase the field of use rights for the technology they have already licensed. In such a case, we amend our license agreement with the customer and charge additional licensing fees, thus deriving additional revenue.

Our professional services group provides customers with project management, architecture and design, physical deployment, custom development, education and practitioner certification services. Customers typically pay for professional services either at a fixed price or at hourly or daily rates for the time it takes us to complete the project.

We have contracted with outside manufacturing organizations to produce our RSA SecurID authenticators, and some of our products contain technology that is licensed from third parties. Our cost of revenue consists primarily of costs associated with the manufacture and delivery of RSA SecurID authenticators and royalty fees that we pay for the licensed technology. Cost of revenue also includes labor and overhead costs associated with professional service, customer support, and production activities. Production costs include the programming labor, shipping, inspection and quality control functions associated with the RSA SecurID authenticators. We are currently working to establish new vendor relationships in order to increase the number of suppliers from which we buy our authenticators and authenticator components, in order to reduce our vulnerability to potential supply problems.

Our direct sales to our customers in countries outside of the United States are denominated in U.S. dollars and local currency, with the majority of our sales denominated in U.S. dollars. Our sales through indirect distribution channels are generally denominated in U.S. dollars. For countries outside the United States, we generally pay our operating expenses in local currency. Where we do invoice customers in local currency, we are exposed to foreign exchange rate fluctuations from the time of invoice until collection occurs. We are also exposed to foreign currency fluctuations between the time we collect in U.S. dollars and the time we pay our operating expenses in local currency. Fluctuations in currency exchange rates could affect the profitability and cash flows in U.S. dollars of our products sold in international markets.

We operate our business in one reporting segment, e-Security Solutions. Prior to January 1, 2003, we reported two segments, e-Security Solutions segment and RSA Capital segment, which contained our investment activities. We have modified our reporting segments to reflect the divesture of substantially all of our investments held in RSA Capital and our reduction of resources allocated to RSA Capital.

Information on our segments may be found in Note 8 of the notes to our condensed consolidated financial statements.

***Application of Critical Accounting Policies and Estimates***

The discussion and analysis of our financial condition and results of operations are based on our condensed consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America. The preparation of these condensed consolidated financial statements requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the condensed consolidated financial statements and the reported amounts of revenue and expense during the reporting period. On an ongoing basis, we evaluate our estimates, including those related to revenue recognition, sales returns, allowance for doubtful accounts, investments, intangible assets, income taxes, financing operations, warranty obligations, restructurings, contingencies and litigation. We base our estimates on historical experience and on various other assumptions that we believe are reasonable under the circumstances. However, our actual results could differ from those estimates.

We believe the following critical accounting policies affect our significant estimates and assumptions used in the preparation of our consolidated financial statements.

*Revenue Recognition* — We derive our revenue primarily from two sources: sales of products, including hardware and software licenses, and services, including maintenance, support and professional services. Our management must make and use judgments and estimates in connection with the revenue recognized in any reporting period. We recognize revenue from the sale of products when persuasive evidence of an arrangement exists, delivery has occurred, the fee is fixed or determinable, and collection is considered probable. Revenue is reduced by provisions for estimated sales returns. The amount and timing of our revenue for any period may materially differ if our management made different judgments or utilized different estimates in establishing our allowance for sales returns.

For all sales, we use a binding contract, purchase order or another form of documented agreement as evidence of an arrangement with the customer. Sales to our distributors are evidenced by a master agreement governing the relationship, together with binding purchase orders on a transaction-by-transaction basis. We consider delivery to occur when we ship the product, so long as title and risk of loss have passed to the customer.

At the time of a transaction, we assess whether the sale amount is fixed or determinable based upon the terms of the documented agreement. If we determine the fee is not fixed or determinable, we recognize revenue when the fee is fixed. We assess if collection is probable based on a number of factors, including past transaction history with the customer and the creditworthiness of the customer.

If we determine that collection is not probable, we do not record revenue until such time as collection becomes probable, which is generally upon the receipt of cash.

We do not generally include acceptance provisions in arrangements with customers, however, if an arrangement includes an acceptance provision, we recognize revenue upon the customer's acceptance of the product, which occurs upon the earlier of receipt of a written customer acceptance or expiration of the acceptance period.

In accordance with Statement of Financial Accounting Standards ("SFAS") No. 48, "Revenue Recognition when Right of Return Exists," we recognize revenue upon shipment of product to stocking distributors who have only limited return rights, and record a sales return reserve to provide for estimated product returns. We estimate product returns from distributors based upon historical experience.

When arrangements contain multiple elements and vendor specific objective evidence ("VSOE") of fair value exists for all undelivered elements, we recognize revenue for the delivered elements using the residual method. We base our determination of VSOE of fair value of each of the undelivered elements in multi-element arrangements on either the price we charge when the same element is sold separately or the price established by the members of our management, who have the relevant authority to set prices, for an element not yet sold separately. For arrangements containing multiple elements where VSOE of fair value does not exist for all undelivered elements, revenue for the delivered and undelivered elements is deferred until VSOE of fair value exists or all elements have been delivered.

Maintenance service revenue, whether sold separately or as part of a multiple element arrangement, is deferred and recognized ratably over the term of the maintenance contract, generally twelve months. We recognize revenue allocated to professional service elements as the services are performed.

*Allowance for Sales Returns* – We record allowances for estimated sales returns and allowances on products and maintenance and professional service related revenue in the same period as the related revenue is recorded. We base these estimates on historical sales returns, analysis of credit memo data, current economic trends, product line and customer industry and other known factors. Our historical experience with sales returns varies by product line depending on the customer's industries and markets. We must make judgments and estimates in connection with establishing the allowances for estimated sales returns in any reporting period. The amount and timing of our revenue for any reporting period may materially differ if actual sales returns and allowances differ from our estimates.

*Allowance for Doubtful Accounts* – We maintain allowances for doubtful accounts for estimated losses resulting from the inability of our customers to make required payments. We analyze accounts receivable and the composition of the accounts receivable aging, historical bad debts, customer creditworthiness, current economic trends, foreign currency exchange rate fluctuations, changes in our customer payment terms, and other known factors when evaluating the adequacy of the allowance for doubtful accounts. Based upon the analysis and estimates of the uncollectibility of our accounts receivable, we record an increase in the allowance for doubtful accounts when the prospect of collecting a specific account receivable becomes doubtful. Actual results could differ from the allowances for doubtful accounts recorded, and this difference may have a material effect on our financial position and results of operations. We record recoveries of accounts previously written off as uncollectible as increases to the allowance for doubtful accounts.

*Warranty Reserves* – Our standard practice is to provide a warranty on all RSA SecurID hardware authenticators for the customer selected programmed life of the authenticator (generally three to four years) and to replace any defective authenticators free of charge. We sell our other products to customers with a warranty for product defects for a specified period, generally ninety days. We maintain a reserve for warranty expense based upon the estimated expenses associated with replacing authenticators or correcting product defects. We estimate our reserve for warranty expense based upon analysis of historical experience and estimated future liabilities. We utilize analysis of historical warranty expenses as well as the identification of issues related to the quality and reliability of our products to estimate future warranty liabilities. We record an increase to our warranty reserve when we encounter issues related to our products that may cause our warranty expense to increase. Actual results could differ from the warranty reserves recorded, and this difference may have a material effect on our financial position and results of operations.

*Income Taxes* – The preparation of our consolidated financial statements requires us to estimate our income taxes in each of the jurisdictions in which we operate, including those outside the United States which may be subject to certain risks that ordinarily would not be expected in the United States. The income tax accounting process involves our estimating our actual current exposure together with assessing temporary differences resulting from differing treatment of items for tax and accounting purposes. These differences result in the recognition of deferred tax assets and liabilities. We must then record a valuation allowance to reduce our deferred tax assets to the amount that is more likely than not to be realized.

Management judgment is required in determining our provision for income taxes, our deferred tax assets and liabilities and any valuation allowance recorded against deferred tax assets. We have recorded a valuation allowance of $25.4 million as of March 31, 2003 due to uncertainties related to our ability to utilize some of our deferred tax assets, primarily consisting of acquisition related net operating losses carried forward. We base the valuation allowance on our estimates of taxable income by jurisdiction in which we operate and the period over which our deferred tax assets will be recoverable. If actual results differ from these estimates or we adjust these estimates in future periods we may need to adjust our valuation allowance, which could materially impact our consolidated financial position and results of operations.

*Valuation of Goodwill and Other Intangible Assets* – In assessing the recoverability of our goodwill, we must make assumptions regarding estimated future cash flows and earnings and other factors to determine the fair value of the respective assets. If these estimates or their related assumptions change in the future, we may be required to record impairment charges against these assets in the reporting period in which the impairment is determined. We will record an impairment charge in the amount by which the carrying value of the assets exceeds their fair value. Fair value is determined generally based on estimated discounted future cash flows or a market multiple valuation method. Any such impairment charge could be significant and could have a material adverse effect on our consolidated financial position and results of operations. We perform an annual test for impairment as of November 30 of each year and, if events or circumstances occur that would more likely than not reduce the fair value of the goodwill below its carrying amount, will perform an interim impairment test. At March 31, 2003, we had approximately $188.4 million of goodwill which accounted for approximately 39% of our total assets. Any goodwill impairment test could result in a decrease to the carrying value of goodwill and could have a material effect on our results of operations and consolidated financial position.

*Restructurings* – During 2002 and 2001, we initiated consolidation of certain operations in order to enhance operational efficiency and reduce expenses, and recorded significant restructuring charges in connection with these actions. Restructuring charges were $56.0 million and $20.0 million for 2002 and 2001, respectively. These restructuring charges require us to make estimates based upon real estate market conditions, rental rates, future corporate requirements, general economic conditions and future estimated cash flows. Included in the restructuring charges recorded in 2002 are facility exit costs of $44.0 million, which represents estimated shortfalls of sublease rental income compared to lease payments due through 2009 under certain exited facilities lease agreements, impaired leasehold improvements and furniture and fixtures, and other associated facilities expenses. We base estimates related to the length of time to reserve excess facilities on assumptions regarding the period required to locate and contract with suitable subtenants and are based on market trend information analysis. We base estimates of sublease income upon the terms of existing sublease agreements that we have obtained and market trend information analysis. If the assumptions for these estimates change due to changes in the real estate and sublease markets, or due to the terms of sublease agreements that we have obtained, the ultimate restructuring expenses for these facilities could vary by material amounts, and could cause us to record additional or revise previously recorded restructuring charges in future reporting periods.

## Results of Operations

The following table sets forth certain consolidated financial data as a percentage of our total revenue:

| | Three Months Ended March 31, | |
|---|---|---|
| | 2003 | 2002 |
| Revenue | | |
| Products | 74.3% | 70.7% |
| Maintenance and professional services | 25.7 | 29.3 |
| Total revenue | 100.0 | 100.0 |
| Cost of revenue Products | 13.1 | 13.7 |
| Maintenance and professional services | 8.4 | 10.5 |
| Total cost of revenue | 21.5 | 24.2 |
| Gross margin | 78.5 | 75.8 |
| Costs and expenses Research and development | 20.7 | 27.6 |
| Marketing and selling | 37.4 | 50.0 |
| General and administrative | 15.5 | 12.3 |
| Restructurings | — | 7.9 |
| Amortization of intangible assets | — | 4.2 |
| Total | 73.6 | 102.0 |
| Income (loss) from operations | 4.9 | (26.2) |
| Interest expense and other | (3.0) | (3.7) |
| Income (loss) from investing activities | 2.5 | (4.4) |
| Income (loss) before provision (benefit) for income taxes | 4.4 | (34.3) |
| Provision (benefit) for income taxes | 1.6 | (9.6) |
| Net income (loss) | 2.8% | (24.7)% |

**Revenue**

The following tables set forth the amount, percentage of total revenue and percentage increase (decrease) of our revenue by product group, product type and product line:

| ($ in millions) | Three Months Ended March 31, 2003 Revenue | Percentage | Three Months Ended March 31, 2002 Revenue | Percentage | Percentage Increase (Decrease) |
|---|---|---|---|---|---|
| Product group: | | | | | |
| Enterprise solutions | $55.4 | 90.4% | $48.8 | 88.0% | 13.5% |
| Developer solutions | 5.9 | 9.6% | 6.7 | 12.0% | (12.3)% |
| Total | $61.3 | 100.0% | $55.5 | 100.0% | 10.4% |
| Product type: | | | | | |
| Authenticators | $30.5 | 49.7% | $25.2 | 45.4% | 20.9% |
| Software products | 15.0 | 24.6% | 14.1 | 25.3% | 6.9% |
| Maintenance and professional services | 15.8 | 25.7% | 16.2 | 29.3% | (3.0)% |
| Total | $61.3 | 100.0% | $55.5 | 100.0% | 10.4% |
| Product line: | | | | | |
| Authentication products | $52.1 | 85.0% | $47.4 | 85.4% | 9.9% |
| Encryption products | 5.7 | 9.3% | 6.3 | 11.4% | (10.0)% |
| Web access management products | 3.5 | 5.7% | 1.8 | 3.2% | 95.3% |
| Total | $61.3 | 100.0% | $55.5 | 100.0% | 10.4% |

Revenue of $1.2 million for the three months ended March 31, 2002 has been reclassified from the authentication products division to the encryption products division in order to conform to current period presentation.

The following tables set forth the amount, percentage of total revenue and percentage increase (decrease) of revenue by regional area:

| ($ in millions) | Three Months Ended March 31, 2003 Revenue | Percentage | Three Months Ended March 31, 2002 Revenue | Percentage | Percentage Increase |
|---|---|---|---|---|---|
| United States | $37.9 | 61.9% | $33.8 | 60.9% | 12.2% |
| Europe and other | 17.9 | 29.1% | 17.2 | 30.9% | 4.0% |
| Asia Pacific | 5.5 | 9.0% | 4.5 | 8.2% | 21.1% |
| Total | $61.3 | 100.0% | $55.5 | 100.0% | 10.4% |

We believe the increase in total revenue in the first quarter of 2003 as compared to the first quarter of 2002 was primarily attributable to businesses continuing the trend toward permitting remote access to internal resources and Web enabling existing applications. We believe our identity and access management solutions promote our product synergies and will enable us to generate additional revenue by selling additional products to existing customers. However, information technology budgets continue to be constrained, and the continued uncertainty in the economy may affect revenue generated from the sales of our products in future quarters.

Our RSA SecurID authentication product line continues to generate substantial revenue for us despite the recent downsizing of businesses. We sold approximately 747,000 RSA SecurID authenticator units in the first quarter of 2003, which represents a 25.5% increase from the same period of 2002. The increase in number of units sold combined with a 9% decrease in the average selling price in the first quarter of 2003 as compared to the first quarter of 2002 resulted in increased revenue from our RSA SecurID authentication product line. We believe the decrease in the average selling price of our authenticators is attributable to discounts on larger volume transactions, as well as a number of large customer accounts that significantly expanded deployments in the first quarter of 2003. As deployments are expanded or customers order large quantities, we generally give larger discounts.

We believe that the decrease in Developer solutions and encryption revenue was primarily attributable to a decrease in the number technology companies funding development and in the development of new information technology products. We also believe the availability of free, “open source” products that compete with our RSA BSAFE product line contributed to this decrease.

We believe that as the United States government proceeds with its agenda of increasing awareness of cyber-security issues, and its focus on homeland security, we will benefit with increased revenue. We believe the government sector of our business may increase in the future as government agencies seek e-security partners in order to execute their cyber-security agenda. In addition, we believe the Health Insurance Portability and Accountability Act of 1996 (HIPAA) privacy and security standards that require security for online healthcare transactions and clinical trials has increased and will continue to increase our revenue from the healthcare and pharmaceutical vertical market segment.

**Gross Profit**

The following tables set forth the gross profit and gross margin for products and maintenance and professional services:

| | Three Months Ended March 31, 2003 | | 2002 | |
|---|---|---|---|---|
| ($ in millions) | Gross Profit | Gross Margin | Gross Profit | Gross Margin |
| Products | $37.5 | 82.3% | $31.7 | 80.7% |
| Maintenance and professional services | 10.6 | 67.4% | 10.4 | 63.9% |
| Total | $48.1 | 78.5% | $42.1 | 75.8% |

We believe the increase in total gross margin for the first quarter of 2003 as compared to the first quarter of 2002 was primarily attributable to our efforts to reduce costs and improve operating efficiencies, combined with an increase in total revenue. We believe the increase in gross margin for products for the first quarter of 2003 as compared to the same period of 2002 was primarily attributable to the increase in our software revenue, which typically have higher gross margins than our other product types.

We believe the increase in gross profit from maintenance and professional services in the first quarter of 2003 as compared to first quarter of 2002 was primarily attributable to increased maintenance revenue achieved on decreased customer support costs. Customer support costs decreased due to cost reduction programs implemented over the past two years.

We expect to maintain total gross margins of between 77% and 79% for 2003.

**Research and Development**

Total research and development expenses decreased 17.2% in the first quarter of 2003 to $12.7 million from $15.3 million in the first quarter of 2002, and represented 20.7% and 27.6% of total revenue for the first quarter of 2003 and 2002, respectively. The decrease in research and development expenses of $2.6 million for the first quarter of 2003 as compared to the first quarter of 2002 was from decreased payroll, overhead and consulting expenses associated with our decreased workforce and ongoing cost reduction programs. We believe research and development expenditures will be approximately 19% to 21% of total revenue in 2003.

**Marketing and Selling**

Total marketing and selling expenses decreased 17.5% in the first quarter of 2003 to $22.9 million from $27.8 million in the first quarter of 2002, and represented 37.4% and 50.0% of total revenue for the first quarter of 2003 and 2002, respectively. For the first quarter of 2003, as compared to the first quarter of 2002, approximately $3.2 million of the decrease in marketing and selling expenses was from decreased overhead and payroll expenses associated with our reduced workforce, approximately $1.5 million of the decrease was from reduced spending on marketing programs, and approximately $1.4 million of the decrease was from a reduction in bad debt expense. These decreases are offset by an increase in marketing and selling expense of approximately $1.2 million for commission expenses on increased revenue. We believe marketing and selling expenditures will be approximately 36% to 38% of total revenue in 2003.

**General and Administrative**

Total general and administrative expenses increased 39.2% in the first quarter of 2003 to $9.5 million from $6.8 million in the first quarter of 2002, and represented 15.5% and 12.3% of total revenue for the first quarter of 2003 and 2002, respectively. Approximately $2.2 million of the increase in general and administrative expenses in the first quarter of 2003 as compared to the first quarter of 2002 was from legal expenses associated with the successful defense of the Stambler patent infringement lawsuit discussed in the Legal Proceedings section of this Report. In addition, approximately $0.5 million of the increase in general administrative expense was due to increased payroll and overhead costs. We believe general and administrative expenditures will be approximately 11% to 13% of total revenue in 2003.

**Restructurings**

During 2002 and 2001, we evaluated and initiated restructuring actions in order to consolidate some of its operations, enhance operational efficiency and reduce expenses. These actions resulted in total restructuring charges of $56.0 million and $20.0 million for the years ended December 31, 2002 and 2001, respectively. We continue to monitor and assess our facility obligations, the real estate market and our operating expenses. Based upon our ongoing assessments of our facility obligations and the rental real estate market, or if we are successful in obtaining sublease tenants for our excess facilities, we may have to record additional restructuring charges or revise previously recorded restructuring charges in future reporting periods.

Restructuring charges recorded during 2002 and 2001 consist of facility exit costs, costs associated with the sale and liquidation of our Swedish development operations, and severance and other costs associated with the reduction of employee headcount.

Restructuring charges accrued and unpaid at March 31, 2003 were as follows:

| ($ in millions) | Facility Exit Costs & Related Asset Impairments | Severance Costs | Liquidation of Sweden Development Operations | Other Direct Costs | Total |
|---|---|---|---|---|---|
| Balance at January 1, 2003 | $36.8 | $ 1.4 | $ 0.6 | $ 0.7 | $39.5 |
| Payments and write offs | (2.6) | (0.4) | (0.4) | — | (3.4) |
| Balance at March 31, 2003 | $34.2 | $ 1.0 | $ 0.2 | $ 0.7 | $36.1 |

We expect to pay the remaining restructuring costs accrued at March 31, 2003 as follows:

| | |
|---|---|
| Nine months ending December 31, 2003 | $8.9 |
| Year ending December 31, 2004 | 9.6 |
| Year ending December 31, 2005 | 8.9 |
| Year ending December 31, 2006 | 5.8 |
| Year ending December 31, 2007 | 1.7 |
| Year ending December 31, 2008 and thereafter | 1.2 |

**Interest Expense and Other**

Interest expense and other includes the following:

| ($ in millions) | Three Months Ended March 31, 2003 | 2002 |
|---|---|---|
| Interest expense on 7% convertible debentures | $(1.4) | $(1.5) |
| Non cash amortization of deferred financing costs | (0.4) | (0.4) |
| Non cash accretion of warrant value | (0.3) | (0.3) |
| Interest income, net of other | 0.2 | 0.1 |
| Total interest expense and other | $(1.9) | $(2.1) |

Interest expense, non cash amortization of deferred financing costs and non cash accretion of warrant value included in interest expense and other were incurred in connection with our 7% convertible debentures, which were issued in October and November of 2001.

**Income (loss) from Investing Activities**

Income (loss) from investing activities includes the following gains (losses):

| ($ in millions) | Three Months Ended March 31, 2003 | 2002 |
|---|---|---|
| Gain from sale of marketable securities | — | $ 0.7 |
| Gain on sale of investments | $1.5 | — |
| Decline in fair value of Crosby Finance, LLC | — | (3.2) |
| Total income (loss) from investing activities | $1.5 | $(2.5) |

We sold substantially all of our private equity investments, received cash proceeds of $3.0 million and recognized a gain from the sales of $1.5 million during the three months ended March 31, 2003.

**Provision (Benefit) for Income Taxes**

The provision for income taxes was $0.9 million during the first quarter of 2003 compared to a benefit of $5.3 million during the first quarter of 2002. Our effective tax rate increased to 34.7% for the first quarter of 2003 from 28.0% for the first quarter of 2002. The increase in our effective tax rate was primarily attributable to higher pre-tax income from domestic operations and to losses incurred in certain foreign jurisdictions where no corresponding tax benefit is available.

**Liquidity and Capital Resources**

We had $115.4 million in cash and cash equivalents at March 31, 2003, consisting primarily of operating cash and short-term investments. This represents an increase of $12.4 million in cash and cash equivalents during the three months ended March 31, 2003. The major changes in cash during the three months ended March 31, 2003 include cash provided by investing activities of $6.0 million, cash provided by operations of $4.4 million and cash provided by financing activities of $2.3 million.

Cash provided by investing activities of $6.0 million during the first quarter of 2003 consisted primarily of $3.0 million of cash from sale of equity investments and $3.4 million of cash from distributions from acquisition escrow funds. These increases in cash were partially offset by cash used for property and equipment purchases of $0.5 million.

Cash provided by financing activities of $2.3 million during the first quarter of 2003 consisted primarily of proceeds from employee exercises and purchases under our stock option and employee stock purchase plans.

We have commitments for various operating leases worldwide that expire at various times through 2017 and that are shown below net of existing sublease agreements, excluding facility exit costs included in restructuring charges. The lease commitments of $132.6 million shown below include lease commitments of $11.1 million related to certain exited facilities that have not been reserved for in restructuring charges, which represents our estimated sublease income from these facilities from the end of the period reserved to the end of the lease term. Restructuring commitments shown below are primarily for facility exit costs of up to 75 months of minimum lease payments due under certain excess facilities lease agreements, net of related sublease agreements. The following are our contractual commitments associated with our lease obligations, restructurings and convertible debentures:

| | Years Ending December 31, | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| (in millions) | Nine Months Ending December 31, 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | Thereafter | Total |
| Leases | $ 8.1 | $ 9.6 | $ 8.3 | $ 9.1 | $13.1 | $12.8 | $71.6 | $132.6 |
| Convertible debt principal | — | 80.0 | — | — | — | — | — | 80.0 |
| Convertible debt interest | 2.8 | 4.5 | — | — | — | — | — | 7.3 |
| Restructurings | 8.9 | 9.6 | 8.9 | 5.8 | 1.7 | 1.0 | 0.2 | 36.1 |
| Total commitments | $19.8 | $103.7 | $17.2 | $14.9 | $14.8 | $13.8 | $71.8 | $256.0 |

During October and November 2001, we issued 7% convertible subordinated debentures with an aggregate principal amount of $80.0 million, together with warrants to purchase an aggregate of 873,045 shares of our common stock. Interest on these debentures is payable in cash semi-annually on January 1 and July 1, at a fixed rate of 7% per annum. We expect to make interest payments of approximately $2.8 million during the remainder of the year ending December 31, 2003. The debentures mature on October 17, 2004, unless redeemed earlier by us or converted into shares of our common stock at the holder’s option. At any time and at their option, each holder may convert any outstanding debentures into shares of our common stock at a conversion price of $13.745 per share. Conversion of all of the outstanding debentures would result in the issuance of approximately 5.8 million shares of our common stock. We can redeem all or a portion of the 7% convertible debentures for cash as long as the arithmetic average of the weighted average price of our common stock on each trading day during the fifteen trading day period immediately prior to the election to redeem is 150% of the conversion price. This conversion feature was not exercisable at March 31, 2003. The debentures are unsecured and are subordinated to all existing and future senior indebtedness. The agreements governing the convertible debentures contain covenants restricting our ability to incur and guarantee additional debt. The covenants limit the amount of additional debt we may incur to the lesser of 30% of our consolidated stockholders' equity, which was approximately $80.1 million at March 31, 2003, or a total of $180.0 million including the balance of the 7% convertible debentures outstanding.

We have a $10.0 million line of credit agreement with a major financial institution against which we may elect to borrow at any time until June 30, 2003, and which contains annual extension provisions. Borrowing availability is reduced by letters of credit issued for purposes such as collateralizing real estate rental agreements. At March 31, 2003, we had $7.9 million of borrowing availability under this line of credit. The availability under this line of credit was reduced during the first quarter of 2003 due to a letter of credit issued during March 2003. Borrowings under this agreement will bear interest at either fixed or variable rates linked to either the London Interbank Offered Rate or the Prime Rate. Borrowings will be collateralized by our cash deposits.

In July 2001, we filed a shelf Registration Statement on Form S-3 with the Securities and Exchange Commission. This registration statement, which the SEC declared effective in August 2001, covers our issuance of various types of securities, including debt, common stock and warrants, up to an aggregate offering price of $500 million. As of March 31, 2003, there have been no issuance of securities under this shelf Registration Statement. We currently have no plans to issue any securities under this shelf Registration Statement.

Any increase or decrease in our accounts receivable balance and accounts receivable days outstanding (calculated as net accounts receivable divided by revenue per day) will affect our cash flow from operations and liquidity. Our accounts receivable and accounts receivable days outstanding may increase due to changes in factors such as the amount of international sales and length of customer's payment cycle. We also record deferred maintenance billings as accounts receivable, and the timing of these billings affects the accounts receivable days outstanding. Historically, international and indirect customers pay at a slower rate than domestic and direct customers. An increase in revenue generated from international and indirect customers may increase our accounts receivable days outstanding and accounts receivable balance. Due to the current economic climate, we may observe an increase in the length of our customers' payment cycle. To address increases in accounts receivable balance and to improve cash flow, we may from time to time take actions to encourage earlier payment of receivables. Discounts offered to customers to encourage payment are deducted from revenue. To the extent that our accounts receivable balance increases, we may incur increased bad debt expense and increased estimates for reserves against revenue and will be subject to greater general credit risks.

We expect to receive a tax refund of approximately $57.0 million by the end of 2003. This tax refund is attributable to the recovery of income taxes paid in prior years and is available to us due to the carryback of operating losses incurred in 2002 and 2001. This refund is subject to the timing of the filing of our tax returns and any Internal Revenue Service review.

Crosby Finance, LLC ("Crosby") held approximately 2.0 million shares of VeriSign common stock and a variable delivery forward contract, or VDF, at March 31, 2002. The gain recorded for financial reporting purposes upon execution of the VDF contract in 2000 has not been recognized for tax purposes, and accordingly we recorded a $26.6 million deferred tax liability in 2000. This deferred tax liability will reverse upon maturity of the VDF contract in 2006 and the gain will be included in the calculation of our taxable income for 2006. The recognition of that gain would result in a tax liability to us and may require the payment of cash to settle such tax liability.

Our remaining subscription to invest in RSA Ventures, our venture capital fund, is $15.0 million, which we may invest, at our sole discretion, over the life of RSA Ventures. We currently do not intend to invest this amount.

Our plans for future uses of cash may include additional acquisitions of other entities or technologies, retirement of outstanding debt and additional purchases of property and equipment, and inventory. We anticipate capital expenditures for the remainder of 2003 will be primarily for purchases of property and equipment and will aggregate up to approximately $4.0 million. Due to a high volume of shipments and the timing of inventory purchases during the first quarter of 2003 our inventory levels decreased at March 31, 2003. We typically maintain a two to three months supply of inventory on hand, and we intend to use cash during the second and third quarters of 2003 to re-establish our inventories to these levels. We expect to fund our capital expenditures and increase in inventory supply from cash on hand and cash generated from operations.

We believe that cash generated from our operating activities will be sufficient to fund our working capital requirements through at least the next twelve months. However, because of our concern that the current economic conditions may persist during 2003, if not longer, we have taken and continue to take steps to reduce our expenses and align our cost structure to our revenue. We anticipate that current cash on hand, cash generated from operations, and cash generated from the exercise of employee options and employee stock purchase plans will be adequate to fund our planned capital and financing expenditures for at least the next twelve months.

**New Accounting Pronouncements**

Interpretation No. 46 – In January 2003, the FASB issued Interpretation No. 46 (“FIN 46”), “Consolidation of Variable Interest Entities,” which clarifies the application of Accounting Research Bulletin No. 51, “Consolidated Financial Statements,” relating to consolidation of certain entities. First, FIN 46 will require identification of our participation in variable interest entities (“VIE”), which are defined as entities with a level of invested equity that is not sufficient to fund future activities to permit them to operate on a stand alone basis, or whose equity holders lack certain characteristics of a controlling financial interest. For entities identified as VIE, FIN 46 sets forth a model to evaluate potential consolidation based on an assessment of which party to the VIE, if any, bears a majority of the exposure to its expected losses, or stands to gain from a majority of its expected returns. FIN 46 also sets forth certain disclosure requirements regarding interests in VIE that are deemed significant, even if consolidation is not required. For VIE created before February 1, 2003, FIN 46 applies to interim periods beginning after June 15, 2003. We believe the adoption of FIN 46 will not require the consolidation of our investment in Crosby and therefore will not have a significant impact on our consolidated financial position or results of operations.

EITF No. 00-21 – In November 2002, the EITF issued EITF No. 00-21, “Revenue Arrangements with Multiple Deliverables,” which provides guidance on the timing and method of revenue recognition for sales arrangements that include the delivery of more than one product or service. EITF 00-21 is effective prospectively for arrangements entered into in fiscal periods beginning after June 15, 2003. We anticipate the adoption of EITF No. 00-21 will not have significant impact on our consolidated financial position or results of operations.

**Certain Factors That May Affect Future Results**

Our quarterly operating results have fluctuated in the past and may fluctuate significantly in the future. A variety of factors, many of which are outside of our control, can cause these fluctuations, including, among others:

- the size, timing and shipment of individual orders for our products;
- changes in our operating expenses;
- the timing of the introduction or enhancement of our products and our competitors’ products;
- customers deferring their orders in anticipation of the introduction of new products by us or our competitors;
- market acceptance of new products;
- changes in the mix of products sold;
- changes in product pricing, including changes in competitors’ pricing policies;
- development and performance of our direct and indirect distribution channels;
- the amount and timing of charges relating to the impairment or loss of value of some of our assets, especially goodwill and intangible assets;
- the timing of personnel departures and new hires and the rate at which new personnel become productive; and
- general economic conditions.

We may not be able to achieve, sustain or grow our profitability from quarter to quarter. Because our operating expenses are based on anticipated revenue levels and a high percentage of our expenses are fixed, a small variation in when revenue is recognized can cause significant variations in operating results from quarter to quarter.

We currently lease a number of excess, unused or under-used facilities that we are trying to sublet, and some of our lease commitments for these facilities will not expire for several years. The real estate market, especially the real estate market in the Boston metropolitan area where our headquarters are located, has deteriorated significantly during the last two years, and we do not know when or whether we will be able to find sublessees for our excess facilities.

The global economy, especially the technology sector, is still weak and may continue to be in recession for the foreseeable future. In addition, the US war and continued involvement in Iraq, as well as the emerging SARS epidemic, have contributed to global economic uncertainty. The general economic slowdown has had and may continue to have serious negative consequences for our business and operating results. We believe that the economic slowdown is causing some current or potential customers to defer purchases, to go out of business or to have insufficient capital to buy or pay for our products. In response to the current economic conditions, many companies have reduced their budgets for information technology products and services, which could reduce or eliminate some potential sales of our products and services. In addition, some of our resellers and distributors are experiencing financial difficulties due to the weak economy, which affects our ability to sell to and collect money from those resellers and distributors.

Our stock price has been volatile and is likely to remain volatile. From March 31, 2002 through April 14, 2003, our stock price has ranged from a per share high of $9.10 to a low of $2.23. A number of factors may contribute to the volatility of our stock price, including:

- our ability to meet the expectations of brokerage firms, industry analysts and investors with respect to our operating and financial results;
- the Securities and Exchange Commission investigation into our disclosure in the first quarter of 2001 of a change in our method of estimating distributor revenue and trading in our common stock (for more information about the investigation see Part II, Item 1 “Legal Proceedings” of this Report);
- our public announcements and our competitors’ public announcements;
- the public’s perception of the strength of the e-security solutions market and technology companies generally;
- litigation developments;
- the volatility of the stock market in general and of the technology sector in particular; and
- general economic conditions.

The market for some of our e-security solutions is continuing to develop, and demand for our products depends on, among other things:

- the perceived ability of our products to address real customer problems;
- the continued evolution of electronic commerce as a viable means of conducting business;
- market acceptance and use of digital signatures and digital certificates in business applications;
- the ability of network infrastructures to support an increasing number of users and services;
- the public’s perception of the need for secure electronic commerce and communications over both wired and wireless computer networks;
- the US government’s continued focus on e-security as a means to counteract terrorism and other hostile acts;
- the perceived quality, price, availability and interoperability of our products as compared to our competitors’ products;
- the pace of technological change and our ability to keep up with these changes;
- the market’s perception of our products’ ability to address the e-security aspects of privacy and security legislation, such as the Health Insurance Portability and Accountability Act of 1996 (HIPAA); and
- general economic conditions, which, among other things, influence how much money our customers and potential customers are willing to allocate to their information technology budgets.

E-security technology is constantly changing as we and our competitors introduce new products and retire old ones and as customer requirements develop and change. Our future success will depend in part upon our ability to enhance our existing products and to introduce new, competitively priced products and solutions with features that meet changing customer requirements, all in a timely and cost-effective manner. We may not be successful in introducing new or enhanced products. A number of factors, including the following, could have a negative impact on the success of our products:

- quality, reliability or security failures, which could result in product returns, delays in collecting accounts receivable, unexpected service or warranty expenses, reduced orders and a decline in our competitive position;
- undetected software errors or bugs in the final products shipped to our customers, which could cause market acceptance of our

products to be lost or delayed;

- delays or difficulties in product development;
- our competitors’ introduction of new products ahead of our new products, or their introduction of superior or cheaper products;
- the availability of free, unpatented implementations of encryption algorithms and security protocols;

- the market's failure to accept new technologies, including Web access management, digital certificate and public and private key management technologies;
- our failure to include features in our products, or obtain industry and governmental certifications, that our customers or U.S. or foreign government regulators may require;
- our failure to anticipate changes in customers' requirements; and
- the implementation of industry or government standards that are inconsistent with the technology embodied in our products.

We may need to purchase or license technology from third parties in order to introduce new products or enhance our existing products. We may not be able to find businesses that have the technology we need and, if we find such businesses, may not be able to purchase or license the technology on commercially favorable terms or at all.

Some of our products have long and unpredictable sales cycles. Transactions for some of our products, especially our digital certificate management and Web access management products, often involve large expenditures by our customers. Some of our customers may also need to invest substantial resources and modify their computer network infrastructures to take advantage of our products. Therefore, the sales cycles for these transactions are often lengthy and unpredictable, and the long nature of the sales cycles may impact our quarterly operating results. The sales cycles for these transactions are subject to a number of uncertainties such as:

- customers' budgetary constraints;
- the need to educate potential customers about our products' capabilities;
- customers' willingness to make changes in their network infrastructures to take advantage of our products;
- the timing of customers' budget cycles; and
- delays caused by customers' internal review processes.

In addition, we are currently working on increasing our sales to the United States federal government. Federal regulatory, approval and purchasing requirements can greatly lengthen the sales cycle for sales to the federal government.

If we fail to remain competitive, then we could lose market share for our established products or fail to gain market share for our less mature products. A number of competitive factors could cause us to lose potential sales or to sell our products at lower prices or at reduced margins, including, among others:

- Some of our competitors offer e-security products with features and functionality that our products do not currently offer.
- Some computer and software companies that have not traditionally offered e-security products are now offering free or low-cost e-security products and functionality bundled with their own computer and software products.
- Some of our current and potential competitors have greater financial, marketing and technical resources than we do, allowing them to leverage an installed customer base, adapt more quickly to new technologies and changes in customer requirements, or devote greater resources to the promotion and sale of their products than we can.
- The expiration of some of our patents has permitted the use and distribution of "freeware," free versions of some of our technology, and we believe that some potential customers may be choosing to use freeware instead of buying our products.
- Many companies have reduced their information technology budgets due to the current economic conditions, which could make competition more intense because we are competing for fewer customer dollars.

International sales accounted for more than 30% of our total revenue in each of the years ended December 31, 2002, 2001 and 2000 and in the three months ended March 31, 2003. We may need to tailor or "localize" our products in order to compete in particular international markets and to comply with foreign laws. We may not be able to develop, market and distribute localized versions of our products in a timely manner or at all. In addition, there are certain risks inherent in doing business internationally, including:

- foreign regulatory requirements and the burdens of complying with a wide variety of foreign laws;
- legal uncertainty regarding liability and the costs of resolving or litigating a dispute internationally;

- difficulties in the enforcement of intellectual property rights;
- export and import restrictions on cryptographic technology and products incorporating that technology;
- difficulties and delays in establishing international distribution channels;
- difficulties in collecting international accounts receivable;
- fluctuations in currency exchange rates;
- potentially adverse tax consequences, including restrictions on the repatriation of earnings;

- tariffs and other trade barriers; and

- political instability.

We have experienced some problems, and may experience problems in the future, relating to the quality and reliability of some of our authenticators and authenticator components. For example, during 2002 we encountered some quality control problems with some of the batteries contained in our authenticators and also had to replace some defective tokens. In addition, many of our suppliers are located outside of the United States. If political, economic or health-related events, such as the U.S. actions in Iraq or the SARS epidemic, were to affect international trade, then we could experience difficulties in obtaining product components from our international suppliers. Problems with the availability or quality of our products could cause our revenue to decrease and our costs to increase, damage our reputation in the marketplace and subject us to damage claims from our customers.

If we fail to protect our rights in our proprietary technology, competitors may use our technology, which could weaken our competitive position, reduce our revenue and increase our costs. We rely on a combination of patent, trade secret, copyright and trademark laws, software licenses, nondisclosure agreements and technical measures to protect our proprietary technology. We also generally enter into confidentiality or license agreements with our employees, distributors and strategic partners as well as with our customers and potential customers seeking proprietary information, and limit access to and distribution of our software, documentation and other proprietary information. However, despite our efforts to protect our proprietary rights, unauthorized third parties may nonetheless succeed at:

- copying aspects of our products;

- obtaining and using information that we regard as proprietary; or

- infringing upon our patents and other proprietary rights.

We rely on patents to protect our proprietary rights in our technology, but patents may not provide complete protection:

- It is possible that any patent that we or our licensors hold might be invalidated, circumvented, challenged or terminated.

- It is possible that patent examiners might reject the claims described in our pending or future patent applications.

- The laws of some countries in which our products are now, or may in the future be, developed or sold may not protect our products and intellectual property rights to the same extent as the laws of the United States.

- During the life of a patent, third parties may design and sell “work-around” solutions that accomplish the goals of our patented inventions but do not infringe the patents themselves.

Our 33 issued U.S. patents expire at various dates ranging from 2005 to 2019. When each of our patents expires, competitors may develop and sell products based on the same or similar technologies as those covered by the expired patent, which could result in lower prices, reduced margins or the failure of our products to achieve or maintain market acceptance. In addition, when each of our patents expires, potential customers may choose to rely on “freeware,” free versions of our previously patented technology, rather than buying our products.

From time to time, we have been involved in disputes with third parties who allege that our products may infringe intellectual property rights held by the third parties. For example, we recently completed a trial in the patent infringement case that Leon Stambler brought against us (for more information about the litigation see Part I, Item 3 “Legal Proceedings” of this Report). Any litigation carries a number of significant risks, including:

- litigation is often very expensive, even if it is resolved in our favor; and

- litigation diverts the attention of management and other resources.

Moreover, if a court or other government agency rules against us in any intellectual property litigation, we might be required to:

- discontinue the use of certain processes;

- cease the manufacture, use and sale of infringing products;

- expend significant resources to develop non-infringing technology;

- obtain licenses to the infringing technology; or

- pay significant monetary damages.

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

We are exposed to a variety of risks, including changes in the market value of our investments, our common stock and foreign exchange rates. Market fluctuations could impact our results of operations and financial condition. In the normal course of business, we employ established policies and procedures to manage these risks.

We generally purchase our marketable securities and cash equivalent investments in high credit quality instruments, primarily U.S. Treasury and government agency obligations, tax-exempt municipal obligations and money market investments with contractual maturities of one year or less. We do not expect any material loss from our marketable securities and cash equivalent investments and therefore believe that our potential interest rate exposure is not material. We evaluate the realizable value of these investments using qualitative and quantitative factors including discounted cash flow analysis and liquidation value assessments.

During 2001, we issued 7% convertible subordinated debentures due October 17, 2004 with an aggregate principal amount of $80.0 million, together with warrants to purchase an aggregate of approximately 0.9 million shares of our common stock. At any time and at their option, each holder may convert any outstanding debentures into shares of our common stock at a conversion price of $13.745 per share, which upon conversion of all of the outstanding debentures would result in the issuance of approximately 5.8 million shares of our common stock. The holders of the warrants issued with the debentures may exercise the warrants at any time until October 17, 2006 at an exercise price of $13.745 per share. The conversion price of the debentures and the exercise price of the warrants may be adjusted under certain circumstances, such as events that would cause dilution of the holder's interest. We may redeem all or a portion of the debentures for cash as long as the arithmetic average of the weighted average price of our common stock on each trading day during the fifteen trading day period immediately prior to the election to redeem is at least 150% of the conversion price. The conversion feature was not exercisable at March 31, 2003. If the 7% convertible debentures are redeemed in part or total before their maturity date, we will record a non cash charge for unamortized deferred financing costs and the unamortized value of the warrants. At March 31, 2003, unamortized deferred financing costs were $2.5 million and the unamortized value of the warrants was $2.2 million. Interest is payable in cash semi-annually at a fixed rate of 7% per annum, and therefore we believe we have no interest rate exposure with these debentures.

As a global concern, we face exposure to adverse movements in foreign currency exchange rates. These exposures may change over time as business practices evolve and could have a material adverse impact on our financial results. Historically, our primary exposures to fluctuations in foreign currency exchange rates related to sales and operating expenses denominated in local currencies. Our direct sales to our customers in countries outside of the United States are denominated in U.S. dollars and local currencies, with the majority of our direct sales denominated in U.S. dollars. Our sales through indirect distribution channels are generally denominated in U.S. dollars. For countries outside the United States, we generally pay our operating expenses in local currency. When we do invoice customers in local currency, we are exposed to foreign exchange rate fluctuations from the time of invoice until collection occurs. We are also exposed to foreign currency rate fluctuations between the time we collect in U.S. dollars and the time we pay our operating expenses in local currency. Fluctuations in foreign currency exchange rates could affect the profitability and cash flows in U.S. dollars of our products sold in international markets.

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

*Evaluation of disclosure controls and procedures* – During the 90 days before the filing date of this report, our Chief Executive Officer and Chief Financial Officer evaluated our disclosure controls and procedures (as defined in the SEC rules promulgated under the Securities Exchange Act of 1934, as amended), which are designed to ensure that information required to be disclosed in our Securities and Exchange Commission reports is properly and timely recorded, processed, summarized and reported. The officers concluded that these controls and procedures are operating in an effective manner.

*Changes in internal controls* – There were no significant changes in our internal controls or in other factors that could significantly affect these controls since the date of the last evaluation of the controls.

## PART II. OTHER INFORMATION

**Item 1.** ***Legal Proceedings***

By notice dated January 23, 2002, the Securities and Exchange Commission notified us that it is conducting a formal investigation of (1) our disclosure of a change in our method for estimating our distributor revenue, and (2) certain trading in our common stock. On or about July 11, 2002, the SEC staff notified RSA Security and some of its officers that the staff was considering seeking permission from the SEC to commence a civil injunctive proceeding against them, and that RSA Security and the officers could submit a written statement explaining why no such proceeding should be commenced. We and the officers submitted such a statement in August 2002 and are waiting for the SEC's response. We and the officers are continuing to cooperate with the SEC, but we cannot predict the ultimate outcome of this matter.

On or about February 2, 2001, Leon Stambler filed a complaint for patent infringement in U.S. District Court for the District of Delaware against RSA Security, VeriSign, Inc., First Data Corporation, Openwave Systems Inc., and Omnisky Corporation, Case Number 01-0065. In his complaint, Mr. Stambler alleged that certain products marketed by each of the defendants infringed various patents that he owns, and he sought unspecified damages as well as a preliminary and permanent injunction enjoining the defendants from infringing the claims asserted. The trial took place in March 2003, and the jury determined that our products did not infringe Mr. Stambler's patents. On April 17, 2003, the court entered final judgment in our favor on all claims of non-infringement. In May 2003, Mr. Stambler filed a motion asking the court to set aside the jury's verdict. We intend to oppose this motion. We believe that the final disposition of this matter will not have a material adverse effect on our continuing operations and consolidated financial position.

On or about December 20, 2001, France Telecom and Telediffusion de France ("FT") filed a Request for Arbitration with the International Court of Arbitration. FT claims that we breached a license agreement with FT and seeks unspecified damages including a payment in excess of $20.0 million plus the legal fees and other costs associated with the arbitration. The arbitration is scheduled to take place in June 2003. We believe that FT's claims are without merit, and we intend to defend the arbitration vigorously. In a related matter, FT has also filed a patent infringement suit in Delaware against Novell, Inc., one of our licensees. In August 2002, we signed a letter agreement with Novell agreeing that if a court requires Novell to pay FT damages, we will reimburse Novell for 50% of the damages, up to a maximum payment of $2.5 million by us. If the damages payable by Novell exceed $5.0 million, then the indemnification provisions of our license agreement with Novell will govern our indemnification obligations. Although we believe that FT's claims against Novell are without merit, we cannot predict the ultimate outcome of this matter. However, we believe that neither the disposition of our arbitration with FT nor the disposition of the litigation between Novell and FT will have a material adverse effect on our continuing operations and consolidated financial position.

From time to time, we have been named as a defendant in other legal actions arising from our normal business activities, which we believe will not have a material adverse effect on us or our business.

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

**(a) Exhibits**

See the Exhibit Index attached to this Report.

**(b) Reports on Form 8-K:**

On January 24, 2003, we filed a Current Report on Form 8-K reporting our financial results for the fourth quarter and year ended December 31, 2002.

On February 4, 2003, we filed a Current Report on Form 8-K furnishing our presentation entitled Seamless and Transparent e-Security Solutions for Competitive Advantage dated February 3, 2003.

## SIGNATURE

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

RSA SECURITY INC.

/s/ JEFFREY D. GLIDDEN

**Jeffrey D. Glidden**
**Senior Vice President, Finance and Operations,**
**Chief Financial Officer and Treasurer**
**(Principal Financial and Accounting Officer)**

Dated: May 12, 2003

## CERTIFICATIONS

I, Arthur W. Coviello, Jr., certify that:

1. I have reviewed this quarterly report on Form 10-Q of RSA Security 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 officer 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 officer 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:

   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 officer 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/ ARTHUR W. COVIELLO, JR.

**Arthur W. Coviello, Jr.**
**President and Chief Executive Officer**

Dated: May 12, 2003

**CERTIFICATIONS**

I, Jeffrey D. Glidden, certify that:

1. I have reviewed this quarterly report on Form 10-Q of RSA Security 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 officer 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 officer 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:

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 officer 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/ JEFFREY D. GLIDDEN

**Jeffrey D. Glidden**
**Senior Vice President, Finance and Operations,**
**Chief Financial Officer and Treasurer**

Dated: May 12, 2003

## EXHIBIT INDEX

| ITEM | DESCRIPTION |
|---|---|
| 10.1 | 1994 Director Stock Option Plan, as amended. |
| 10.2 | Second Amendment to the 2000 Deferred Compensation Plan. |
| 99.1 | Certifications pursuant to 18 U.S.C. §1350. |
| 99.2 | Trading plan, pursuant to Rule 10b5-1 under the Securities Exchange Act of 1934, as amended, adopted by William L. McQuaide on April 1, 2003. |
| 99.3 | Trading plan, pursuant to Rule 10b5-1 under the Securities Exchange Act of 1934, as amended, adopted by Margaret K. Seif on August 28, 2002, as amended. |