

annual report  
**03**



### **the BakBone of Data Protection and Recovery**

BakBone is growing...As we enter into fiscal 2004 our products are launching us into future markets. Partnerships stand ready testament to our accomplishments as we continue to build. Our solution superiority is winning us more and more deals. Our capabilities are resonating with markets, analysts and customers. BakBone has emerged...

...our emergence is the result of a focused resolve to provide the market, quite simply, the best data protection and recovery solutions. BakBone provides the broadest support of hardware, operating systems, databases, key protocols, and so much more. We are a critical piece of the storage management equation and drive value not only to the users of our products but also to the key players in the market. Just ask our partners...

**Network Appliance** "Based on our co-development agreement, BakBone is the first company to provide an integrated management application for SnapVault, which works with our award-winning NearStore product, that is capable of managing the entire disk-to-disk-to-tape backup and restore process while maximizing simplicity, performance, and reliability. Together we are now providing customers with a powerful, cost-effective, and flexible new option for enterprise-class data protection designed to leverage legacy storage investments, protect enterprise data assets, maintain business continuity, and reduce IT cost."

— Suresh Vasudevan, Senior Director of Software Marketing, Network Appliance

**Sony Electronics, Inc.** "Sony has combined our StorStation network storage system with NetVault software to deliver a complete backup solution for customers who require reliable network file sharing and backup and recovery services. NetVault is easily deployed and together with our StorStation system enables users to share and retrieve files on the network, automatically archive files from disk to tape, back up and restore networked files, as well as centrally manage all functions."

— Stephen Baker, Vice President of Tape Storage Solutions, Sony Electronics, Inc.

the **BakBone** advantage . . . .



partners

BROCADE

EMC

HITACHI

HP

IBM

INTEL

NCR

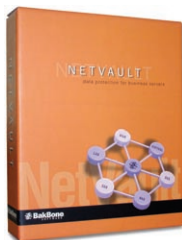
NETWORK APPLIANCE

product

**NetVault™** NetVault 7 is here. And with it comes a solution that is ideally positioned to help customers with the new challenges that have arisen from trends in the storage industry, and in particular, the backup and recovery market segment.

A critical issue for IT departments today is the management and execution of their data protection policies. The proliferation of storage networks is actually making this requirement more, not less, complex.

NetVault 7 is our latest generation release that is clearly positioned as the best data recovery product for storage networks.



Why? It has built advanced policy management and event notification infrastructure into its solution—data management that now leverages multiple protection options with various recovery time characteristics. It is architected for performance and adaptability. It supports more platforms, operating systems and databases than its competition.

NetVault 7 provides the ability to produce reports on all aspects of the NetVault system including job execution, media utilization and system operations. No other product on the market offers the advanced reporting capabilities that NetVault 7 does.

It is scalable and robust for the largest enterprises, yet flexible enough for small businesses—all within the same product.



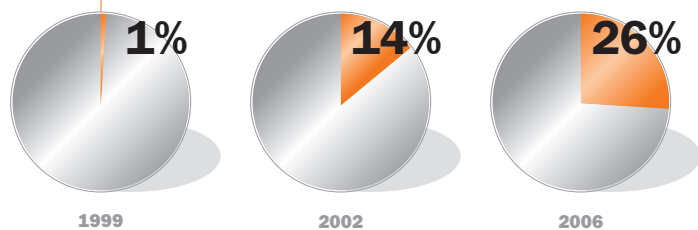
What makes BakBone's NetVault so compelling? It offers a solution that dramatically lowers total cost of ownership (TCO) by automating device discovery and configuration across the most complex SAN and NAS environments. And tellingly, NetVault requires no professional services to install or deploy. This means that our resellers and partners can shift the mix of their offerings to concentrate on products and services that afford them the most differentiation and value for customers.

NetVault 7—we believe it is "simply the best!"

COMPLIANCE  
 ORACLE  
 OVERLAND STORAGE  
 QUANTUM  
 REDHAT  
 SONY ELECTRONICS  
 SPECTRA LOGIC  
 STORAGE GETEK  
 SUN MICROSYSTEMS

vision

value



Linux Market Share Growth in the Backup Server Market

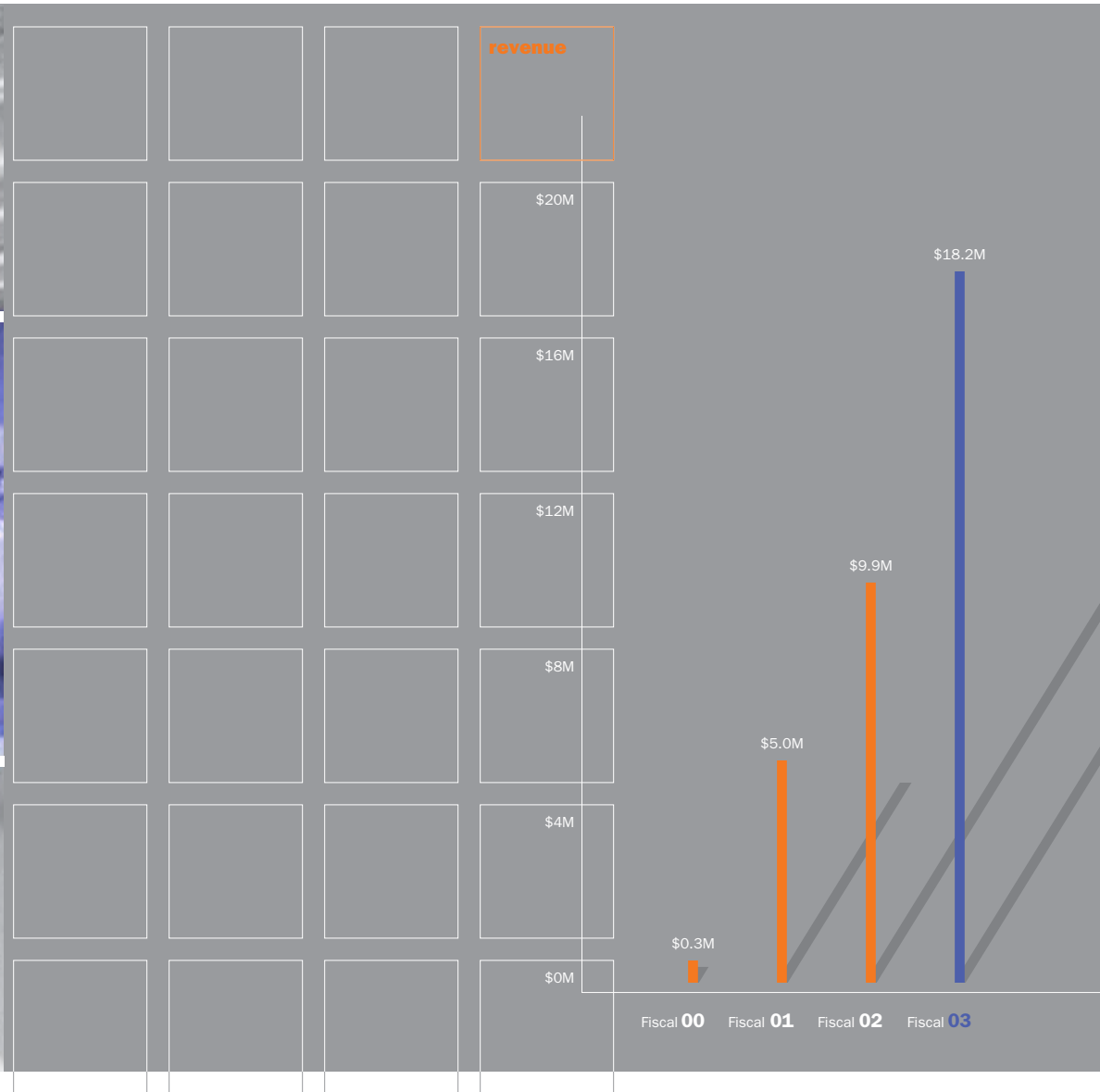
**Linux** A powerful movement is on the rise and BakBone is ready.

Linux is the fastest growing platform being deployed across small businesses through to the enterprise. More and more application vendors are porting their offerings to Linux, fueling adoption rates globally. Business is depending more and more on the Linux platform, but not all backup and recovery solutions can meet the challenge. Linux was one of the original development platforms that NetVault was written to — the result? No limitations in features and functions. The most supported versions in the global market. BakBone is already a world leader in the number of Linux deployments and is now poised to build on a growing market.

**TCO** Effective backup and recovery solutions have become the key to all well managed network data environments. The cost of acquiring, implementing, and operating a backup and recovery solution must balance with the benefits of ownership, including making the best use of staff resources and achieving the highest possible performance.

According to a recent study<sup>1</sup>, BakBone's NetVault solution has an average 30% overall lower total cost of ownership (TCO) than the market's largest competitor. The same study shows that BakBone's customers also rate our solution higher in satisfaction on cost, feature, and function.

<sup>1</sup>INPUT, 2002 study, *Backup and Recovery Software: A Competitive Study on Total Cost of Ownership.*



**Revenue Growth** Our track record of revenue growth is a result of the many advantages that BakBone and our products provide. BakBone has remained on a path of substantial revenue growth each year since our inception due to our commitment to creating a robust product, addressing emerging markets such as Linux, providing the lowest TCO for customers and for many more reasons.

In fact, fiscal 2003 saw another year of revenue growth in each of our operating regions: North America, Pacific Rim and EMEA (Europe, Middle East, and Africa), showing that our strengths have driven growth despite difficult current economies throughout the world.

Fiscal 2004 promises to bring with it continued strong revenue growth. Growth that will be fueled by the increase of channel sales, new and higher profile partners and further penetration of the geographic markets in which we operate today.

**Dear Shareholders** Fiscal year 2003 continued to tell a very powerful story for BakBone. As with our previous reports, this past year was marked by sound financial results, technological innovation and further expansion of market share. It's important to note that our consistent, quarter-by-quarter revenue growth was achieved as we were "swimming upstream" in one of the most challenging technological climates on record. In a time when IT budgets were flat at best, we garnered in excess of an 80% gain in revenues. More importantly, we continued our steady path toward profitability. **1**

As past fiscal years have been marked by rapid revenue growth and a clear focus on expense control, fiscal year 2004 will usher in another key financial milestone – profitability! And as any technology analyst would tell you, profitability is no small achievement in these difficult times in the tech markets. It results from the culmination of careful planning, financial responsibility, great hires and the kind of technological agility that our competitors can only dream of. **2**

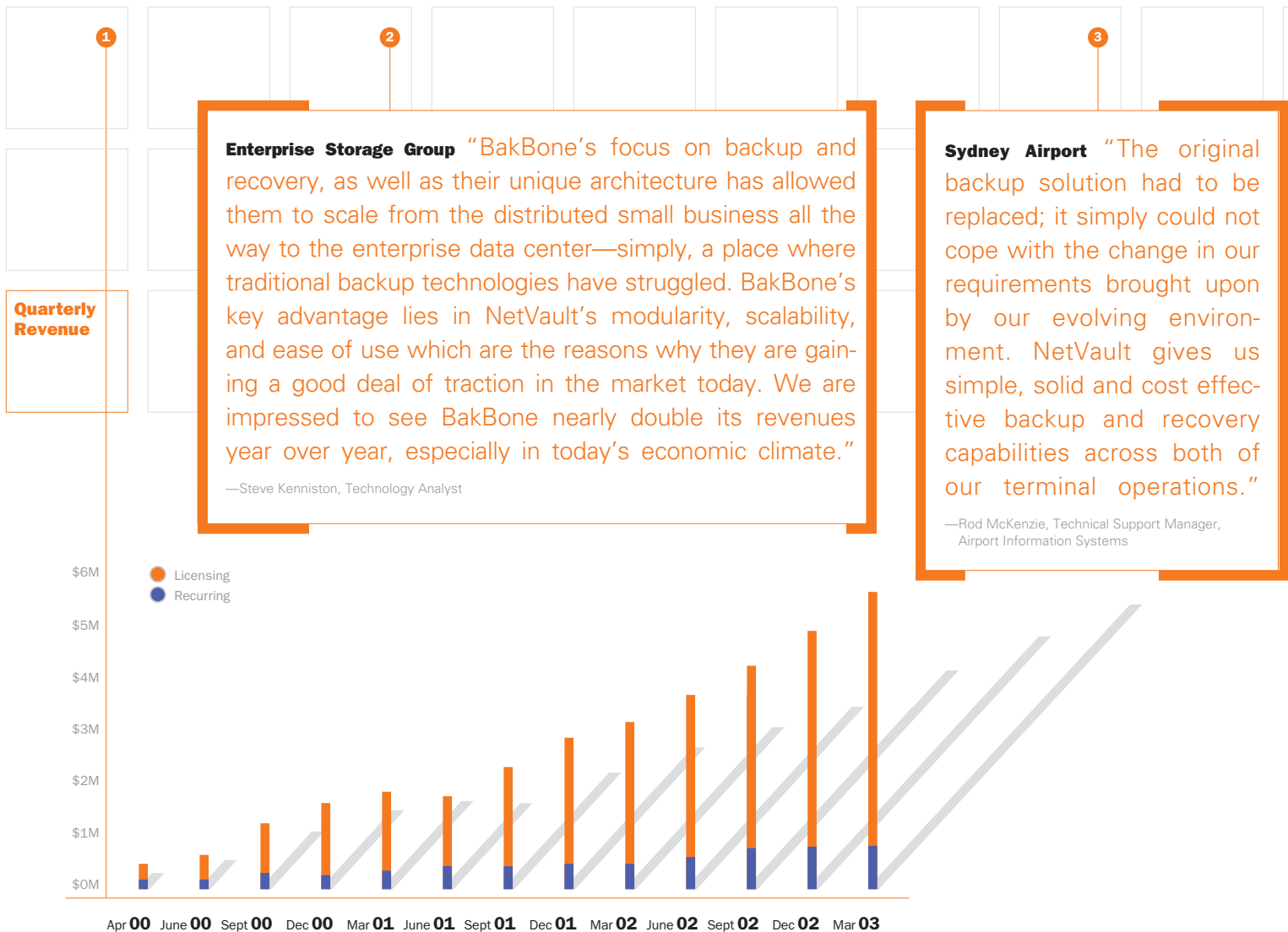
Companies are demanding software that delivers robust functionality, scalability and a compelling return on their IT investment – software that is the heart of BakBone's product offering. We are meeting these demands with the software we sell today and our engineering vision is one that supports these attributes in our future development. In other words, monolithic and difficult to deploy solutions are out, modular solutions are in. **3**

The modularity of our NetVault backup and recovery software continues to win customers, fueling growth in our market share. Even though most companies' IT budgets are restricted, the proliferation of data continues to grow unchecked. As a result, IT managers are being asked to do far more with fewer IT dollars. Quite simply, nobody can afford a complete system overhaul. And with NetVault, nobody needs one. **4**

To truly enhance our bottom line, sales growth needs to be balanced with a focus on controlling expenses. This year we held our G&A expenditures flat, while adding key sales and engineering personnel to fuel our growth. In addition, we decided to eliminate our MagnaVault nearline storage management software – resulting in further cost savings. As such, we will now be able to focus all our resources on our flagship product, NetVault.

**The Market is Getting Our Message** As the market has learned, BakBone is the best recovery solution for storage networking, period. What's more, BakBone carries with it the lowest total cost of ownership (TCO). **5 6**

These are powerful messages at any time – but especially now. IT departments need to maximize functionality while minimizing expenditures. They want backup software to work with minimal



intervention, and they want to install it in hours, not days. They want to install it themselves, and not depend on outsiders.

And that leads to BakBone's biggest advantage over the competition: we don't require professional services to install or scale our product as an end-user's needs grow. After all, people are expensive; software installation shouldn't be. BakBone's software has already been tested across a broad range of operating systems, devices and configurations. We have taken the time to certify our product with many of the top equipment manufacturers to enhance compatibility and we have designed our product specifically for networked storage. And that's why NetVault's installation is quick and easy.

After the installation, the modularity of our software is what keeps customers coming back. No matter what systems, software and vendors they are using in the data center, NetVault brings savings and flexibility to our customers. Savings and flexibility go a long way on a limited budget.

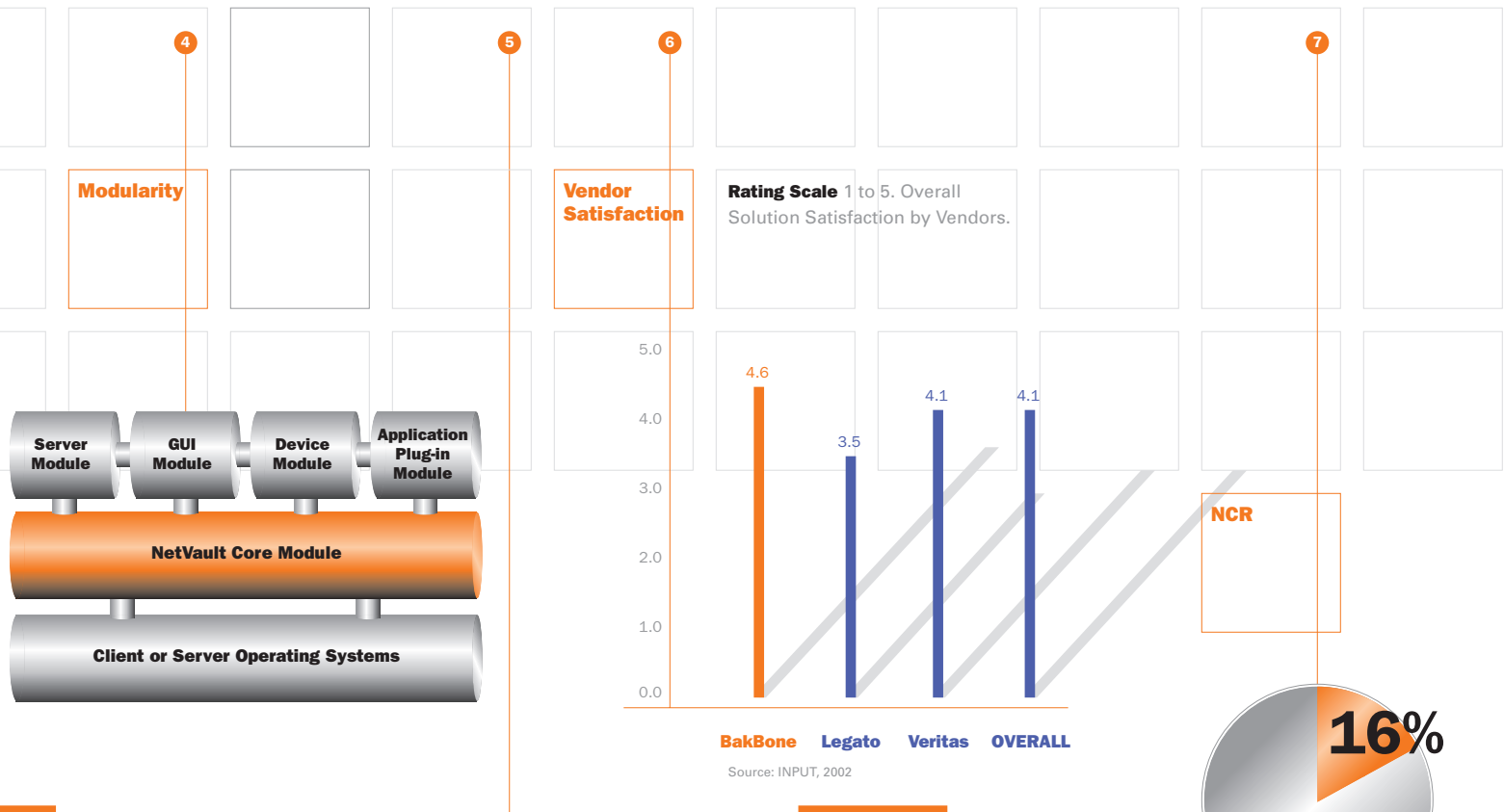
**Partnerships** When word of a good thing gets out, you never know who is listening. This year, it was Sony. In fact, the signing of the Sony OEM agreement brought with it the biggest "win" in BakBone's three-year history—\$3.5 million. Our NetVault product is running on Sony's StorStation, a network attached storage

(NAS) offering, that provides a complete network and backup storage system for customers.

Our partnership with Network Appliance (NetApp) has significantly increased our exposure in the NAS market, which incidentally is one of the industry's fastest growing. We are pleased to be working with NetApp to co-develop solutions that enable customers to consolidate their backup infrastructures, providing ease and flexibility as well as a more robust disk-based solution.

Fiscal year 2003 was a time of building new relationships while strengthening existing ones. NCR Teradata continues to pay dividends and open doors for us. We can now attribute approximately 16% of our revenues to our relationship with NCR. Sales associated with NCR Teradata are made to many of the world's largest and most recognizable companies—companies that are now using NetVault! **7**

And of course when you're in the software business, certifications are important. Fiscal year 2003 saw NetVault successfully complete interoperability testing utilizing the IBM TotalStorage Proven program with IBM's NAS, Tape, FASTT and Enterprise Storage Server. NetVault was also successfully certified for advanced interface operations with many more key vendors' products.



**INPUT Independent TCO Study** "Whether concerning scalability, compatibility, reliability, ease of implementation or management, speed of deployment, features, or cost, BakBone's backup and recovery product is rated the highest in satisfaction every time." —INPUT, 2002

**Linux** BakBone's revenues continue to come mostly from Windows and Unix environments. Yet as the Linux market blossomed, many storage software providers addressed its needs on a patchwork, ad hoc basis. Unlike those vendors, Linux was built into the NetVault source code during its re-architecting in the late 1990's, so future modifications for Linux on NetVault are quick and universal. Providing for rapid backup and recovery time as well as the most robust Linux backup solution on the market today. **8**

Linux is rising in the market as a viable alternative to other operating systems and our successes are numerous. In fact, 50% of our Japanese revenues are Linux-based. In addition, many U.S. governmental agencies including the Air Force, Department of Defense, and Federal Aviation Administration run Linux systems. The German Minister of the Interior recently announced the German government has decided to move to standardize on Linux and the open source IT model at the federal, state, and communal levels. China's Post Office runs on Linux as does France's Culture, Defense and Education ministries. Numerous other countries have made sizable investments in Linux systems, including Singapore, Australia, Canada, Spain and the U.K.

Because NetVault has always incorporated Linux, it offers faster certifications—making us the most well positioned backup and recovery vendor to capitalize on Linux growth. In fact, we are the only storage software company to support all 10 of the leading

Linux vendors. Needless to say, we're very excited about the Linux market, a market that already accounts for approximately 30% of our revenue. **9**

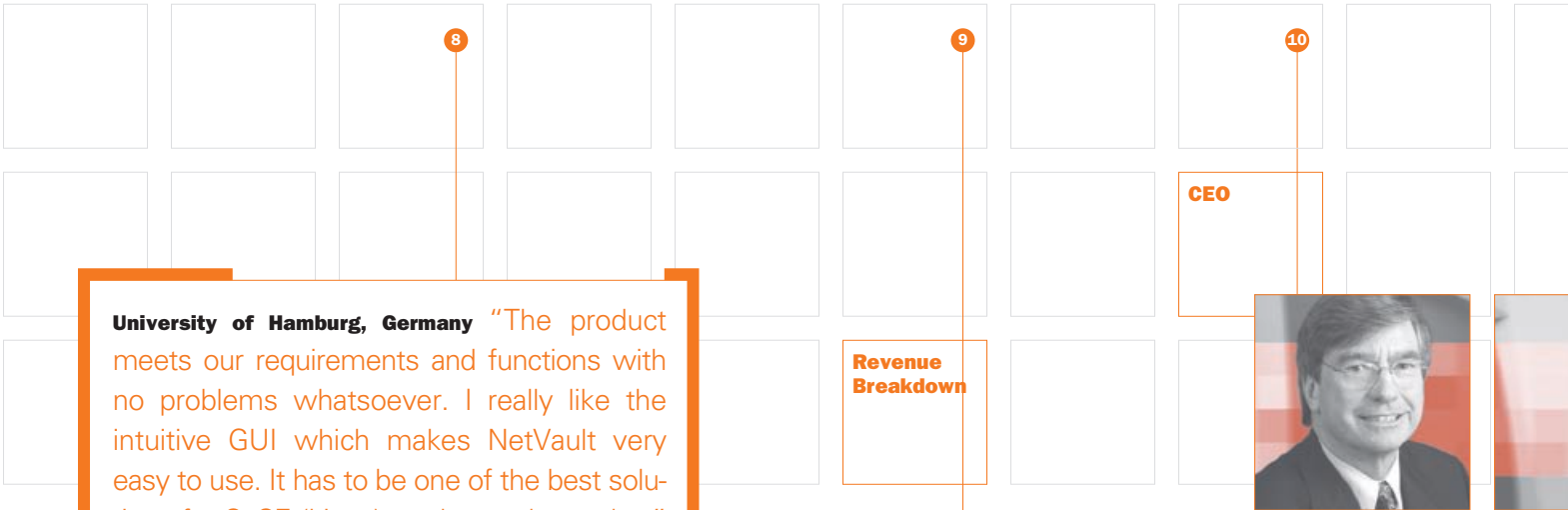
**Closing Thoughts** Strong shareholder return begins with a strong commitment to controlling expenses, tapping new markets and driving new technology. More than ever, I remain personally committed to producing a strong return for our shareholders.

I would like to thank our employees and associates who have worked so tirelessly this year. We have made some gigantic strides and owe it all to their enthusiasm and dedication. I would like to thank our strategic and channel partners for their support and belief in our product offering. And I would also like to thank all of our shareholders. Your faith and support throughout the year have enabled us to meet and surpass the challenges of the current market.

I look forward to keeping you informed of BakBone's progress throughout the year.

Sincerely,  

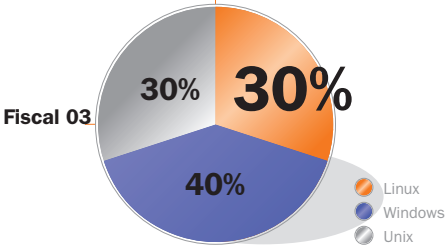

**Keith Rickard**  
 President and Chief Executive Officer **10**



**University of Hamburg, Germany** "The product meets our requirements and functions with no problems whatsoever. I really like the intuitive GUI which makes NetVault very easy to use. It has to be one of the best solutions for SuSE (Linux) on the market today."  
 —Volkmar Glauche, IT Director, University of Hamburg, Germany

**Revenue Breakdown**

**CEO**



## MANAGEMENT'S FINANCIAL DISCUSSION AND ANALYSIS

The following section contains forward-looking statements relating to revenues, expenditures and sufficiency of capital resources. Actual results may differ from those projected in the forward-looking statements for a number of reasons, including those described in the Risk Factors section below. The following discussion and analysis should be read in conjunction with the consolidated financial statements and accompanying notes contained in this annual report. All amounts are expressed in United States dollars unless otherwise noted.

### **Overview**

BakBone Software Incorporated (the Company) is an international storage management software company that develops and globally distributes storage management solutions to the open systems markets, providing data protection and management solutions scalable from workgroup to enterprise. Our corporate headquarters is located in San Diego, California. This facility houses executive management as well as sales, marketing, engineering, customer support and administrative departments. We maintain offices in Tokyo, Japan and Poole, Dorset, United Kingdom, whose primary activities surround the sales, marketing and administrative functions for the Asian and European regions, respectively. In addition, our United Kingdom and San Diego offices include engineering personnel responsible for the development effort of our NetVault core and NetVault Application Plug-in Module (APM) software products, respectively.

We have incurred operating losses and net losses since inception of our operations in March 2000. Our operating losses were \$7.0 million, \$12.3 million and \$19.1 million for the years ended March 31, 2003 and 2002 and the eleven months ended March 31, 2001, respectively. We expect to achieve profitability during fiscal 2004 as we expand our sales efforts worldwide, leverage our original equipment manufacturer (OEM) relationships, particularly in North America, and develop and enhance our current software product offerings. We have incurred an accumulated deficit of \$50.0 million through March 31, 2003.

Subsequent to the MagnaVault product line's "end of life", effective December 31, 2002, the Company develops and sells one main product, NetVault. The following is a brief discussion of the product.

### ***NetVault***

NetVault is a backup and recovery software that permits computer network administrators to maintain "backup" copies of documents, data, images and records so that they may be restored for access if files are lost or corrupted in the event of a future catastrophic local server or network failure. NetVault addresses the growing data storage needs of systems administrators across a wide range of storage topologies, including: Direct Attached Storage (DAS), Storage Area Networks (SAN), Network Attached Storage (NAS), Local Area Networks (LAN) and Wide Area Networks (WAN). NetVault's scalable, modular architecture meets the challenges of storage management for a wide variety of applications, including those used by firms worldwide such as, Oracle, Informix, DB2, SQL, Sybase and Microsoft Exchange.

NetVault is a fully functional software suite that offers several advantages over competitive products (such as Veritas' NetBackup and Legato's Networker). Recognizing the impact of emerging trends, NetVault was redesigned in 1999 to allow for the rapid and seamless integration of new features. From a business standpoint, this gives BakBone faster adaptations for new databases, operating systems and devices. This time to market in our dynamically changing industry is key for customers. From a user's standpoint, it allows for the addition of new features and enhancements without adding significant administrative burden.

### ***Target Markets***

BakBone's software can be used in virtually any industry where there is a need for electronic data or images to be backed up, archived or prepared for disaster recovery. The environments covered within those industries

range from workgroup, to departmental, to enterprise-wide. More specifically, within those environments, BakBone's product is targeted to networked storage, a market projected to constitute 70% of all data storage by the year 2006, according to an IDC December 2002 report. The growth of networked storage is due to the emergence of cost and performance efficiencies associated with NAS and SAN solutions, for which NetVault is designed.

### ***Technology Alliances***

One of BakBone's key areas of focus is working with complementary storage software and hardware vendors to assure smooth operation of our software with other solution devices. BakBone maintains an interoperability laboratory that is populated with an extensive array of hardware and software from all the leading storage vendors. To date, over 500 configurations have been tested and certified with BakBone software. Certified hardware includes drives and libraries including, but not limited to: HP, Hitachi, IBM, Panasonic, Quantum/ATL, Seagate, Sony, and StorageTek, as well as a variety of smaller storage manufacturers.

### ***Product Distribution***

We presently market our software and associated services indirectly to end-user customers through sales channels such as resellers, OEMs, solution providers, hardware distributors, application software vendors and systems integrators.

BakBone Software KK, located in Tokyo, Japan, distributes NetVault software in the Pacific Rim via distribution channels in Japan and other countries throughout Asia.

BakBone Software Ltd., located in the United Kingdom, distributes NetVault software in Europe, Africa and the Middle East.

BakBone Software Inc., located in the United States, distributes NetVault software throughout the United States, Canada and Latin America.

## **Operating Results**

**Our operating results for the year ended March 31, 2003 compared to the year ended March 31, 2002.**

### ***Revenues***

Revenues increased approximately 84%, to \$18.2 million for the year ended March 31, 2003, from \$9.9 million for the year ended March 31, 2002. Revenues for the year ended March 31, 2003 consisted of \$15.4 million in licensing revenues and \$2.8 million in service revenues, compared to revenues for the year ended March 31, 2002, which consisted of \$8.1 million in licensing revenues and \$1.8 million in service revenues.

### ***Licensing Revenues***

Our products are sold almost exclusively through our channel partners, value-added resellers (VARs), value-added distributors (VADs) and OEMs, in three geographic segments: North America, Asia and Europe. OEM revenues prior to fiscal 2003 were not significant, but they increased substantially in all regions due to our relationship with NCR Teradata (NCR). Substantially all of our OEM revenues to date have been derived from our worldwide relationship with NCR. We anticipate that OEM licensing revenues worldwide will continue to increase in absolute dollars and as a percentage of revenues as we expand our relationship with NCR, and with other newer OEM partners, such as Sony Electronics (Sony) and Network Appliance.

In North America, licensing revenues for the year ended March 31, 2003 increased approximately 97% to \$6.0 million, from \$3.0 million for the year ended March 31, 2002. Licensing revenues growth in North America

was driven by both the reseller and OEM channels. During fiscal 2003, we established many new reseller relationships, while leveraging existing relationships to grow our revenues through the reseller channel. Prior to fiscal 2003, North American OEM licensing revenues were relatively insignificant in terms of consolidated revenues, but fiscal 2003 experienced significant OEM licensing revenues growth. In addition to the fiscal 2003 OEM licensing revenues growth, we anticipate that we will recognize \$2.1 million in revenue in the first quarter of fiscal 2004 related to the arrangement signed with Sony in the fourth quarter of fiscal 2003. Based on the terms of this deal, the recognition of revenue was deferred pending completion of certain contract deliverables.

In Asia, licensing revenues for the year ended March 31, 2003 increased approximately 71% to \$6.3 million, from \$3.7 million for the year ended March 31, 2002. Similar to North America, Asia grew licensing revenues through both the reseller and OEM channels. The year ended March 31, 2003 was the first year in which Asia generated significant OEM revenues. This was due to the strength of our worldwide relationship with NCR, who accounted for a majority of Asia's OEM revenues during fiscal 2003. Additionally, expansion into new territories during fiscal 2003, including India and Kuala Lumpur, contributed to the increase in licensing revenues in fiscal 2003.

In Europe, licensing revenues for the year ended March 31, 2003 increased approximately 128% to \$3.1 million, from \$1.4 million for the year ended March 31, 2002. Increased sales to existing resellers, supplemented by sales to new resellers, and the maturation of our relationship with NCR, helped to drive revenues higher. Furthermore, licensing revenues increased due to the fact that we increased the significance of our operations in several territories, most notably Germany, during the year ended March 31, 2003.

### ***Service Revenues***

Service revenues consist principally of maintenance revenues derived from the sale of customer support contracts. These contract fees generally approximate 20% of the licensing fee. Revenues from customer support contracts are deferred and amortized on a straight-line basis over the life of the contract, generally one year.

In North America, service revenues for the year ended March 31, 2003 increased approximately 49% to \$1.5 million, from \$1.0 million for the year ended March 31, 2002. In Asia, service revenues for the year ended March 31, 2003 increased approximately 98% to \$710,000, from \$359,000 for the year ended March 31, 2002. In Europe, service revenues for the year ended March 31, 2003 increased approximately 45% to \$550,000, from \$379,000 for the year ended March 31, 2002. The worldwide increase in service revenues is directly related to the increased licensing revenues from sales to new customers and to maintenance contract renewals from existing customers.

### ***Cost of Revenues***

Cost of revenues for the year ended March 31, 2003 totaled \$1.7 million with a gross margin of 91%, compared with cost of revenues of \$1.2 million with a gross margin of 87% for the year ended March 31, 2002. These costs consisted primarily of the direct cost of providing customer support, including salary and benefits of staff working in our customer support departments as well as associated costs of computer equipment, telephone and other general costs necessary to maintain an adequate level of customer support to our end users. Also included in cost of revenues are the direct costs of raw materials and packaging for the products shipped to customers. These costs, however, are nominal as the products shipped to customers consist of a CD, manual, printed box and other media. Product costs for these items individually and in aggregate are minimal and we have little risk of inventory obsolescence due to the small quantities of these items needed to fill our customers' orders and the short lead time to acquire additional materials. Raw material purchases are held in inventory until the sale of the related software product at which time the cost per unit sold is released to cost of revenues.

The decrease in cost of revenues as a percent of total revenues for the year ended March 31, 2003 compared to the year ended March 31, 2002 was due primarily to the overall increase in service revenues. As cost of

revenues is comprised primarily of fixed customer support salaries, cost of revenues as a percent of total revenues is likely to decrease as revenues increase.

### ***Sales and Marketing Expenses***

Sales and marketing expenses consist primarily of payroll, commission, marketing, and travel costs for our worldwide sales staff. Sales and marketing expenses increased \$1.4 million, or 13%, to \$12.1 million for the year ended March 31, 2003, from \$10.8 million for the year ended March 31, 2002. The increase was attributed primarily to an increase in performance-based (i.e. commissions and bonuses) payments, which are a direct function of revenues. Headcount remained relatively stable, although the year ended March 31, 2003 experienced a slight increase in salaries expense due to the hiring of a VP of Sales and a VP of Marketing during fiscal 2003. Furthermore, our expansion into new territories, primarily in Asia and Europe, contributed to the increase.

Sales and marketing expenses as a percentage of total revenues for the year ended March 31, 2003 decreased to 67%, from 109% for the year ended March 31, 2002. The decrease was due primarily to the increase in total revenues.

### ***Research and Development Expenses***

Research and development expenses consist primarily of salary and related costs for our worldwide engineering staff. Research and development expenses increased \$442,000, or 10%, to \$5.0 million for the year ended March 31, 2003, from \$4.5 million for the year ended March 31, 2002. The overall increase was due primarily to increased salaries and travel-related expenditures. During the first six months of fiscal 2003, headcount was increased in order to facilitate the increase in NetVault product development and product sales volume. In November 2002, headcount was reduced in conjunction with the MagnaVault exit activities. Although headcount between March 31, 2003 and March 31, 2002 remained stable, year-over-year salary expense actually increased due to the aforementioned hiring that took place during the first half of the fiscal year. Additionally, increased travel-related costs surrounding off-site software testing activities added to the overall increase in research and development expenses.

Research and development expenses as a percentage of total revenues for the year ended March 31, 2003 decreased to 27%, from 46% for the year ended March 31, 2002. The decrease was due primarily to the increase in total revenues.

### ***General and Administrative Expenses***

General and administrative expenses include salaries and benefits for our corporate personnel and other expenses, such as facilities costs and professional services. General and administrative expenses increased \$51,000, or 1%, during the year ended March 31, 2003. The slight increase in general and administrative expenses relates primarily to increases in payroll and insurance premiums, as well as to a charge relating to the administration of an employee stock program. Although headcount remained stable, salary and related costs increased slightly due to annual compensation increases. Recent national and global events have caused insurance premiums to increase leading to an increase in our insurance costs. Finally, we incurred an operating charge related to the administration of an employee stock program, which was established in March 2000 as a retention tool for key personnel associated with an acquired entity. We had not incurred such a charge prior to fiscal 2003.

General and administrative expenses as a percentage of total revenues for the year ended March 31, 2003 decreased to 31%, from 57% for the year ended March 31, 2002. The decrease was due primarily to the increase in total revenues.

### ***Stock-based Compensation***

Effective April 1, 2002, we adopted the Canadian Institute of Chartered Accountants Handbook (CICA) Section 3870, *Stock-based Compensation and Other Stock-based Payments* (Section 3870), under which we are required to apply a fair value-based method of accounting for all stock-based payments issued to non-employees and all direct awards of stock to employees. We continue to use settlement date accounting to account for employee stock options.

During the year ended March 31, 2003, we recognized \$326,000 in stock-based compensation expense in connection with the issuance of warrants to non-employees for services they rendered to us. The fair value of these warrants was calculated using the Black-Scholes option pricing model and was recorded as stock-based compensation expense during the year ended March 31, 2003.

### ***Special Charges***

In November 2002, we undertook a plan to cease all activities, with the exception of customer support, related to the MagnaVault product offering. In connection with the MagnaVault exit activities, we recorded a charge of \$415,000 during the year ended March 31, 2003. The charge was comprised of expenses related to employee severance of \$87,000, idle facility costs of \$192,000 and fixed asset impairment and other exit costs totaling \$136,000.

### ***Amortization of Goodwill***

Effective April 1, 2002 and pursuant to CICA Section 3062, *Goodwill and Other Intangible Assets* (CICA Section 3062), goodwill is no longer amortized, but is reviewed at least annually for impairment. Therefore, we incurred no amortization expense during the year ended March 31, 2003 compared to \$3.7 million during the year ended March 31, 2002.

### ***Impairment of Goodwill***

We recorded goodwill impairment charges of \$888,000 and \$2.5 million for the years ended March 31, 2003 and 2002, respectively. The impairment charges in fiscal 2003 and 2002 related to goodwill recorded in connection with our acquisition of the MagnaVault intellectual property.

In connection with the acquisition of Tracer, we acquired exclusive intellectual property rights to MagnaVault. From the initial acquisition date in June 2000, through the MagnaVault "end of life" in December 2002, we marketed and sold MagnaVault as a stand-alone software product. MagnaVault revenues were flat during the first three quarters of fiscal 2002, with a notable decrease during the fourth quarter of the same fiscal year. Based on MagnaVault's results of operations during the fourth quarter of fiscal 2002, we performed an impairment analysis of the MagnaVault-related goodwill, which resulted in an impairment charge of \$2.5 million in the year ended March 31, 2002, reflecting the difference between the carrying value and projected discounted future cash flows from the MagnaVault product line.

During the first two quarters of fiscal 2003, despite our efforts to revitalize MagnaVault's operations by allocating additional resources to MagnaVault, total revenues generated from MagnaVault experienced a continued decline. This trend continued into the third quarter of fiscal 2003, and in November 2002, management decided to "end of life" the MagnaVault product line, whereby all activities, with the exception of customer support, related to MagnaVault would cease permanently, effective December 31, 2002. In connection with this decision, we terminated several employees and closed our Maryland office facility. Based on this triggering event, in accordance with CICA Section 3062, we performed an impairment analysis on the MagnaVault-related goodwill as of December 31, 2002. The first step in the impairment analysis involved comparing the carrying values of the MagnaVault reporting units to their fair values. It was determined that the carrying values of the reporting units exceeded the estimated fair values, consequently, step two of the impairment test was required.

As a result of step two, the related goodwill was deemed impaired and we recognized a charge of \$442,000 in the third quarter of fiscal 2003. This charge represented the amount by which the goodwill's carrying value exceeded its estimated fair value, a component of which related to the estimated terminal value of the MagnaVault intellectual property (MagnaVault IP). During the third quarter of fiscal 2003, we began negotiations with a third party to sell the MagnaVault IP. As of December 31, 2002, it appeared likely that the sale of the MagnaVault IP would be consummated. The negotiations continued into the fourth quarter of fiscal 2003; however, as of March 31, 2003, management believed the probability of a successful sale of the MagnaVault IP to the aforementioned third party to be unlikely. Based on this triggering event, we performed an additional impairment analysis, following the steps outlined above, on the MagnaVault-related goodwill. As a result of the additional analysis, the related goodwill was deemed impaired and we recognized a charge of \$446,000 in the fourth quarter of fiscal 2003. This charge represented the remaining carrying value of the MagnaVault-related goodwill.

#### ***Provision for income taxes***

During the year ended March 31, 2003, we recognized a provision for income taxes related to transactions between our foreign subsidiaries. Certain transactions between our foreign subsidiaries trigger tax liabilities in the respective jurisdictions in which we do business. Income taxes arising out of these transactions were immaterial during the year ended March 31, 2002.

#### **Our operating results for the year ended March 31, 2002 compared to the eleven months ended March 31, 2001.**

#### ***Revenues***

Revenues for the year ended March 31, 2002 were \$9.9 million, consisting of \$8.1 million in licensing revenues and \$1.8 million in service revenues. Comparatively, revenues for the eleven months ended March 31, 2001 were \$5.0 million, consisting of \$4.2 million in licensing revenues and \$789,000 in service revenues.

#### ***Licensing Revenues***

Our products are sold almost exclusively through our channel partners, VARs, VADs and OEMs, in three geographic segments: Asia, North America and Europe. Asia, North America and Europe contributed \$3.7 million, \$3.0 million and \$1.4 million, respectively, of licensing revenues during the year ended March 31, 2002. During the eleven months ended March 31, 2001, Asia, North America and Europe contributed \$2.5 million, \$1.3 million and \$400,000, respectively.

During the year ended March 31, 2002 and the eleven months ended March 31, 2001, our Asian operations provided 46% and 60% of total licensing revenues, respectively. Asian revenues increased \$1.2 million, or 48%, in fiscal 2002 due to continued market acceptance of NetVault software in Japan and to expansion into new territories including: China, Korea and Vietnam. As of March 31, 2002, these new territories were directed from one office in Tokyo, Japan.

During the year ended March 31, 2002 and the eleven months ended March 31, 2001, our North American operations provided 37% and 30% of total licensing revenues, respectively. North American licensing revenues increased \$1.8 million, or 137%, resulting primarily from the growth in our North American NetVault sales force and the increased market acceptance of NetVault. We began establishing our partner channels for NetVault in North America in July 2000 and as of March 31, 2001, we had executed partner agreements with over 50 VAR/VAD partners, and grew the number of VAR/VAD partners to 70 by March 31, 2002. Furthermore, as we first introduced NetVault in North America in August 2000, the year ended March 31, 2002 contained 12 months of NetVault sales, whereas the eleven months ended March 31, 2001 contained only eight months of NetVault sales. Average monthly sales were \$252,000 and \$160,000 for the year ended March 31, 2002 and the eleven months ended March 31, 2001, respectively. The increase in average monthly revenue coincides with the overall revenue growth trend in North America.

During the year ended March 31, 2002 and the eleven months ended March 31, 2001, our European operations provided 17% and 10% of total licensing revenues, respectively. These revenues resulted almost entirely from sales of NetVault and were generated from our sales office in Poole, Dorset, United Kingdom. European revenues increased \$957,000, or 240%, resulting from increased sales in all regions of Europe, as well as from expansion into Israel and South Africa during the year ended March 31, 2002.

### ***Service Revenues***

North America, Asia and Europe contributed \$1.0 million, \$359,000 and \$379,000, respectively, for service revenues for the year ended March 31, 2002.

During the year ended March 31, 2002, service revenues generated in North America, European and Asian regions were 58%, 22% and 20% of total service revenues, respectively. During the eleven months ended March 31, 2001, service revenues generated in the North America, European and Asian regions were 40%, 35% and 25%, respectively. The increase noted in North American service revenues as a percent of total service revenues resulted from a combination of the first full year of maintenance services being provided to North American customers and the first maintenance contract renewals.

As of March 31, 2002, NetVault and MagnaVault were supported from our offices in North America, Europe and Asia.

### ***Cost of Revenues***

Cost of revenues totaled \$1.2 million and \$782,000, or 13% and 16% of total revenues, during the year ended March 31, 2002 and the eleven months ended March 31, 2001, respectively.

The decrease in cost of revenues as a percent of total revenues resulted from a combination of higher average revenue per client service representative, increased efficiencies in distributing and supporting our software products, and reduced customer service headcount during the year ended March 31, 2002.

### ***Sales and Marketing Expenses***

Sales and marketing expenses totaled \$10.8 million and \$11.7 million, or 109% and 235% of total revenues, during the year ended March 31, 2002 and the eleven months ended March 31, 2001, respectively. Sales and marketing expenses remained relatively consistent between the two periods. However, additional resources were expended during the eleven months ended March 31, 2001 to introduce the NetVault product in North America. Our efforts to introduce NetVault and promote MagnaVault in North America during the eleven months ended March 31, 2001 led to substantial spending in advertising and public relations. We engaged in similar activities during the year ended March 31, 2002, albeit to a lesser extent.

The decrease in sales and marketing expenses as a percentage of total revenues was primarily a function of revenue growth during the year ended March 31, 2002, as total sales and marketing expenses in dollars remained fairly consistent. Thus, to the extent that revenues increase, we expect that sales and marketing expense will decrease as a percentage of total revenues.

### ***Research and Development Expenses***

Research and development expenses totaled \$4.5 million and \$3.6 million, or 46% and 72% of total revenues, during the year ended March 31, 2002 and the eleven months ended March 31, 2001, respectively. The decrease in research and development expenses as a percentage of revenues was due primarily to the increase in revenue between the year ended March 31, 2002 and the eleven months ended March 31, 2001.

The increase in total dollars spent on research and development activities during the year ended March 31, 2002 was due to increased average monthly headcount and increased expenditures related to travel, as we increased our focus on sales engineer client site visits during the year ended March 31, 2002. The majority of our engineering efforts are carried out in the United States and United Kingdom; these locations are responsible for the ongoing development and testing of our products. Engineering efforts in Japan are minimal and relate to creating functionality and interface capabilities for users in the Asian region.

#### ***General and Administrative Expenses***

General and administrative expenses totaled \$5.7 million and \$8.0 million, or 57% and 162% of total revenues, during the year ended March 31, 2002 and the eleven months ended March 31, 2001, respectively. General and administrative expenses consisted primarily of salary and related costs for our 29 executive and administrative employees throughout our worldwide offices as of March 31, 2002, which decreased from 32 employees as of March 31, 2001. The headcount and expense decrease was partially attributable to the departure from the company of several highly compensated individuals. In addition, during the eleven months ended March 31, 2001, we incurred higher levels of both computer systems and corporate structure related consulting fees, as well as higher intellectual property related legal fees than we did during the year ended March 31, 2002. During the eleven months ended March 31, 2001, we implemented a new accounting system and expended significant resources on securing and protecting our intellectual property.

#### ***Amortization of Goodwill***

Amortization of goodwill totaled \$3.7 million and \$3.2 million for the year ended March 31, 2002 and the eleven months ended March 31, 2001, respectively. The increase in amortization of goodwill was due primarily to the fact that the year ended March 31, 2002 contained 12 months of amortization related to the \$8.5 million of goodwill recorded in connection with the acquisition of Tracer in June 2000, where the eleven months ended March 31, 2001 contained only 10 months of amortization.

#### ***Impairment of Goodwill***

We recorded goodwill of \$8.5 million relating to the acquisition of Tracer in June 2000, \$99,000 relating to the 25% minority interest acquisition of Tracer KK in January 2002, and \$3.1 million relating to the 53% minority interest acquisition of BakBone KK in March of 2002.

In connection with the acquisition of Tracer, we acquired exclusive intellectual property rights to MagnaVault. Since the initial acquisition date, we marketed and sold MagnaVault as a stand-alone software product. MagnaVault revenues were flat during the first three quarters of the year ended March 31, 2002, with a notable decrease during the fourth quarter of the year ended March 31, 2002. Based on MagnaVault's results of operations during the fourth quarter of the year ended March 31, 2002, we performed an impairment analysis of the MagnaVault-related goodwill. As of March 31, 2002, we determined that the carrying value of the MagnaVault-related goodwill exceeded fair value as determined by the estimated discounted cash flows expected to be generated by the underlying assets. Therefore, we recorded an impairment charge of \$2.5 million in the accompanying consolidated statement of operations for the year ended March 31, 2002, reflecting the difference between the carrying value and discounted projected future cash flows.

## Quarterly Results of Operations

The following tables present certain unaudited statement of operations data for each of our last eight fiscal quarters and the percentage relationship of certain items to total revenue for the respective periods. This unaudited data has been prepared on the same basis as the audited financial statements and, in the opinion of management, contains all adjustments, consisting only of normal recurring adjustments, necessary for a fair presentation of such data.

	Quarter Ended							
	2003				2002			
	Mar-03	Dec-02	Sep-02	Jun-02	Mar-02	Dec-01	Sep-01	Jun-01
	<i>(in thousands)</i>							
Revenues . . . . .	\$ 5,604	\$ 4,932	\$ 4,024	\$ 3,630	\$ 3,087	\$ 2,869	\$ 2,286	\$ 1,621
Cost of revenues . . . . .	534	405	390	321	326	324	293	301
Gross profit . . . . .	<u>5,070</u>	<u>4,527</u>	<u>3,634</u>	<u>3,309</u>	<u>2,761</u>	<u>2,545</u>	<u>1,993</u>	<u>1,320</u>
Operating expenses:								
Sales and marketing . . . . .	3,068	3,025	2,893	3,139	2,733	2,596	2,639	2,782
Research and development . . . . .	1,146	1,233	1,343	1,241	1,181	1,107	1,110	1,123
General and administrative . . . . .	1,504	1,407	1,431	1,368	1,507	1,091	1,464	1,597
Stock-based compensation . . . . .	—	—	(70)	396	—	—	—	—
Special charges . . . . .	—	415	—	—	—	—	—	—
Total operating expenses . . . . .	<u>5,718</u>	<u>6,080</u>	<u>5,597</u>	<u>6,144</u>	<u>5,421</u>	<u>4,794</u>	<u>5,213</u>	<u>5,502</u>
Operating loss . . . . .	(648)	(1,553)	(1,963)	(2,835)	(2,660)	(2,249)	(3,220)	(4,182)
Interest expense, net . . . . .	(83)	(38)	(32)	(29)	(34)	(60)	(9)	(5)
Amortization of goodwill . . . . .	—	—	—	—	(931)	(933)	(933)	(930)
Impairment of goodwill . . . . .	(446)	(442)	—	—	(2,508)	—	—	—
Foreign exchange (loss) gain, net . . . . .	(24)	(29)	(15)	9	95	(14)	5	24
Other (expense) income, net . . . . .	(7)	(10)	(1)	(1)	(431)	4	(5)	73
Minority interest . . . . .	—	—	—	—	12	42	45	13
Loss before income taxes . . . . .	(1,208)	(2,072)	(2,011)	(2,856)	(6,457)	(3,210)	(4,117)	(5,007)
Provision for income taxes . . . . .	385	79	24	22	—	—	—	—
Net loss . . . . .	<u><u>\$(1,593)</u></u>	<u><u>\$(2,151)</u></u>	<u><u>\$(2,035)</u></u>	<u><u>\$(2,878)</u></u>	<u><u>\$(6,457)</u></u>	<u><u>\$(3,210)</u></u>	<u><u>\$(4,117)</u></u>	<u><u>\$(5,007)</u></u>

	Quarter Ended							
	2003				2002			
	Mar-03	Dec-02	Sep-02	Jun-02	Mar-02	Dec-01	Sep-01	Jun-01
Revenues .....	100%	100%	100%	100%	100%	100%	100%	100%
Gross profit .....	90%	92%	90%	91%	90%	89%	87%	81%
Operating expenses:								
Sales and marketing .....	55%	61%	72%	86%	89%	90%	115%	172%
Research and development .....	20%	25%	33%	34%	38%	39%	49%	69%
General and administrative .....	27%	29%	36%	38%	49%	38%	64%	99%
Stock-based compensation .....	—	—	-2%	11%	—	—	—	—
Special charges .....	—	8%	—	—	—	—	—	—
Total operating expenses .....	102%	123%	139%	169%	176%	167%	228%	340%
Operating loss .....	-12%	-31%	-49%	-78%	-86%	-78%	-141%	-259%
Interest expense, net .....	-2%	-1%	-1%	-1%	-1%	-2%	—	—
Amortization of goodwill .....	—	—	—	—	-30%	-33%	-41%	-57%
Impairment of goodwill .....	-8%	-9%	—	—	-81%	—	—	—
Foreign exchange (loss) gain, net .....	—	-1%	—	—	3%	—	—	1%
Other (expense) income, net .....	—	—	—	—	-14%	—	—	5%
Minority interest .....	—	—	—	—	—	1%	2%	1%
Loss before income taxes .....	-22%	-42%	-50%	-79%	-209%	-112%	-180%	-309%
Provision for income taxes .....	7%	2%	1%	—	—	—	—	—
Net loss .....	-29%	-44%	-51%	-79%	-209%	-112%	-180%	-309%

## Liquidity and Capital Resources

We have financed our operations primarily through private placements and public offerings of equity instruments in the Provinces of British Columbia, Alberta and Ontario, Canada. During the year ended March 31, 2003, we raised gross proceeds of \$1.1 million through the private placement of 1,917,788 units at a price of \$0.56 per unit. Each unit was comprised of one common share and one-half common share purchase warrant. We also raised \$1.3 million during the year ended March 31, 2003, through the exercise of 1,268,747 warrants at a weighted average price of \$1.04. During the year ended March 31, 2002, we raised gross proceeds of \$9.7 million through the private placement of 3,000,000 Special Warrants at a price of \$3.24 per Special Warrant. Additionally, during the year ended March 31, 2002, we completed a public offering of 7,170,400 units at a price of \$0.80 per unit for gross proceeds of \$5.7 million. Each unit was comprised of one common share and one-quarter common share purchase warrant. During the eleven months ended March 31, 2001, we raised gross proceeds of \$4.5 million through the exercise of 3,694,934 warrants at a weighted average price of \$1.23 per warrant, and we entered into a line of credit with a bank that provided us with \$2.5 million in net borrowings during the eleven months ended March 31, 2001.

Net cash used in operating activities was \$3.1 million and \$12.7 million during the years ended March 31, 2003 and 2002, respectively. Cash used in operating activities during the year ended March 31, 2003 included a net loss of \$8.7 million, partially offset by non-cash depreciation of \$899,000, impairment of goodwill of \$888,000, stock-based compensation of \$326,000 and non-cash special charges of \$104,000. Other operating activities that contributed to the use of cash during the year ended March 31, 2003 included increases in accounts receivable of \$1.5 million and other assets of \$262,000. Operating activities providing sources of cash included increases in accounts payable, accrued liabilities and deferred revenue of \$220,000, \$1.1 million and \$3.9 million, respectively. Cash used in operating activities during the year ended March 31, 2002 resulted from a net loss of \$18.8 million, partially offset by non-cash depreciation and amortization of \$4.6 million and impairment of goodwill of \$2.5 million. Other operating activities that contributed to the use of cash during the year ended March 31, 2002 included increases in accounts receivable of \$1.9 million and other assets of \$10,000, and a

decrease in accounts payable of \$723,000. Providing sources of cash were increases in accrued liabilities of \$647,000 and deferred revenue of \$626,000. The overall decrease in cash used in operating activities of \$9.6 million during the year ended March 31, 2003 from the year ended March 31, 2002, is due primarily to an 84 percent increase in revenues coupled with an operating expense increase of only 12 percent. We expect this trend to continue as we grow revenues while holding operating expenses relatively stable.

Net cash used in investing activities was \$413,000 and \$509,000 during the years ended March 31, 2003 and March 31, 2002, respectively. Net cash used in investing activities during the year ended March 31, 2003 included \$415,000 of capital expenditures related to our expansion into new geographic locations. Net cash used in investing activities during the year ended March 31, 2002, consisted partially of capital expenditures of \$433,000, which related primarily to the purchase of computer equipment. Cash expended in connection with the January 2002 minority interest acquisition of Tracer KK accounted for \$117,000 of cash used in investing activities.

Net cash provided by financing activities was \$2.7 million and \$15.1 million during the years ended March 31, 2003 and March 31, 2002, respectively. Cash provided by financing activities during the year ended March 31, 2003 consisted primarily of gross proceeds from a private placement of \$1.1 million, and from warrant exercises of \$1.3 million. Other sources of cash from financing activities included \$804,000 from the release of restricted cash and \$144,000 from the exercise of stock options. Uses of cash for financing activities included \$202,000 in capital lease payments, \$298,000 in payments on a note payable, \$75,000 in costs related to the private placement and \$63,000 of payments on related party notes payable. Net cash provided by financing activities during the year ended March 31, 2002 consisted primarily of gross proceeds from special warrants of \$9.7 million, gross proceeds from a public warrant offering of \$5.7 million, and gross proceeds from a private placement of \$332,000. The proceeds were partially offset by cash used in financing activities consisting mainly of the payment of notes payable of \$812,000, the payment of equity offering costs of \$507,000, and the payment of capital lease obligations of \$177,000.

The following summarizes BakBone's contractual obligations at March 31, 2003 (in thousands).

	<u>Total</u>	<u>Less Than One Year</u>	<u>1-3 Years</u>	<u>4-5 Years</u>	<u>After 5 Years</u>
<b>CONTRACTUAL OBLIGATIONS:</b>					
Note payable (1) .....	\$1,652	1,652	—	—	—
Capital lease obligations .....	\$ 142	97	45	—	—
Non-cancelable operating lease obligations .....	\$3,883	1,566	1,646	319	352

(1) Under our note payable arrangement, an amount equal to 10% of the net proceeds raised from any of our financings through December 2003 is to be paid to the credit provider in the form of principal reductions.

We currently expect to fund expenditures for capital requirements as well as liquidity needs from a combination of available cash balances, internally generated funds and financing arrangements. We believe that existing cash and cash equivalents will be sufficient to meet our anticipated cash needs through the current fiscal year. In fact, the fourth quarter in fiscal 2003 was the first operating cash flow positive quarter in our history. Additionally, we recently entered into a non-binding letter of intent with a third party venture capital firm (VC Firm), pursuant to which we expect to, by way of private placement, issue to the VC Firm an aggregate of approximately 22,000,000 Series A preferred shares at CDN\$1.00 per preferred share. The closing of the private placement is not guaranteed by the letter of intent and is subject to requisite regulatory and shareholder approval. However, in the event that the aforementioned private placement does not close and cash generated from operations is insufficient to satisfy our liquidity requirements, we may seek additional sources of funding. We are currently a party to a term note with a bank that matures on December 31, 2003. Internally generated funds may not be sufficient to cover the Company's liquidity requirements, and in that case, we may be required to obtain additional credit facilities from either our existing credit facility provider or others. Additional debt would result in increased interest expenses and could result in covenants that would restrict our operations. Additionally, a

decrease in demand for our products and services could adversely affect our business, which in turn, could adversely affect our ability to renew existing, or obtain access to new credit facilities in the future and could increase the cost of such facilities. We may also seek additional sources of funding, including the public or private issuance of equity instruments; however, there is no guarantee that such sources will be available in amounts or on terms acceptable to us, if available at all. The sale of additional equity securities would result in immediate and potentially significant dilution to our shareholders.

Estimated future uses of cash in fiscal 2004 include capital expenditures for equipment of approximately \$525,000.

At March 31, 2003, we did not have any relationships with unconsolidated entities or financial partnerships, such as entities often referred to as structured finance or special purpose entities, which would have been established for the purpose of facilitating off-balance sheet arrangements or other contractually narrow or limited purposes. In addition, we did not engage in trading activities involving on-exchange traded contracts. As a result, we are not exposed to any financing, liquidity, market or credit risk that could arise if we had engaged in such relationships. We do not have relationships and transactions with persons or entities that derive benefits from their non-independent relationship with us or our related parties except as disclosed herein.

### **Inflation and Changing Prices**

Inflation and changing prices have not had a material impact on our operations.

### **Foreign Currency**

Our revenues result mainly from sales made in U.S. dollars, British pounds and Japanese yen. We will continue to incur operating costs mainly in U.S. dollars, British pounds, Japanese yen and, to a lesser extent, Canadian dollars. Thus, our operations are susceptible to fluctuations in currency exchange rates. We do not currently engage in hedging or other activities to reduce exchange rate risk but may do so in the future, if conditions warrant.

## **Risk Factors**

The Company is subject to each of, and the cumulative effect of all of, the following risk factors:

- Competition in our target markets could reduce our sales on several fronts;
- We may require additional capital and raising such capital will dilute our shareholders' ownership interest in us;
- Our revenues will decline significantly if the market does not continue to accept our NetVault product;
- We derive a significant amount of revenues from only a few customers;
- Failure to manage our growth could adversely affect our business;
- Inability to protect our technologies could affect our ability to compete;
- Inability to protect our proprietary information will adversely affect our business;
- Our products have a short product life cycle;
- Our foreign operations and sales create unique challenges that could adversely affect our operating results;
- Our success depends on our ability to develop new and enhanced products that achieve widespread market acceptance;
- Our quarterly revenue may fluctuate significantly, which could cause the market price of our stock to be extremely volatile;
- Existing strategic alliances may be terminated and we may be unable to develop new relationships;
- Our products may contain significant defects, which may result in liability and/or decreased sales;
- Evolving regulation of corporate governance and public disclosure may result in additional expenses and continuing uncertainty;
- We may be unable to hire and retain qualified employees; and
- We rely on competing equipment manufacturers as a material source of revenues.

## MANAGEMENT'S REPORT

The financial statements of BakBone and the other financial information included in this annual report are the responsibility of the Company's management and have been examined and approved by its Board of Directors. These financial statements have been prepared by management in accordance with generally accepted accounting principles in Canada and include some amounts that are based on management's best estimates using careful judgment. The selection of accounting principles and methods is management's responsibility.

The Company maintains internal systems designed to ensure that financial information is relevant and accurate and that assets are safeguarded. Management recognizes its responsibility for conducting the Company's affairs to comply with the requirements of applicable laws and established financial standards and principles, and for maintaining proper standards of conduct in its activities.

The Board of Directors supervises the financial statements and other financial information through its Audit Committee, which consists solely of outside directors.

This committee's role is to examine the financial statements and recommend that the Board of Directors approve them, to examine the internal control and information protection systems and all other matters relating to the Company's accounting and finances. In order to do so, the Audit Committee meets periodically with the external auditors, with and without the Company's management, to review their audit plan and discuss the results of their examinations.

KPMG LLP has audited the financial statements in accordance with generally accepted accounting standards. KPMG LLP is the external auditor who was appointed by the shareholders. KPMG LLP has full and unrestricted access to the Audit Committee to discuss their audit and related findings as to the integrity of the Company's financial reporting.

/s/ KEITH RICKARD

Keith Rickard

President and Chief Executive Officer

/s/ JOHN FITZGERALD

John Fitzgerald

Chief Financial Officer

## AUDITORS' REPORT

To the Shareholders  
BakBone Software Incorporated:

We have audited the consolidated balance sheets of BakBone Software Incorporated (the Company) as of March 31, 2003 and 2002, and the related consolidated statements of operations, shareholders' equity, and cash flows for the years ended March 31, 2003 and 2002 and the eleven months ended March 31, 2001. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in Canada and the United States of America. Those standards require that we plan and perform an audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the Company as of March 31, 2003 and 2002, and the results of its operations and its cash flows for the years ended March 31, 2003 and 2002 and the eleven months ended March 31, 2001, in accordance with Canadian generally accepted accounting principles.

KPMG LLP

Calgary, Canada  
May 9, 2003

**BAKBONE SOFTWARE INCORPORATED**  
**CONSOLIDATED BALANCE SHEETS**

**March 31, 2003 and 2002**

(in thousands, except share data)

(in U.S. dollars)

	<b>2003</b>	<b>2002</b>
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents .....	\$ 5,045	\$ 5,502
Restricted cash .....	—	804
Accounts receivable, net of allowance for doubtful accounts of \$87 and \$72, respectively .....	4,822	3,289
Other assets .....	850	588
Total current assets .....	10,717	10,183
Capital assets, net (Notes 3 and 14) .....	2,239	2,762
Goodwill, net (Notes 4 and 14) .....	3,982	4,784
Other assets .....	567	567
Total assets .....	\$ 17,505	\$ 18,296
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
Current liabilities:		
Accounts payable .....	\$ 865	\$ 645
Accrued liabilities .....	3,017	1,938
Deferred revenue .....	5,152	1,297
Current portion of capital lease obligations (Note 13) .....	97	201
Current portion of note payable (Note 11) .....	1,652	—
Loans from related parties .....	—	63
Total current liabilities .....	10,783	4,144
Capital lease obligations, excluding current portion (Note 13) .....	45	54
Note payable, excluding current portion (Note 11) .....	—	1,950
Other liabilities .....	24	—
Total liabilities .....	10,852	6,148
Shareholders' equity:		
Share capital, no par value, unlimited shares authorized, 58,625,216 and 53,121,681 shares issued and outstanding, respectively .....	57,524	51,861
Share capital to be issued .....	—	2,877
Share capital held by subsidiary .....	(66)	(66)
Accumulated deficit .....	(50,036)	(41,379)
Cumulative exchange adjustment .....	(769)	(1,145)
Total shareholders' equity .....	6,653	12,148
Commitments and contingencies (Notes 10, 13 and 15)		
Total liabilities and shareholders' equity .....	\$ 17,505	\$ 18,296

See accompanying notes to consolidated financial statements.

**BAKBONE SOFTWARE INCORPORATED**  
**CONSOLIDATED STATEMENTS OF OPERATIONS**

**Years ended March 31, 2003 and 2002**  
**and the eleven months ended March 31, 2001**

(in thousands, except per share and share data)  
(in U.S. dollars)

	<u>2003</u>	<u>2002</u>	<u>2001</u>
Revenues (Note 14) . . . . .	\$ 18,190	\$ 9,863	\$ 4,975
Cost of revenues . . . . .	<u>1,650</u>	<u>1,244</u>	<u>782</u>
Gross profit . . . . .	<u>16,540</u>	<u>8,619</u>	<u>4,193</u>
Operating expenses:			
Sales and marketing . . . . .	12,125	10,750	11,672
Research and development . . . . .	4,963	4,521	3,584
General and administrative (excluding \$326, \$0, and \$0 of stock-based compensation) . . . . .	5,710	5,659	8,044
Stock-based compensation (Note 7) . . . . .	326	—	—
Special charges (Note 9) . . . . .	<u>415</u>	<u>—</u>	<u>—</u>
Total operating expenses . . . . .	<u>23,539</u>	<u>20,930</u>	<u>23,300</u>
Operating loss . . . . .	(6,999)	(12,311)	(19,107)
Interest (expense) income, net . . . . .	(182)	(108)	396
Amortization of goodwill (Note 4) . . . . .	—	(3,727)	(3,203)
Impairment of goodwill (Note 4) . . . . .	(888)	(2,508)	—
Foreign exchange (loss) gain, net . . . . .	(59)	110	5
Other (expense) income, net . . . . .	(19)	(359)	177
Minority interest . . . . .	<u>—</u>	<u>112</u>	<u>40</u>
Loss before income taxes . . . . .	(8,147)	(18,791)	(21,692)
Provision for income taxes (Note 8) . . . . .	<u>510</u>	<u>—</u>	<u>—</u>
Net loss . . . . .	<u>\$ (8,657)</u>	<u>\$ (18,791)</u>	<u>\$ (21,692)</u>
Loss per share—basic and diluted . . . . .	<u>\$ (0.16)</u>	<u>\$ (0.46)</u>	<u>\$ (0.87)</u>
Weighted-average common shares . . . . .	<u>53,259,938</u>	<u>40,869,526</u>	<u>24,903,458</u>

See accompanying notes to consolidated financial statements.

**BAKBONE SOFTWARE INCORPORATED**  
**CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY**

Years ended March 31, 2003 and 2002  
and the eleven months ended March 31, 2001

(in thousands, except share data)  
(in U.S. dollars)

	Share Capital		Share Capital to be Issued		Share Capital Held by Subsidiary	Accumulated Deficit	Special Warrants	Cumulative Exchange Adjustment	Total Shareholders' Equity
	Shares	Amount	Shares	Amount					
BALANCE, APRIL 30, 2000	27,423,030	\$ 60	—	\$ —	\$—	\$ (896)	\$24,357	\$(285)	\$23,236
Exercise of stock options	303,958	570	—	—	—	—	—	—	570
Conversion of special warrants and remaining issuance costs	9,726,000	24,213	—	—	—	—	(24,357)	—	(144)
Exercise of warrants	3,694,934	4,536	—	—	—	—	—	—	4,536
Issued to acquire Tracer	600,000	6,464	—	—	—	—	—	—	6,464
Share capital held by subsidiary	—	—	—	—	(66)	—	—	—	(66)
Cumulative exchange adjustment	—	—	—	—	—	—	—	(675)	(675)
Net loss	—	—	—	—	—	(21,692)	—	—	(21,692)
BALANCE, MARCH 31, 2001	41,747,922	35,843	—	—	(66)	(22,588)	—	(960)	12,229
Exercise of stock options	13,000	9	—	—	—	—	—	—	9
Sale of special warrants, net of issuance costs	—	—	—	—	—	—	9,706	—	9,706
Conversion of special warrants	3,000,000	9,706	—	—	—	—	(9,706)	—	—
Issued in public share offering, net of issuance costs	7,170,400	5,212	—	—	—	—	—	—	5,212
Issued in private placement, net of issuance costs	440,834	322	—	—	—	—	—	—	322
Exercise of warrants	749,525	769	—	—	—	—	—	—	769
Issued to acquire remaining interest in BakBone KK	—	—	2,100,000	2,877	—	—	—	—	2,877
Cumulative exchange adjustment	—	—	—	—	—	—	—	(185)	(185)
Net loss	—	—	—	—	—	(18,791)	—	—	(18,791)
BALANCE, MARCH 31, 2002	53,121,681	51,861	2,100,000	2,877	(66)	(41,379)	—	(1,145)	12,148
Exercise of stock options	217,000	144	—	—	—	—	—	—	144
Issued in private placement, net of issuance costs	1,917,788	1,000	—	—	—	—	—	—	1,000
Exercise of warrants	1,268,747	1,316	—	—	—	—	—	—	1,316
Issued to acquire remaining interest in BakBone KK	2,100,000	2,877	(2,100,000)	(2,877)	—	—	—	—	—
Stock-based compensation	—	326	—	—	—	—	—	—	326
Cumulative exchange adjustment	—	—	—	—	—	—	—	376	376
Net loss	—	—	—	—	—	(8,657)	—	—	(8,657)
BALANCE, MARCH 31, 2003	58,625,216	\$57,524	—	\$ —	\$(66)	\$(50,036)	\$ —	\$(769)	\$ 6,653

See accompanying notes to consolidated financial statements.

**BAKBONE SOFTWARE INCORPORATED**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**

**Years ended March 31, 2003 and 2002**  
**and the eleven months ended March 31, 2001**

(in thousands)  
(in U.S. dollars)

	<b>2003</b>	<b>2002</b>	<b>2001</b>
Cash flows from operating activities:			
Net loss .....	\$(8,657)	\$(18,791)	\$(21,692)
Adjustments to reconcile net loss to net cash used in operating activities:			
Depreciation and amortization .....	899	4,637	3,788
Stock-based compensation .....	326	—	—
Non-cash special charges .....	104	—	—
Impairment of goodwill .....	888	2,508	—
Minority interest .....	—	(112)	(40)
Loss on disposal of capital assets .....	—	443	13
Gain on sale of non-operating subsidiaries .....	—	(119)	—
Unrealized loss on investment .....	—	76	—
Changes in assets and liabilities, net of effects of acquisitions:			
Accounts receivable, net .....	(1,533)	(1,885)	(363)
Other assets .....	(262)	(10)	(568)
Accounts payable .....	220	(723)	190
Accrued liabilities .....	1,103	647	417
Deferred revenue .....	3,855	626	273
Net cash used in operating activities .....	(3,057)	(12,703)	(17,982)
Cash flows from investing activities:			
Capital expenditures .....	(415)	(433)	(3,011)
Cash expenditures related to acquisitions, net of cash acquired .....	—	(117)	(1,614)
Proceeds from sale of capital assets .....	2	41	26
Net cash used in investing activities .....	(413)	(509)	(4,599)
Cash flows from financing activities:			
Payments of capital lease obligations .....	(202)	(177)	(132)
Proceeds from note payable .....	—	—	2,500
Payments of note payable .....	(298)	(812)	(288)
Proceeds from issuance of special warrants .....	—	9,734	—
Proceeds from public offering .....	—	5,681	—
Proceeds from private placement .....	1,075	332	—
Offering costs related to equity financings .....	(75)	(507)	(144)
Proceeds from exercise of stock options .....	144	9	570
Proceeds from exercise of warrants .....	1,316	769	4,536
Payments of related party loans .....	(63)	(12)	—
Decrease (increase) in restricted cash .....	804	66	(870)
Net cash provided by financing activities .....	2,701	15,083	6,172
Effect of exchange rate changes on cash and cash equivalents .....	312	(184)	(511)
Net (decrease) increase in cash and cash equivalents .....	(457)	1,687	(16,920)
Cash and cash equivalents, beginning of period .....	5,502	3,815	20,735
Cash and cash equivalents, end of period .....	\$ 5,045	\$ 5,502	\$ 3,815
Cash paid during the period for:			
Interest .....	\$ 204	\$ 291	\$ 77
Income taxes .....	\$ 60	\$ —	\$ —
Supplemental disclosures of cash flow information:			
Fair value of assets acquired, net of cash acquired .....	\$ —	\$ —	\$ 688
Liabilities assumed in acquisition .....	\$ —	\$ —	\$ 970
Acquisition consideration classified in accrued liabilities .....	\$ —	\$ 170	\$ —
Non-cash investing and financing activities:			
Equipment acquired under capital leases .....	\$ 89	\$ —	\$ 555
Investment received from sale of non-operating subsidiaries .....	\$ —	\$ 126	\$ —
Share capital issued in connection with acquisitions .....	\$ 2,877	\$ —	\$ 6,509
Share capital to be issued in connection with acquisitions .....	\$ —	\$ 2,877	\$ —

See accompanying notes to consolidated financial statements.

## BAKBONE SOFTWARE INCORPORATED AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

March 31, 2003 and 2002

(in U.S. dollars)

#### (1) The Company and Business Combinations

BakBone Software Incorporated (BakBone or the Company) is an international storage management software company that develops and globally distributes storage management solutions to the open systems markets, providing data protection and management solutions scalable from workgroup to enterprise. The Company's corporate headquarters is located in San Diego, California.

The Company, formerly Net Resources Incorporated (Net Resources), was originally incorporated in the Canadian Province of British Columbia under the Company Act. In November 1992, the Company continued from British Columbia to the Province of Alberta where it engaged in mineral exploration activities. These exploration activities were ceased during 1999 due to declining prices in the mineral markets, and the mining assets were written off. On March 13, 2000, the Company changed its name to BakBone Software Incorporated.

On March 16, 2000, the Company acquired 100% of NVS Holdings Inc. (NVS). This acquisition resulted in a reverse takeover of the Company by NVS as the greater proportion of the voting shares of the Company were held by NVS shareholders after the acquisition. Concurrent with the reverse takeover of the Company, the merged entity acquired NetVault Holdings Limited, NetVault Limited and an aggregate 47% of BakBone KK. At the time of this acquisition, NetVault Holdings Limited was a non-operating private shell while NetVault Limited and BakBone KK had substantive operations.

On June 9, 2000, the Company acquired all of the issued and outstanding common shares of Tracer Technologies, Inc. and its 50% ownership of the common shares of Tracer Technologies Japan Corporation (collectively Tracer), for cash and acquisition costs totaling \$1.6 million (net of cash acquired of \$800,000) and 600,000 common shares of the Company valued at \$6.5 million on the date of acquisition. The excess of purchase price over the fair value of the net assets acquired of \$400,000 was \$8.5 million. In order to retain certain principals of Tracer as employees, the Company issued stock options to acquire 250,000 common shares at an exercise price of \$4.06 (\$6.00 Canadian) per share. One of the principals is a relative of a former director of the Company and received options to acquire 62,500 common shares. The former director also indirectly received 3,060 common shares of the Company through his ownership in Tracer Technologies Japan Corporation (Tracer KK), one of the former shareholders of Tracer.

In January 2002, the Company acquired an additional 25% of Tracer KK in exchange for \$100,000 in cash and contingent consideration, consisting of \$100,000 in cash and 30,000 shares of the Company's common stock. The \$100,000 in cash was paid in fiscal 2003; however, as specific milestones were not met, the 30,000 shares of the Company's common stock were never issued. The excess of purchase price over the fair value of net assets acquired was \$99,000. In March 2002, the company acquired the remaining 25% of Tracer KK for nominal consideration. Both acquisitions were accounted for by the purchase method of accounting. Following the March 2002 acquisition, Tracer KK became a wholly owned subsidiary of the Company.

In March 2002, the Company acquired the remaining 53% of BakBone KK for 2,100,000 common shares of the Company, valued at \$2.9 million at the time of acquisition, and \$170,000 in cash. The 2,100,000 shares were issued and the \$170,000 was paid during fiscal 2003. The acquisition was accounted for by the purchase method of accounting and the excess of purchase price over the fair value of the net assets acquired was \$3.1 million.

During fiscal 2003, the Company executed two intercompany mergers in order to simplify its corporate structure. These transactions reduced the number of BakBone wholly owned subsidiaries from two to one, in both Asia and Europe. The transactions had no effect on the consolidated financial statements.

**BAKBONE SOFTWARE INCORPORATED AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)**

**March 31, 2003 and 2002**

**(in U.S. dollars)**

**(2) Significant Accounting Policies**

The accompanying consolidated financial statements are prepared in accordance with accounting principles generally accepted in Canada.

***(a) Principles of Consolidation***

The consolidated financial statements include the accounts of the Company and its subsidiaries, BakBone Software, Inc., BakBone Software Ltd. (formerly NetVault Holdings Ltd.), BakBone Acquisition Corp. (formerly Tracer Technologies, Inc.) and BakBone KK. All intercompany transactions and accounts have been eliminated in consolidation.

Prior to the March 2002 acquisitions, upon which BakBone KK and Tracer KK became wholly owned subsidiaries of the Company, the Company recorded entries to account for the minority interests in the net income or loss of BakBone KK and Tracer KK. As the minority interest parties were not legally liable to fund BakBone KK and Tracer KK's net losses, the Company did not record their minority interest share of BakBone KK and Tracer KK's net losses to the extent it would result in a minority interest receivable. In conjunction with the March 2002 acquisitions, all minority interest liabilities were eliminated.

***(b) Foreign Currency***

The accounts of the Company's foreign subsidiaries are translated into U.S. dollars using the current rate method whereby monetary items are translated at the rate of exchange in effect at the balance sheet date, and revenue and expense items are translated at the average exchange rate during the reporting period. Foreign currency translation gains and losses are included as a separate component of shareholders' equity.

Certain transactions of the Company's foreign subsidiaries are carried out in currencies other than the subsidiaries' local currency. Gains or losses resulting from these transactions are included in results of operations as incurred.

***(c) Cash and Cash Equivalents***

Cash and cash equivalents consist of money market instruments, commercial paper and other highly liquid investments with original maturities of three months or less from the date of purchase.

***(d) Capital Assets***

Capital assets are recorded at cost and depreciated using the straight-line method over the assets' useful lives as follows:

Computer equipment and software . . . . .	3–5 years
Furniture and fixtures . . . . .	5–7 years
Leasehold improvements . . . . .	Shorter of estimated useful life or life of lease
Capitalized leased assets . . . . .	Shorter of estimated useful life or life of lease

**BAKBONE SOFTWARE INCORPORATED AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)**

**March 31, 2003 and 2002**

**(in U.S. dollars)**

**(e) Goodwill**

The Company has recorded goodwill in connection with the acquisitions it has completed in prior periods. As of April 1, 2002, the Company adopted the provisions of the Canadian Institute of Chartered Accountants Handbook Section 3062, *Goodwill and Other Intangible Assets* (CICA Section 3062) and accordingly, ceased amortization of goodwill and performed the transitional impairment test prescribed by CICA Section 3062. The transitional impairment test was completed as of April 1, 2002, and resulted in no indication of impairment. The Company reviews goodwill for impairment during the first quarter of each fiscal year or when an event or a change in facts and circumstances indicates the fair value of a reporting unit may be below its carrying amount. Events or changes in facts and circumstances that we consider as impairment indicators include the following:

- significant underperformance of its business relative to expected operating results;
- significant adverse economic and industry trends;
- significant decline in stock price;
- significant decline in revenues; and
- expectations that a reporting unit will be sold or otherwise disposed of.

The annual goodwill impairment test consists of a two-step process as follows:

*Step 1.* The Company compares the fair value of its reporting units to their carrying amount, including any existing goodwill. If the carrying amount of a reporting unit exceeds its fair value, an indication exists that the reporting unit's goodwill may be impaired and the Company then performs the second step of the impairment test. If the fair value of the reporting unit exceeds its carrying amount, no further analysis is required.

*Step 2.* The Company compares the implied fair value of a reporting unit's goodwill, determined by allocating the reporting unit's fair value to all of its assets and its liabilities in a manner similar to a purchase price allocation, to its carrying amount. If the carrying amount of the reporting unit's goodwill exceeds its fair value, an impairment loss will be recognized in an amount equal to that excess.

**(f) Revenue Recognition**

The Company recognizes software license revenue upon delivery, provided all significant obligations have been met, persuasive evidence of an arrangement exists, fees are fixed and determinable, collections are probable, and the Company is not involved in significant production, customization, or modification of the software or services that are essential to the functionality of the software.

If the arrangement involves significant production, customization, or modification of software or service essential to the functionality of the software, the revenue is generally recognized under contract accounting using either the completed contract or percentage complete method of contract accounting. For arrangements that contain inherent risks related to the preparation of project cost estimates, the Company generally utilizes the completed contract method of revenue recognition. For arrangements in which the inherent risks do not exist or are sufficiently mitigated, the Company utilizes the percentage complete method of revenue recognition.

The Company often licenses software in multiple element arrangements in which a customer purchases a combination of software, post-contractual support (PCS) and/or professional services. PCS includes rights to unspecified upgrades and enhancements, and telephone support. Professional services relate to implementation services and training. When vendor specific objective evidence (VSOE) of fair value exists for all elements in a

**BAKBONE SOFTWARE INCORPORATED AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)**

**March 31, 2003 and 2002**

**(in U.S. dollars)**

multiple element arrangement, revenue is allocated to each element based on the relative fair value of each of the elements. VSOE of fair value is established by the price charged when the same element is sold separately. We determine VSOE of fair value of PCS based on renewal rates for the same term PCS.

In a multiple element arrangement whereby VSOE of fair value exists for all undelivered elements but VSOE of fair value does not exist for one or more delivered elements, revenue is recognized using the residual method. Under the residual method, the fair value of undelivered elements is deferred and the remaining portion of the arrangement fee is recognized as revenue, assuming delivery has occurred and collectibility is probable. Revenue allocated to PCS is recognized ratably over the contractual term, generally one year.

The Company has standard payment terms, which it offers to all of its customers, and the Company does not offer any extended payment terms. In addition, the Company's sales agreements do not contain stock balancing rotation rights.

***(g) Cost of Revenue***

Cost of revenue includes material, packaging, shipping and other production costs. Cost of revenue also includes salaries, benefits and overhead costs associated with employees providing support services.

***(h) Product Development Costs***

Product development costs related to research, design and development of software applications are charged to expense as incurred. To date, completion of working models of the Company's applications and the general release of the products have substantially coincided. As a result, the Company has not capitalized any application development costs as such costs have been insignificant.

***(i) Loss per Share***

Basic earnings or loss per share is calculated using the weighted-average number of common shares outstanding. Diluted earnings or loss per share is calculated similar to basic earnings or loss per share except that the weighted-average shares outstanding are increased to include additional shares from the assumed exercise of potential common shares, if dilutive. For the years ended March 31, 2003 and 2002 and the eleven months ended March 31, 2001, 8,252,631, 10,561,095, and 14,579,746 potential common shares, respectively, were excluded from the computations of diluted loss per share as their effect was anti-dilutive.

***(j) Stock-Based Compensation***

Effective April 1, 2002, the Company adopted the Canadian Institute of Chartered Accountants Handbook Section 3870, *Stock-based Compensation and Other Stock-based Payments* (CICA Section 3870), under which the Company is required to apply a fair value-based method of accounting for all stock-based payments issued to non-employees and to all direct awards of stock to employees. The Company will continue to use settlement date accounting to account for employee stock options, whereby the Company does not record stock-based compensation for stock options granted to employees.

***(k) Income Taxes***

The Company applies the assets and liability method of accounting for deferred income taxes, under which future income tax assets and liabilities are determined based on temporary differences and are measured using the

**BAKBONE SOFTWARE INCORPORATED AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)**

**March 31, 2003 and 2002**

**(in U.S. dollars)**

current, or substantially enacted, tax rates and laws expected to apply when these differences reverse. In preparing the consolidated financial statements, the Company estimates its income tax liability in each of the jurisdictions in which it operates by estimating its actual current tax exposure together with assessing temporary differences resulting from differing treatment of items for tax and financial statement purposes. These differences result in deferred tax assets and liabilities. Significant management judgment is required in assessing the realizability of the Company's deferred tax assets. In performing this assessment, the Company considers whether it is more likely than not that some portion or all of the deferred tax assets will not be realized. The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income during the periods in which those temporary differences become deductible. The Company considers the scheduled reversal of deferred tax liabilities, projected future taxable income, and tax planning strategies in making this assessment. In the event that actual results differ from the estimates or the Company adjusts its estimates in future periods, the Company may need to reduce the valuation allowance which could materially impact its financial position and results of operations.

***(l) Financial Instruments and Market Risk***

Cash and cash equivalents, restricted cash, accounts receivable, accounts payable, accrued liabilities, notes payable and loans from related parties constitute financial instruments. The carrying value of cash and cash equivalents, accounts receivable, accounts payable and accrued liabilities approximates their fair value given the relatively short periods to maturity. The carrying value of notes payable approximates its fair value because its interest rates and other terms are comparable to those currently available to the Company in the marketplace. The fair value of loans from related parties cannot be ascertained due to the related party nature of the debt.

The Company is exposed to the risks that arise from fluctuations in foreign exchange rates and the volatility of those rates. The Company does not use derivative instruments to reduce its exposure to foreign currency exchange risk.

During the year ended March 31, 2003, one customer represented approximately 16% of total revenues. During the year ended March 31, 2002 and the eleven months ended March 31, 2001, no single customer represented more than 10% of total revenues.

The Company maintains an allowance for doubtful accounts for estimated losses resulting from the inability of its customers to make required payments, which results in a provision for bad debt expense. The Company determines the adequacy of this allowance by evaluating individual customer accounts receivable, considering the customer's financial condition, credit history and current economic conditions.

***(m) Use of Estimates***

The preparation of consolidated financial statements in conformity with accounting principles generally accepted in Canada 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 consolidated financial statements and the reported amounts of revenue and expenses during the reporting periods. Areas where significant judgment are made include, but are not limited to: allowance for doubtful accounts, deferred income tax asset valuation allowance, revenue recognition, capital assets and goodwill valuation, and contingencies. Actual results could differ from those estimates.

**BAKBONE SOFTWARE INCORPORATED AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)**

**March 31, 2003 and 2002**

(in U.S. dollars)

**(n) Reclassification**

Certain prior period amounts shown in the consolidated financial statements have been reclassified to conform to the current presentation.

**(3) Capital Assets**

Capital assets consisted of the following at March 31, 2003 and 2002 (in thousands):

	<u>Cost</u>	<u>Accumulated depreciation</u>	<u>Net book value</u>
March 31, 2003:			
Computer equipment and software . . . . .	\$3,051	\$1,529	\$1,522
Furniture and fixtures . . . . .	632	297	335
Leasehold improvements . . . . .	517	135	382
	<u>\$4,200</u>	<u>\$1,961</u>	<u>\$2,239</u>
March 31, 2002:			
Computer equipment and software . . . . .	\$2,833	\$ 959	\$1,874
Furniture and fixtures . . . . .	523	154	369
Leasehold improvements . . . . .	620	101	519
	<u>\$3,976</u>	<u>\$1,214</u>	<u>\$2,762</u>

**(4) Goodwill and Intangible Assets**

In September 2001, the Canadian Institute of Chartered Accountants issued Handbook Section 1581, *Business Combinations*, and CICA Section 3062. The new standards require that the purchase method of accounting be used for business combinations and require that goodwill no longer be amortized, but instead be tested for impairment at least annually. The standards also specify criteria that intangible assets must meet in order to be recognized and reported apart from goodwill. The Company adopted these new standards as of April 1, 2002 and accordingly, discontinued the amortization of goodwill. Furthermore, the Company had no separately identifiable intangible assets as of April 1, 2002.

As of April 1, 2002, the Company had unamortized goodwill of \$4.8 million. Net loss would have been as follows if CICA Section 3062 had been adopted on April 1, 2000 (in thousands, except per share data):

	<u>Year ended March 31, 2003</u>	<u>Year ended March 31, 2002</u>	<u>Eleven months ended March 31, 2001</u>
Net loss, as reported . . . . .	\$(8,657)	\$(18,791)	\$(21,692)
Add: amortization of goodwill . . . . .	—	3,727	3,203
Net loss, as adjusted . . . . .	<u>\$(8,657)</u>	<u>\$(15,064)</u>	<u>\$(18,489)</u>
Net loss per share:			
Net loss, as reported . . . . .	<u>\$ (0.16)</u>	<u>\$ (0.46)</u>	<u>\$ (0.87)</u>
Net loss, as adjusted . . . . .	<u>\$ (0.16)</u>	<u>\$ (0.37)</u>	<u>\$ (0.74)</u>

In connection with the transitional goodwill impairment evaluation as of April 1, 2002, specified by CICA Section 3062, the Company completed the first step of the transitional impairment test of goodwill by the end of

**BAKBONE SOFTWARE INCORPORATED AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)**

**March 31, 2003 and 2002**

**(in U.S. dollars)**

the second quarter of fiscal 2003. The first step of the transitional goodwill impairment test required the Company to determine and compare the fair value of its defined reporting units to their carrying values as of April 1, 2002. The fair value of each reporting unit was determined using a discounted cash flow valuation analysis. The carrying value of each reporting unit was determined by specifically identifying and allocating the assets and liabilities of BakBone to each reporting unit based on headcount, relative revenues, or other methods as deemed appropriate by management. The Company believes that the assumptions made for these analyses are reasonable and consistent. The estimated fair values exceeded the carrying values for each reporting unit, resulting in no indication of impairment. Consequently, the second step of the impairment test was not required.

During the first two quarters of fiscal 2003, total revenues generated by MagnaVault, the Company's comprehensive secondary storage archival storage management software for UNIX and Linux host operating environments, experienced a significant decline. This trend continued into the third quarter of fiscal 2003, and in November 2002, the Company decided to "end of life" the MagnaVault product, whereby all activities, with the exception of customer support, related to MagnaVault would cease permanently, effective December 31, 2002. In connection with this decision, the Company terminated several employees and closed its Maryland office facility. Based on this triggering event, in accordance with CICA Section 3062, the Company was required to perform an impairment analysis on the MagnaVault-related goodwill as of December 31, 2002. The first step in the impairment analysis involved comparing the carrying values of the MagnaVault reporting units to their fair values. It was determined that the carrying values of the reporting units exceeded the estimated fair values, and consequently, step two of the impairment test was required. As a result of step two, the related goodwill was deemed impaired and the Company recognized a charge of \$442,000 in the third quarter of fiscal 2003. The charge represented the amount by which the goodwill's carrying value exceeded its estimated fair value, a component of which related to the estimated terminal value of the MagnaVault intellectual property (MagnaVault IP). During the third quarter of fiscal 2003, the Company began negotiations with a third party to sell the MagnaVault IP. As of December 31, 2002, it appeared likely that the sale of the MagnaVault IP would be consummated. The negotiations continued into the fourth quarter of fiscal 2003; however, as of March 31, 2003, management believed the probability of a successful sale of the MagnaVault IP to the aforementioned third party to be unlikely. Based on this triggering event, the Company performed an additional impairment analysis, following the steps outlined above, on the MagnaVault-related goodwill. As a result of the additional analysis, the related goodwill was deemed impaired and the Company recognized a charge of \$446,000 in the fourth quarter of fiscal 2003. This charge represented the remaining carrying value of the MagnaVault-related goodwill. The goodwill balance of \$4.0 million as of March 31, 2003 relates entirely to the Company's NetVault product line.

**(5) Equity**

***Public Offering***

In December 2001, the Company completed a public offering of 7,170,400 units at a price of \$0.80 per unit for gross proceeds of \$5.7 million, excluding issuance costs of \$469,000. Each unit was comprised of one common share and one-quarter common share purchase warrant. Each full share purchase warrant entitled the holder to purchase one common share at \$1.04 and expired 120 days from the closing of this offering. As of March 31, 2003, 1,789,100 of the purchase warrants had been exercised, resulting in gross proceeds of \$1.9 million. The remaining 3,500 purchase warrants expired unexercised in April 2002. In connection with the offering, the Company issued 250,000 Agent Options to a third party who assisted in the offering. The Agent Options entitled the holder thereof to purchase, at a price of \$0.99, one common share and expired in December 2002. As of March 31, 2003, 210,000 of the Agent Options had been exercised for gross proceeds of \$209,000. The remaining 40,000 Agent Options expired unexercised in December 2002.

**BAKBONE SOFTWARE INCORPORATED AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)**

**March 31, 2003 and 2002**

(in U.S. dollars)

*Private Offerings*

In January 2003, the Company completed a private offering of 1,917,788 units at a price of \$0.56 per unit for gross proceeds of \$1.1 million, excluding issuance costs of \$75,000. Each unit was comprised of one common share and one-half common share purchase warrant. Each full share purchase warrant entitles the holder to purchase one common share at \$0.64 and expires one year from the closing of the offering. The parties to the offering consisted of various members of Company management and employees. As of March 31, 2003, none of the 958,894 purchase warrants had been exercised and all remained outstanding.

In February 2002, the Company completed a private offering of 440,834 units at a price of \$0.75 per unit for gross proceeds of \$332,000, excluding issuance costs of \$10,000. Each unit was comprised of one common share and one common share purchase warrant. Each common share purchase warrant entitled the holder to purchase one common share at \$0.75 and expired one year from the closing of the offering. The parties to the offering consisted of various members of Company management and employees. During the year ended March 31, 2003, 19,167 purchase warrants were exercised for gross proceeds of \$14,000. The remaining 421,667 purchase warrants expired unexercised in February 2003.

In May 2001, the Company completed a private placement of 3,000,000 Special Warrants at a price of \$3.24 per Special Warrant for proceeds of \$9.7 million, excluding issuance costs of \$28,000. Each Special Warrant was exercisable, for no additional consideration, into one common share and one-half share purchase warrant upon receipt of the final prospectus filed in the provinces of Alberta and British Columbia. Each full share purchase warrant entitled the holder to purchase one common share at \$4.84. All of the 1,500,000 purchase warrants, which resulted from this private placement, expired unexercised in November 2001.

Warrant activity is summarized as follows:

	<u>Number of special warrants</u>	<u>Number of other warrants</u>	<u>Total warrants</u>	<u>Weighted-average exercise price</u>
Balance at April 30, 2000	9,936,995	322,500	10,259,495	\$0.02
Issued	—	5,249,995	5,249,995	4.39
Exercised for no consideration	(9,936,995)	—	(9,936,995)	—
Exercised for cash	—	(3,694,934)	(3,694,934)	1.23
Expired	—	(35,566)	(35,566)	8.82
Balance at March 31, 2001	—	1,841,995	1,841,995	9.88
Issued	3,000,000	3,983,434	6,983,434	1.39
Exercised for no consideration	(3,000,000)	—	(3,000,000)	—
Exercised for cash	—	(749,525)	(749,525)	1.03
Expired	—	(3,341,995)	(3,341,995)	7.62
Balance at March 31, 2002	—	1,733,909	1,733,909	0.97
Issued	—	1,568,899	1,568,899	0.68
Exercised for cash	—	(1,268,747)	(1,268,747)	1.04
Expired	—	(465,167)	(465,167)	0.77
Balance at March 31, 2003	<u>—</u>	<u>1,568,894</u>	<u>1,568,894</u>	\$0.68

All warrants outstanding as of March 31, 2003 were exercisable.

**BAKBONE SOFTWARE INCORPORATED AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)**

**March 31, 2003 and 2002**

**(in U.S. dollars)**

During the year ended March 31, 2003, the Company granted 510,000 and 100,000 warrants to service providers and an employee, respectively, with per share prices ranging from \$0.60 to \$0.83. As of March 31, 2003, these warrants were fully vested and related to past services provided.

***Escrowed Shares***

In March 2000, in connection with the NVS acquisition, 10,425,000 common shares were deposited in escrow, of which one-third were scheduled to be released on September 16, 2000, March 16, 2001 and September 16, 2001. In July 2000, in order to obtain receipt of the final prospectus from the Province of Ontario, the Company entered into an additional escrow agreement covering 5,285,686 common shares, of which 4,956,686 related to the March 2000 escrowed shares and were re-deposited under this escrow agreement. These common shares were to be released in three equal installments on July 13, 2001, July 13, 2002 and July 13, 2003. As of March 31, 2003, the first two installments had been released in full on the dates specified above.

The total common shares released during the years ended March 31, 2003 and 2002, were 1,761,894 and 3,584,667, respectively. As of March 31, 2003, 1,761,897 common shares remained in escrow and will be released on July 13, 2003.

**(6) Stock-Based Awards**

The Company has a stock option plan (the Plan) pursuant to which the Board of Directors of the Company may grant nontransferable stock options to purchase common shares of the Company to directors, officers, employees, advisors and consultants. As of March 31, 2003, 2002 and 2001, 6,500,000, 4,596,042, and 3,809,042 common shares, respectively, have been reserved for issuance under this plan. The maximum number of common shares which may be reserved for issuance to any one person under the Plan is 5% of the common shares outstanding at the time of grant (calculated on a non-diluted basis). The options vest generally over four years and are exercisable for a maximum term of ten years.

The Company's options are denominated in Canadian dollars as the underlying stock is listed on the Toronto Stock Exchange. Per share amounts stated below have been translated to U.S. dollars at the rate of exchange in effect at the balance sheet date unless otherwise noted.

On August 17, 2001, the Company announced a voluntary Option Cancel and Regrant Program (Program) for its employees. Under the Program, the Company's employees were given the opportunity, if they so chose, to cancel outstanding stock options previously granted to them in return for an equal number of replacement options at a later date. The replacement options were granted on March 1, 2002 at the then fair market value. As the replacement options were not granted within six months of the cancellation date, variable plan accounting is not required for the replacement options.

In October 2000, the Company repriced 1,698,000 stock options from \$11.82 to \$7.74.

**BAKBONE SOFTWARE INCORPORATED AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)**

**March 31, 2003 and 2002**

(in U.S. dollars)

A summary of the status of the Company's stock option plan is as follows:

	<u>Number of options</u>	<u>Weighted-average exercise price</u>
Outstanding at April 30, 2000 .....	2,340,904	\$8.00
Granted .....	2,059,000	9.35
Exercised .....	(303,958)	1.88
Cancelled .....	<u>(760,908)</u>	9.00
Outstanding at March 31, 2001 .....	3,335,038	8.40
Granted .....	2,716,464	2.26
Exercised .....	(13,000)	0.69
Cancelled .....	<u>(3,282,689)</u>	6.68
Outstanding at March 31, 2002 .....	2,755,813	2.62
Granted .....	2,101,455	1.30
Exercised .....	(217,000)	0.71
Cancelled .....	<u>(1,335,013)</u>	3.07
Outstanding at March 31, 2003 .....	<u>3,305,255</u>	1.78
Exercisable at March 31, 2003 .....	<u>2,395,386</u>	\$1.89

The following table summarizes information regarding stock options outstanding and exercisable at March 31, 2003:

<u>Exercise prices</u>	<u>Options outstanding</u>			<u>Options exercisable</u>	
	<u>Number outstanding</u>	<u>Average remaining contractual life (years)</u>	<u>Weighted-average exercise price</u>	<u>Number exercisable</u>	<u>Weighted-average exercise price</u>
\$0.58 to \$0.95 .....	108,729	9.21	\$0.77	—	\$ —
\$1.04 to \$1.16 .....	895,926	8.83	1.06	653,495	1.05
\$1.22 to \$1.36 .....	1,703,200	9.07	1.30	1,400,000	1.29
\$1.48 to \$1.54 .....	161,000	9.05	1.53	—	—
\$3.33 to \$4.08 .....	272,900	5.87	3.72	182,870	3.82
\$8.39 to \$8.50 .....	163,500	3.02	\$8.46	159,021	\$8.46

During the year ended March 31, 2002, the Company granted 2,664 stock options to a consultant with a per share price of \$4.33. These options were fully vested upon grant and related to past services rendered.

During the eleven months ended March 31, 2001, the Company granted 475,000 stock options to advisors at prices ranging from \$3.86 to \$8.15 per share. Of the stock options granted, 25,000 were fully vested upon grant, 350,000 vest generally over one year based on the terms of the consulting agreements and 100,000 were to vest based on specified performance milestones. However, these milestones were not met, and none of the 100,000 stock options vested.

**BAKBONE SOFTWARE INCORPORATED AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)**

**March 31, 2003 and 2002**

**(in U.S. dollars)**

**(7) Stock-Based Compensation and Other Stock-Based Payments**

Effective April 1, 2002, the Company adopted CICA Section 3870, under which the Company is required to apply a fair value-based method of accounting for all stock-based payments issued to non-employees and to all direct awards of stock to employees. The Company will continue to use settlement date accounting to account for employee stock options, whereby stock-based compensation is not generally recognized in connection with options granted to employees.

During the year ended March 31, 2003, the Company recognized \$326,000 in stock-based compensation expense in connection with the issuance of warrants to non-employees. The Company issued warrants to the non-employees in connection with services they rendered to the Company. The fair value of these warrants was calculated using the Black-Scholes option-pricing model and was recorded as stock-based compensation expense during the year ended March 31, 2003.

In addition to the disclosures relating to the Company's outstanding stock options presented in Note 6, CICA Section 3870 requires the disclosure of pro forma net earnings and earnings per share information as if the Company had accounted for employee stock options and warrants under the fair value method. The Company has elected to disclose pro forma net loss and pro forma loss per share as if the Company had accounted for its employee stock options and warrants issued since April 1, 2002 under the fair value method. A summary of the pro forma disclosure and the impact on the consolidated statements of operations for the year ended March 31, 2003 would have been as follows (in thousands, except per share data):

Net loss, as reported	\$(8,657)
Compensation expense determined under the fair value method for employee stock options and warrants	860
Pro forma net loss	\$(9,517)
Net loss per share:	
Net loss, as reported	\$ (0.16)
Pro forma net loss	\$ (0.18)

The fair value of employee stock options and warrants granted during the year ended March 31, 2003 was estimated at the date of grant using the Black-Scholes option-pricing model using the following assumptions:

	<u>Options</u>	<u>Warrants</u>
Risk-free interest rate	3.72%	1.79%
Dividend yield	—	—
Volatility factor	100%	100%
Weighted-average expected life	2.83	2.00

The Company has assumed no forfeiture rate; adjustments for actual forfeitures are made in the period they occur. The weighted-average fair value of employee stock options and warrants granted during the year ended March 31, 2003 was \$0.73 and \$0.65, respectively.

**BAKBONE SOFTWARE INCORPORATED AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)**

**March 31, 2003 and 2002**

**(in U.S. dollars)**

**(8) Income Taxes**

The income tax effects of the temporary differences that give rise to significant portions of the Company's deferred tax assets as of March 31, 2003 and 2002 are presented below by tax jurisdiction (in thousands):

	<u>Canada</u>	<u>United States</u>	<u>United Kingdom</u>	<u>Japan</u>	<u>Total</u>
March 31, 2003:					
Deferred tax assets:					
Accruals . . . . .	\$ 507	\$ 945	\$ 118	\$ 28	\$ 1,598
Net operating losses . . . . .	574	12,273	1,322	193	14,362
	1,081	13,218	1,440	221	15,960
Less valuation allowance . . . . .	(1,081)	(13,188)	(1,440)	(219)	(15,928)
Deferred tax assets . . . . .	—	30	—	2	32
Deferred tax liabilities—capital assets . . .	—	(30)	—	(2)	(32)
Net deferred tax assets . . . . .	<u>\$ —</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ —</u>
March 31, 2002:					
Deferred tax assets:					
Accruals . . . . .	\$ 507	\$ 264	\$ 1	\$ 28	\$ 800
Net operating losses . . . . .	542	10,929	1,205	135	12,811
	1,049	11,193	1,206	163	13,611
Less valuation allowance . . . . .	(1,049)	(11,193)	(1,206)	(156)	(13,604)
Deferred tax assets . . . . .	—	—	—	7	7
Deferred tax liabilities—capital assets . . .	—	—	—	(7)	(7)
Net deferred tax assets . . . . .	<u>\$ —</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ —</u>

A reconciliation of the expected income tax benefit to the actual income tax expense reported in the consolidated statements of operations is as follows (in thousands):

	<u>2003</u>	<u>2002</u>	<u>2001</u>
Computed expected income tax benefit at Canadian statutory income tax rate of 41.1%, 41.1% and 41.7% for 2003, 2002 and 2001, respectively . . . . .	\$(3,350)	\$(7,727)	\$(9,053)
Foreign tax rate differential . . . . .	556	518	1,039
Debt discharge . . . . .	615	—	—
Nondeductible goodwill . . . . .	365	2,193	652
Unrecognized recoveries from losses . . . . .	2,324	5,883	7,349
Permanent differences . . . . .	—	(867)	13
Actual income tax expense . . . . .	<u>\$ 510</u>	<u>\$ —</u>	<u>\$ —</u>

The fiscal 2003 income tax expense of \$510,000 relates to foreign operations and activities.

**BAKBONE SOFTWARE INCORPORATED AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)**

**March 31, 2003 and 2002**

**(in U.S. dollars)**

The net change in the total valuation allowance for the years ended March 31, 2003 and 2002 and the eleven months ended March 31, 2001, was an increase of \$2.3 million, \$6.0 million and \$7.3 million, respectively. In assessing the realizability of deferred tax assets, management considers whether it is more likely than not that some portion or all of the deferred tax assets will not be realized. The ultimate realization of deferred tax assets is dependent upon the generation of deferred taxable income during the periods in which those temporary differences become deductible. Management considers the scheduled reversal of deferred tax liabilities, projected deferred taxable income, and tax planning strategies in making this assessment. Based on the level of historical operating results and projections of deferred taxable income, management has determined that it is more likely than not that the portion of deferred tax assets not utilized through the reversal of deferred tax liabilities will not be realized. Accordingly, the Company has recorded a valuation allowance to reduce deferred tax assets to the amount that is more likely than not to be realized.

The Company has Canadian non-capital losses of CDN\$2.1 million at March 31, 2003 that are available to apply against future Canadian taxable income. These losses begin to expire in 2007.

BakBone Software, Inc. has federal net operating loss carryforwards of \$30.6 million at March 31, 2003 that are available as reductions to its taxable income in future years. These carryforwards will begin to expire in 2020.

BakBone Software Ltd. has trade loss carryforwards of UK£2.3 million at March 31, 2003 that are available as reductions to its taxable income in future years. These carryforwards generally have an indefinite carry forward period.

BakBone Software KK has net operating loss carryforwards of ¥53.0 million at March 31, 2003 that are available as reductions to its taxable income in future years. These carryforwards began to expire in 2003.

**(9) Special Charges**

In November 2002, the Company undertook a plan to cease all activities, with the exception of customer support, related to its MagnaVault product offering, effective December 31, 2002. In the third quarter of fiscal 2003 and in connection with the MagnaVault exit activities, the Company recorded special charges of \$415,000, related primarily to a specific workforce reduction, idle facility costs and the impairment of fixed assets. A summary of these charges is as follows (in thousands):

	<u>Total Charge</u>	<u>Payments</u>	<u>Non-cash Charges</u>	<u>Liability at March 31, 2003</u>
Employee severance .....	\$ 87	\$ 87	\$—	\$—
Idle facility .....	192	33	—	159
Fixed asset impairments and other exit costs .....	136	32	104	—
Total .....	<u>\$415</u>	<u>\$152</u>	<u>\$104</u>	<u>\$159</u>

The current and non-current portions of the idle facility liability are included in “Accrued liabilities” and “Other liabilities”, respectively, in the consolidated balance sheet as of March 31, 2003.

**BAKBONE SOFTWARE INCORPORATED AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)**

**March 31, 2003 and 2002**

**(in U.S. dollars)**

**(10) Retirement Plans**

During the eleven months ended March 31, 2001, the Company established a voluntary deferred contribution plan for employees in the United States (the U.S. Plan) in accordance with the provisions of the Internal Revenue Code Section 401(k). The U.S. Plan allows participants to contribute up to 15% of their annual salary, subject to certain limitations, as provided by federal law. Each year, the Company's Board of Directors determines the amount, if any, of the Company's matching contributions. There were no matching contributions to the U.S. Plan during the years ended March 31, 2003 and 2002 or during the eleven months ended March 31, 2001.

The Company maintains a voluntary defined contribution plan for employees in the United Kingdom (the U.K. Plan). The U.K. Plan allows participants to defer a minimum of 3% of their annual salary with a maximum contribution ranging from 17.5% to 40% of salary, depending on the age of the participant. In addition, the U.K. Plan calls for the Company to annually match 5% of each participant's salary; these matching contributions vest immediately. During the years ended March 31, 2003 and 2002 and the eleven months ended March 31, 2001, the Company contributed \$195,000, \$149,000, and \$76,000 respectively, to the U.K. Plan.

The Company currently maintains no retirement plans for employees working in Japan.

**(11) Note Payable**

The Company has an unsecured term loan with a bank, which bears interest at 7.5% and matures on December 31, 2003. During the year ended March 31, 2003, the Company made principal and interest payments totaling \$447,000. As the loan matures in December 2003, it is classified as short-term.

**(12) Related Party Transactions**

A director of the Company is a partner of a law firm that provides legal services to the Company. During the years ended March 31, 2003 and 2002 and the eleven months ended March 31, 2001, the Company paid the associated law firm \$118,000, \$120,000 and \$270,000, respectively, relating to the services rendered. As of March 31, 2003, there was \$48,000 owed to this related party.

A director of the Company has provided certain consulting and legal advice to the Company. During the years ended March 31, 2003 and 2002 and the eleven months ended March 31, 2001, the Company paid the director \$57,000, \$155,000 and \$62,000, respectively, relating to the services rendered. As of March 31, 2003, there was no amount owed to this related party.

A director of the Company is the president of a firm which provided certain consulting services to the Company. During the year ended March 31, 2003, the Company paid the firm \$72,000 relating to the services rendered. The Company made no payments to this related party during the year ended March 31, 2002 and the eleven months ended March 31, 2001. As of March 31, 2003, there was \$12,000 owed to this related party.

A former director of the Company provided certain consulting and investor relation services to the Company. During the year ended March 31, 2002 and the eleven months ended March 31, 2001, the Company paid the former director \$41,000 and \$70,000, respectively, relating to the services rendered. The Company made no payments to this related party during the year ended March 31, 2003. As of March 31, 2003 there was no amount owed to this related party.

Prior to the acquisition of BakBone KK, two former directors and officers of the Company provided interest-free loans to BakBone KK. As of March 31, 2002, the balance owed to these individuals totaled \$63,000. During the year ended March 31, 2003, these loans were paid in full.

**BAKBONE SOFTWARE INCORPORATED AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)**

**March 31, 2003 and 2002**

**(in U.S. dollars)**

**(13) Commitments and Contingencies**

**(a) Litigation**

The Company is involved in litigation and claims, which arise from time to time in the normal course of business. In the opinion of management, based in part on the advice of legal counsel, any liability that may arise from such contingencies would not have a significant adverse effect on the consolidated financial position, results of operations or liquidity of the Company.

**(b) Leases**

The Company leases certain facilities and equipment under non-cancelable operating and capital leases. Future minimum lease payments for years ending March 31 are as follows (in thousands):

	<u>Capital leases</u>	<u>Operating leases</u>
2004 .....	\$105	\$1,566
2005 .....	35	1,084
2006 .....	13	562
2007 .....	—	256
2008 .....	—	63
Thereafter .....	<u>—</u>	<u>352</u>
Total minimum lease payments .....	153	<u>\$3,883</u>
Less amount representing interest .....	<u>(11)</u>	
Present value of net minimum lease payments, including current portion of \$97 .....	<u>\$142</u>	

Rent expense for the years ended March 31, 2003 and 2002 and the eleven months ended March 31, 2001 approximated \$1.7 million, \$1.6 million and \$1.2 million, respectively.

The net book value of assets under capital leases at March 31, 2003 and 2002 was approximately \$142,000 and \$255,000, respectively, which are net of accumulated amortization of \$378,000 and \$176,000, respectively.

The Company has an operating lease for a facility in Maryland which became idle during the year ended March 31, 2003 when the Company ceased all activities, with the exception of customer support, related to its MagnaVault product offering. As the facility will most likely remain idle through the end of the lease term, May 2004, the Company recorded a liability in the amount of \$192,000 representing the present value of the future lease payments through May 2004. As of March 31, 2003, \$159,000 of this liability remained, of which \$135,000 and \$24,000 are included in "Accrued liabilities" and "Other liabilities", respectively, on the accompanying consolidated balance sheet.

As of March 31, 2002, the Company had an operating lease for an idle facility in San Diego. The Company estimated that the facility would remain idle until October 2002, and thus, the Company recorded a liability and a corresponding expense in the statement of operations during the year ended March 31, 2002 in the amount of \$212,000, representing the present value of the future lease payments through October 2002. In August 2002, the Company exchanged the leased space under the aforementioned operating lease for leased space in an adjacent building (the New Space), moved a portion of its operations into the New Space, and accordingly, reversed the carrying balance of the idle lease liability.

**BAKBONE SOFTWARE INCORPORATED AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)**

**March 31, 2003 and 2002**

**(in U.S. dollars)**

***(c) Employee Benefit Trust***

In connection with the Company's acquisition of NetVault Holdings Ltd. in March 2000 and in an attempt to retain key NetVault Holdings Ltd. employees, 2,100,000 common shares of the Company were placed in an Employee Benefit Trust (EBT) and allocated to certain NetVault Holdings Ltd. employees. The Company incurs a National Insurance Contribution (NIC) liability in the United Kingdom, which is a tax on earned income, whenever an employee removes shares from the EBT. The NIC liability incurred equates to a percentage of the fair value of common shares on the date of removal. Due to the uncertain nature of estimating when shares will be removed from the EBT, NIC liabilities will be recorded when incurred. As of March 31, 2003, 951,168 allocated and unexercised shares remained in the EBT and the NIC liability rate as of this date was 11.8%.

**(14) Segment Information**

The Company has segmented its operations by product line. In November 2002, the Company decided to "end of life" the MagnaVault product line. MagnaVault revenues for the year ended March 31, 2003 have been included below for comparative purposes. Subsequent to December 31, 2002, the Company's operations consist of the NetVault product line only. Revenues are generated from the selling of software licenses and related support services. The following table represents a summary of revenues by product line for the periods presented (in thousands):

	<u>2003</u>	<u>2002</u>	<u>2001</u>
Revenues			
Licensing:			
NetVault .....	\$14,493	\$6,894	\$2,378
MagnaVault .....	905	1,201	1,808
Total .....	<u>15,398</u>	<u>8,095</u>	<u>4,186</u>
Service:			
NetVault .....	2,330	1,218	530
MagnaVault .....	462	550	259
Total .....	<u>2,792</u>	<u>1,768</u>	<u>789</u>
Total revenues .....	<u>\$18,190</u>	<u>\$9,863</u>	<u>\$4,975</u>

**BAKBONE SOFTWARE INCORPORATED AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)**

**March 31, 2003 and 2002**

**(in U.S. dollars)**

The following table represents a summary of revenues by major geographic region for the years ended March 31, 2003 and 2002, and the eleven months ended March 31, 2001 (in thousands):

	<u>2003</u>	<u>2002</u>	<u>2001</u>
Revenues			
Licensing:			
Europe .....	\$ 3,092	\$1,355	\$ 398
Asia .....	6,334	3,714	2,512
North America .....	<u>5,972</u>	<u>3,026</u>	<u>1,276</u>
Total .....	<u>15,398</u>	<u>8,095</u>	<u>4,186</u>
Service:			
Europe .....	550	379	278
Asia .....	710	359	198
North America .....	<u>1,532</u>	<u>1,030</u>	<u>313</u>
Total .....	<u>2,792</u>	<u>1,768</u>	<u>789</u>
Total revenues .....	<u>\$18,190</u>	<u>\$9,863</u>	<u>\$4,975</u>

The following table represents a summary of capital assets and goodwill by major geographic region as of March 31, 2003 and 2002 (in thousands):

	<u>Europe</u>	<u>Asia</u>	<u>North America</u>	<u>Total</u>
Identifiable assets as of March 31, 2003:				
Capital assets, net .....	\$374	\$272	\$1,593	\$2,239
Goodwill, net .....	\$907	\$—	\$3,075	\$3,982
Identifiable assets as of March 31, 2002:				
Capital assets, net .....	\$431	\$261	\$2,070	\$2,762
Goodwill, net .....	\$821	\$—	\$3,963	\$4,784

**(15) Subsequent Events**

In April 2003, the Company entered into a non-binding letter of intent with a third party venture capital firm (VC Firm), pursuant to which the Company expects to, by way of private placement, issue to the VC Firm an aggregate of approximately 22,000,000 Series A preferred shares at CDN\$1.00 per preferred share. The closing of the private placement is not guaranteed by the letter of intent and is subject to requisite regulatory and shareholder approval.



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