

**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549**

**FORM 10-K**

(Mark One)

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

For the Fiscal Year Ended December 31, 2006

OR

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

For the Transition Period from \_\_\_\_\_ to \_\_\_\_\_.

Commission File No. 000-26937

**QUEST SOFTWARE, INC.**

(Exact Name of Registrant as Specified in its Charter)

**California**  
(State or Other Jurisdiction of  
Incorporation or Organization)

**5 Polaris Way**  
**Aliso Viejo, California**  
(Address of Principal Executive Offices)

**33-0231678**  
(I.R.S. Employer  
Identification No.)

**92656**  
(Zip Code)

**Registrant's Telephone Number, Including Area Code: (949) 754-8000**

Securities Registered Pursuant to Section 12(b) of the Act:

Title of Each Class  
**Common Stock**

Name of Exchange on Which Registered  
The Nasdaq Stock Market LLC  
(Nasdaq Global Select Market)

Securities Registered Pursuant to Section 12(g) of the Act: Common Stock

Title of Each Class  
None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.

Yes  No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15 (d) of the Act.

Yes  No

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

Yes  No

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein and will not be contained, to the best of Registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act. (check one):

Large accelerated filer  Accelerated filer  Non-accelerated filer

Indicate by check mark whether the Registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes  No

The aggregate market value of the voting stock held by non-affiliates of the Registrant was approximately \$1.1 billion as of June 29, 2007, based upon the closing sale price reported for that date on The Nasdaq Global Select Market.

As of November 15, 2007, 102,154,171 shares of the Registrant's common stock were outstanding.

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**Documents Incorporated by Reference**

None

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### **Forward-Looking Information**

Discussions under the captions “*Business*,” “*Risk Factors*,” and “*Management’s Discussion and Analysis of Financial Condition and Results of Operations*” include or may include forward-looking statements within the meaning of the federal securities laws. We have based these forward-looking statements on currently available information and our current beliefs, expectations and projections about future events. All forward-looking statements contained herein are subject to numerous risks and uncertainties. Our actual results and the timing of certain events could differ materially from those projected in the forward looking statements due to a number of factors discussed under the heading “*Risk Factors*” in this Report and in our other filings with the Securities and Exchange Commission (“SEC”). Should one or more of these risks or uncertainties materialize, or should the underlying estimates or assumptions prove incorrect, actual results or outcomes may vary significantly from those suggested by forward-looking information. Any forward-looking statements contained in this document are based on information available at the time of filing and we make no undertaking to update any of these forward-looking statements.

### **Explanatory Note**

This Annual Report on Form 10-K of Quest Software, Inc. for the year ended December 31, 2006 reflects the restatement of our consolidated financial statements for the years ended December 31, 2005 and 2004, and the notes related thereto. This Report also includes the restatement of our selected consolidated financial data as of and for the fiscal years ended December 31, 2005, 2004, 2003 and 2002, which is included in Item 6, and a restatement of our unaudited quarterly financial data for each of the quarters in the fiscal year ended December 31, 2005 and for the quarter ended March 31, 2006 which is included in Item 8. Item 8 of this Report also includes unaudited quarterly financial data for each of the quarters ended June 30, 2006 and September 30, 2006, which data were not previously filed. The Company’s decision to restate its accounting for employee stock options was based on the results of a voluntary, independent investigation of its historical stock option granting practices and related accounting that was conducted by a Special Committee of the Company’s Board of Directors.

In May 2006, we formed a special committee of the Company’s Board of Directors, comprised of two independent directors (the “Special Committee”), to conduct an investigation into our historic stock option granting practices and related accounting. The investigation was conducted with the assistance of independent outside legal counsel and outside forensic accounting consultants. The background, scope and findings of the investigation are more fully described in Part II, Item 7 of this Report.

As a result of the Special Committee’s investigation and management’s review of its findings, we have determined that the accounting measurement dates for most of the stock option grants we awarded during the period from June 1998 to April 2002 were not determined in accordance with Generally Accepted Accounting Principles (“GAAP”). Accordingly we have applied revised measurement dates for financial accounting purposes to those option grants and corrected our accounting for such awards.

The Company determined revised accounting measurement dates for options to purchase approximately 21.8 million shares of Common Stock granted in 3,324 awards on 56 grant dates during the period from June 1998 to April 2002. The Company also determined revised accounting measurement dates for options to purchase 778,250 shares of Common Stock granted in 58 individual awards made after April 30, 2002 through December 2005. As a result, the Company recorded \$136.9 million in additional stock-based compensation expense on a pre-tax basis for the years 1999 through 2005. The additional stock-based compensation expense is net of forfeitures related to employee terminations. To determine revised measurement dates, management evaluated all of the available evidence. For those grants where the revised measurement date could not be determined with certainty, management applied judgment to determine what it believes to be the most appropriate accounting measurement date in accordance with GAAP, and considered what different amounts of additional compensation expense that would have resulted had different dates been selected. For a discussion of the judgments underlying the revised measurement dates, see “*Management’s Discussion and Analysis of Financial Condition and Results of Operations*” in Part II, Item 7 of this Report.

The stock option accounting errors corrected in the restatement were primarily caused by inadequate procedures and controls for stock option granting activity. For most of the grants requiring measurement date changes, the process of obtaining formal approvals of the Company’s Board of Directors or Compensation Committee was generally not completed until after the grant date. For some grants, the Company also had not finalized the recipients and amounts of these options on the originally stated grant date. The Special Committee also concluded that grant dates and exercise prices for many stock options granted during the period from October 1999 to April 2002 were determined retrospectively by means of an

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administrative practice initially designed for monthly processing of option grants to new employees whereby the grant date was determined to be the date during the month of the employee's hiring when the Company's closing stock price had reached its lowest level during the month. This practice was expanded to include option grants to existing employees and, in some cases, the period was expanded from a monthly determination to a quarterly determination. This practice was discontinued after the April 2002 grants.

From May 2002 through December 2005, the Company made significant changes in its stock option granting practices, processes and controls. These changes included revising the form of the unanimous written consent used to document Compensation Committee actions to include an execution date and a delegation of authority by the Board of Directors to a Secondary Committee, consisting of the Company's Chairman and Chief Executive Officer, to approve option grants subject to certain parameters. Grants to officers and directors and other grants outside of the delegation parameters continued to require Compensation Committee approval but the delegation of authority significantly reduced the number of grants that required Compensation Committee approval. The additional compensation expense resulting from the correction of accounting for options granted after April 2002 was not material to any subsequent interim or annual financial statement period.

The Special Committee made no finding of fraud or intentional misconduct by any current or former employees, officers or directors, and concluded that no further changes in the company's executive officers will be recommended.

We are also recording approximately \$5.4 million of pre-tax accounting adjustments for the years 1999 through December 31, 2005 relating to stock option modifications, repricings of stock option grants and other errors in accounting for stock option transactions with our employees and consultants. The Company also determined that additional errors in its historical financial statements require correction as part of the restatement.

The cumulative effect of all restatement adjustments for periods before 2004 is reflected as an adjustment to our accumulated deficit as of January 1, 2004 from \$(47.1) million to \$(139.4) million. The cumulative after tax impact to net income for all of the periods effected by the restatement was \$96.0 million.

For a detailed description of the restatement, see Note 2, "*Restatement of Previously Issued Financial Statements*" to the accompanying audited consolidated financial statements and the section entitled "*Restatement*" in Management's Discussion and Analysis of Financial Condition and Results of Operations contained in Item 7 of this Report.

Unless otherwise noted, all of the information in this Annual Report on Form 10-K is as of December 31, 2006. This Report does not reflect any events that occurred after December 31, 2006 other than the Special Committee investigation, resulting restatements and related matters, and Note 15 "Subsequent Events" of our Notes to Consolidated Financial Statements. Our previously filed financial statements for the quarter ended March 31, 2006 will be restated in our Quarterly Report on Form 10-Q for the quarter ended March 31, 2007.

We have not amended and do not intend to amend any of our previously filed Annual Reports on Form 10-K or Quarterly Reports on Form 10-Q for the periods affected by the restatement. For this reason, the consolidated financial statements and related financial information contained in any related previously filed financial reports for periods affected by the restatement, and related opinions of the Company's independent registered public accounting firm, should not be relied upon.

## **PART I**

### **Item 1. Business**

#### **Overview**

Quest Software, Inc. ("Quest," the "Company," "we," "us" or "our") designs, develops, markets, distributes and supports enterprise systems management software products. Our goal is to provide our customers with products that improve the performance, productivity and reliability of their software applications and associated software infrastructure components such as databases, application servers and operating systems. Quest is an "Independent Software Vendor," or "ISV," a company whose products are designed to support or to interact or interoperate with other vendors' software or hardware platforms. As such, we continually strive to innovate and evolve our product portfolio to support the dynamic nature of our markets as well as those of our customers' IT environments. Our success has been predicated on identifying large and growing markets, developing and acquiring new products and technologies and then leveraging our sales organization and installed base to further our growth. While the company began as a provider of tools and solutions for the Oracle database, we continued to expand our offerings into other markets such as Application Performance Management and Windows

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Management. Most recently, the success of Virtualization as a “platform” has created new opportunities for Quest solutions and we entered that market with a key majority investment in late 2005 to serve as the underpinning of the entry into this market-space. We believe that this will bring Quest into a new era of management products where we can leverage our expertise in managing the physical IT assets which have already been deployed over the years while also supporting newer virtualization based solutions that customers are utilizing to support their dynamic environment.

We generate revenues by licensing our software products, principally on a perpetual basis, and by providing support, maintenance and implementation services for these products. As such, our reportable operating segments are Licenses and Services. The Licenses segment develops and markets licenses to use our software products. The Services segment provides after-sale support for software products and fee-based training and consulting services related to our software products. We have a large product portfolio of high-value products that include very technically complex solutions focused on improving the management and performance of mission-critical software applications and the underlying component infrastructure. We also have volume products and software tools that enable our customers to reduce capital and operating expenditures or leverage existing investments in personnel and IT systems. An active acquisition program is an important element of our corporate strategy and has served as a key mechanism upon which to broaden our product portfolio and enter new markets. This is evidenced by the entrance into both the Application Management and Windows Management businesses, both through a series of key acquisitions which served to propel the company beyond its Database Management roots. Within the last three fiscal years, we have invested over \$290.0 million, in the aggregate, to acquire a number of companies. Our acquisition strategy is directed to broaden our product portfolio and strengthen our competitive position against both direct competitors and the continual improvements made by the platform vendors.

Our primary portfolio of software products includes software solutions grouped into three categories: 1) Application Management, 2) Database Management and 3) Windows Management. Examples of the benefits delivered by our products’ include:

- improved application and database performance for large-scale complex mission-critical type systems;
- the ability to manage multi-tiered heterogeneous operating environments with integrated dashboards and metrics to leverage existing investments and support new technologies; and
- comprehensive migration, management and integration capabilities to simplify, automate and secure an organization’s Windows infrastructure.

Application Management is a core competency and is predicated on ensuring performance and availability of mission-critical applications throughout their life cycle. In the last two years we have made significant investments in the form of hiring experienced developers, product managers and others with marketing expertise to improve and broaden our suite of solutions for Application Management. Presently, our products are focused on the monitoring and performance management of customers’ primary enterprise software applications, whether packaged or custom-developed. These applications are complex in that they traverse every layer of the IT stack including storage, databases, application servers, web servers and the actual network itself all of which adds to the complexity of managing this environment. Historically speaking, the management of these applications was sequestered amongst each physical layer of the stack. As applications themselves became more complex over time and the need for our customers to improve application service levels became a market requirement, we embarked on a comprehensive research and development effort to build new product solutions which would unify a set of existing tools and create new functionality to support the current customer demand profile. Today, customers require a solution which not only manages application service levels, and helps diagnose the root causes of performance problems but also integrates and supports means to provide necessary corrective action. Our success within the market and current strategic focus for building increased capabilities is based upon the fact that packaged and custom-developed applications run within multi-vendor infrastructure environments. This means that customers have a myriad of platforms and investments they have deployed over the years and require tools that manage the breadth and depth of their environments. From a breadth perspective, our products manage custom web-based applications written in Java and .NET as well as packaged applications, such as PeopleSoft, Oracle E-Business Suite and SAP. From a depth perspective, our products cover key databases such as Oracle, DB2 and SQL Server as well as Oracle and BEA application servers and all key web servers in today’s market. Quest is in a unique position to provide this solution by leveraging existing products in our other product areas such as Database Management and Windows Management, which in certain cases, can be coupled with new solutions to be delivered in our Application Management product set in 2007.

Database Management is a market where we initially built an industry-leading reputation and today continues to represent a core technical strength for the company. While our revenue growth rate in this area has declined by comparison to our other product areas, our Database Development products have gained wide acceptance in the market and continue to generate a significant amount of cash flow for the company. As databases continue to grow in size, complexity and mission

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criticality every year the environments in which they are deployed require higher levels of service and thus more advanced tools and solutions to support their operation. As such, the predominant customer environment is comprised of a heterogeneous mix of database platforms which are fronted by a wide array of application and web servers all of which must be orchestrated to support a business service. This complex environment requires a vendor to offer a broad tool-set in order to be successful in the market. Our products are marketed to database administrators (“DBA”) and developers and are designed to improve database performance and to increase the level of productivity for those database developers responsible for the efficient and accurate deployment of mission-critical databases. Historically, our products and early success were focused within the Oracle segment of the database market and we are currently recognized as a leading Oracle ISV. However, within the last few years, Oracle has introduced products that compete directly with our Shareplex, Quest Central for Oracle and TOAD products. This in turn has negatively impacted our ability to grow revenues for certain of these products as we have in the past. In order to diversify our database business, enhance our ability to sustain revenue growth, and in direct response to the heterogeneous nature of our customers’ database profile, we embarked on a strategy to build and acquire products which addressed similar customer needs on other database platforms such as IBM’s DB2 and Microsoft’s SQL Server. More specifically, in 2001, we introduced database management tools offerings for DB2 and in the last few years, we entered the SQL Server market. Within our database management product line those products aligned with SQL Server have been the fastest growing products. To capitalize on this trend and further accelerate our move into the SQL Server market we acquired ImcEDA Software, Inc. in 2005. ImcEDA Software expanded our offerings by delivering products for backup, recovery and security auditing solutions for SQL Server.

Our Windows Management product portfolio has been the driver of our revenue growth during the last few years. Our portfolio of products has been built by key acquisitions such as FastLane Technologies, Inc. and Aelita Software Corporation in addition to core development and new product innovation. As we continue to recognize Microsoft’s ubiquity throughout our customer base, our strategy has been to identify areas within Microsoft Windows Server, Active Directory and Exchange platforms where we can broaden the core functionality a customer receives “out of the box”. Active Directory is an essential part of Microsoft’s Windows architecture that acts as the central authority to define and maintain the network infrastructure, perform system administration and control the user experience of a customer’s Microsoft infrastructure, including Microsoft Exchange, Microsoft’s widely used email system. When an individual logs onto his or her employer’s e-mail system, for example, he or she is logging on through Active Directory, which stores and verifies the person’s passwords, access rights and system profiles. Active Directory is a powerful system that is gaining wider acceptance as a primary system for controlling and validating user access rights, with Microsoft’s desktop predominance driving this trend. We believe Microsoft Active Directory will continue to play a strategic role in the enterprise. During 2005, we introduced products to extend Active Directory throughout the heterogeneous enterprise with integration and support for both Linux and UNIX. These products were based upon the products and technologies from Vintela, Inc. which we acquired in July 2005. We also acquired products to assist customers with the migration to the Exchange platform whether they were on earlier versions of a Microsoft product or other messaging systems including Domino/Notes or GroupWise. With our acquisition of AfterMail Limited in January of 2006, we expanded the messaging platforms supported by Quest’s archive solution from purely Microsoft Exchange to heterogeneous enterprises using IBM Lotus Notes, Novell GroupWise, Sendmail and other SMTP-based systems.

We invest a significant portion of our cash flow into our product development and management capabilities, and just over one-third of our employees work in product development, quality assurance or technical documentation roles. Given that we have a large number of products, many of which must perform across different combinations of existing infrastructure within our customers’ IT configurations, we spend a significant amount of our R&D efforts to ensure that our products work consistently within heterogeneous IT environments. For example, a particular customer that deploys an Oracle financial application on an Oracle application server with an Oracle database will generally get different performance characteristics than if it was deployed on a BEA application server with a DB2 database. For Quest, that means we need to test, evaluate and build capabilities within our products that help our customers manage these subtle differences which requires an extended effort to capture the potential and associated combinations and permutations of a customers’ infrastructure. A large proportion of our R&D organization supports and develops existing products lines. As we increasingly seek new product opportunities within emerging markets, we have at times successfully leveraged our expertise from current products. An example of this is our entrance into the Sharepoint market with products that share some technical aspects found in a few of our other products. In other instances where time to market is essential, we have supplemented our own technical efforts with acquisitions of technology and products from acquired companies such as we did with Aftermail Limited which accelerated our move into the messaging market. In building our products, we stress technical innovation and depth, ease of deployment, ease of use and tangible, readily articulated and measurable customer benefits. We sell our products primarily via our direct field sales force and, increasingly, our telesales organization, supplemented by indirect sales through resellers and distributors. We have offices located in 29 countries worldwide.

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We are a California corporation incorporated in 1987. Our principal offices are located at 5 Polaris Way, Aliso Viejo, California, 92656. We operate on a calendar fiscal year.

### **Solutions, Products and Services**

#### *Solutions*

Our products, known for achieving operational excellence, are also used to solve some of today's toughest information technology ("IT") challenges, such as achieving compliance, managing complex applications and simplifying identity management. We have three go-to-market strategies that are utilized in the sales process; Achieving Compliance, Managing Complex Applications and Simplifying Identity Management.

- *Achieving Compliance* — IT organizations are under increasing pressure to effectively control access to systems and build processes to manage an ever increasing user base with expanding geographic complexity. External regulations, such as Sarbanes-Oxley, FISMA, Basel II, and OMB Circular A-123, and internal security and accountability initiatives have made compliance a critical issue for many organizations. The same Quest products that are designed to support performance and productivity improvements for applications, databases and Windows infrastructure can also help the IT organization implement general IT controls. Our solutions address compliance in four key areas: access to sensitive systems and data, change to applications and system configurations, availability of critical systems and data, and retention of important business communications and records.
- *Managing Complex Applications* — Managing both planned and unplanned change in complex application environments is one of IT's toughest challenges. Quest enables organizations to deliver, manage and control the most complex application environments. Whether an organization is in the planning stages, ready to deploy, or is looking for ways to discover, diagnose and resolve application issues, Quest has a deep understanding of the application – from end-user to database.
- *Simplifying Identity Management* — For many organizations, identity management means Active Directory (AD) for Windows systems. For others, identity management means automating specific tasks such as provisioning or password resets. And for others still, identity management means large frameworks for the integration of heterogeneous systems. Whatever an organization's specific challenge with identity management might be, Quest offers tools that simplify identity management with increased manageability, cross-platform integration, and audit and compliance reporting. Identity management solutions from Quest help organizations get increased security, streamlined management and end-user satisfaction.

#### *Products*

We market products grouped along three main categories: 1) Application Management, 2) Database Management and 3) Windows Management. Major products in these categories are described as follows.

#### **Application Management**

Our Application Management products are focused on bringing automation to the tasks performed by the IT organization to manage the complexity of the application lifecycle. Our flagship product for Application Management is Foglight while Spotlight, PerformaSure and JProbe products, the latter two focused on J2EE applications, round out the remainder of our offerings. In the last few years we undertook a significant effort to update Foglight. Foglight Version 5.0 was released in mid-2007. The goal was to evolve an architecture which was bred in the era of broad application level monitoring to a dynamic solution designed to help customers manage their Business Services requirements complete with service dependency mapping, customizable policies and process workflows. Our products can be targeted at both pre-production and production environments and as such, we combine these products into suites which pair business-centric views of applications with deep domain expertise to both measure and improve the performance of packaged and custom applications.

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*Application Assurance Suite for Java & Portals.* Custom-developed J2EE (Java 2 Enterprise Edition) applications require a unique set of performance management solutions to assure performance and reliability across the entire application lifecycle. We provide an integrated solution designed to help all the stakeholders of a J2EE application measure, analyze and optimize the performance of their application environments before they are released to staging and production. Our Application Assurance Suite for Java & Portals is a performance diagnostic tool for multi-tiered Java application and enterprise portals running in pre-production and test environments. The suite is composed of several products including:

- JProbe, a performance toolkit for Java tuning;
- JClass, Java components for visualization and reporting; and
- QDesigner, a database application design tool that combines object-oriented design and physical data modeling capabilities in a single integrated environment.

*Performance Management Suite for Java & Portals.* Within the production environment, customers can ensure high-quality delivery of applications to end-users across the enterprise while managing the many facets of the dynamic infrastructure. Foglight is an application management solution that monitors every tier in critical application stacks including databases, networks, application servers, web servers and applications alerting administrators to problems before they impact end-users. Foglight offers an array of specialized cartridges focused on ERP and CRM applications to provide a complete monitoring solution for a distributed IT environment. Our series of complementary Spotlight diagnostic products allow IT personnel to visualize the components of an application, database or other layer of the application stack all the way down to the end user. Our User Experience Monitor allows administrators to measure and manage web-based application performance and service levels from the end-users' perspective.

*Stat<sup>®</sup> ACM.* Stat ACM (Application Change Management) helps IT managers lower their PeopleSoft and Oracle E-Business Suite total cost of ownership by providing end-to-end change management and version control. It helps keep up with change configurations and customizations so that they are updated, approved and deployed to instances throughout the application implementation lifecycle. By tracking version control and versioning capabilities as well as process management, change request tracking, requirements management and distributed development support, Stat ACM adds visibility, hides complexity and automates workflow through an easy-to-use GUI (graphical user interface) environment.

### **Database Management**

A company's database management systems represent some of the most complex and critical components within its infrastructure. As companies broaden their utilization of databases from multiple platform vendors, database administrators and developers are required to learn to use non-integrated toolsets across their environment to manage the performance and complexity of this tier. Our market leading database management products support the needs of today's database developers and DBA's by providing superior domain capabilities and cross-platform productivity tools within an integrated console to improve database quality and performance.

*Database Development.* These tools improve the productivity and capability of database developers working in the Oracle Procedural Language (PL)/SQL environment. The primary products in this product family are TOAD<sup>®</sup> and SQL Navigator.<sup>®</sup> We provide a complete and integrated development environment for coding stored procedures, schemas and SQL scripts from one intuitive graphical user interface. Debugging, SQL tuning, change analysis, and general administration features improve the quality and performance of database applications before they enter production.

*The Quest Central<sup>®</sup> product family for Oracle, SQL Server, DB2 and Sybase.* Administering large heterogeneous database systems in production involves many tedious, error-prone and repetitive tasks. To streamline and automate these tasks and improve the accuracy and effectiveness of database administrators, we have developed the Quest Central product family. Quest Central is a suite of tools that enables the DBA to identify the cause of performance problems without manual trial and error or decentralized tools. These products provide details on historical performance analysis and metrics to provide insight as to how performance issues occur. The Quest Central family of products provides a consistent presentation delineating the performance management of multiple databases enabling DBAs to manage more databases without adding resources. We are currently marketing and selling Quest Central DBA product families for Oracle, Microsoft SQL Server, DB2 and Sybase databases.

*SharePlex.<sup>®</sup>* SharePlex provides real-time replication of Oracle databases for customers who need to ensure a current, secondary copy of their transactional Oracle database is available if the primary database is unavailable. Many customers use SharePlex to offload management reporting, so the activity no longer compromises the performance of transaction processing. Further, SharePlex is also frequently used to eliminate end user disruption by providing continuous access to data during the migration of operating systems, hardware platforms and major application releases.

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*LiteSpeed for SQL Server.* LiteSpeed offers significant benefits to the entire organization accountable for managing Microsoft's SQL Server databases, including backups, business operations and storage management. Benefits range from time and cost savings for the IT staff on a daily basis and for IT management to support the organization's overall mission. LiteSpeed for SQL Server dramatically reduces storage costs and backup/recovery windows by compressing data in significantly less time than other backup solutions. The LiteSpeed for SQL Server backup engine compresses data up to 95 percent, in half the time required by other backup solutions. LiteSpeed speeds up restore times through its ability to recover individual database objects and encapsulate complete database restores into a single file.

### **Windows Management**

Microsoft applications and their associated infrastructure platform continue to be a global standard. Our products enable IT personnel to simplify, automate and secure their infrastructure with management, migration and integration capabilities for this environment. Our products are focused on key elements of the infrastructure including Microsoft's Active Directory, Exchange and Windows Server. Our Windows Management products include:

*Quest Management for Active Directory.* Microsoft Active Directory is technically complex and requires meticulous management to ensure the accuracy and security of its content across the entire enterprise. Quest Management for Active Directory is a set of products that provide diagnostics, recovery, detailed auditing, group policy management, reporting, self-service, role-based delegation and user provisioning. Our products offer a practical approach to automated user provisioning and provide a comprehensive delegation model, consolidated reporting and auditing and expert advice on problem resolution for teams managing complex Microsoft infrastructures.

*Quest Management for Exchange.* E-mail growth is leading to increased traffic, storage and support issues, including compliance. Quest Management for Exchange provides a comprehensive set of tools to migrate, store, recover and intelligently manage growth and the related spending for mission-critical Exchange infrastructures. Our products enable mailbox and public folder management, distribution list management, usage analysis, and diagnostics to optimize investment and performance in Exchange environments. This allows administrators and managers to better target investments, enforce corporate policies, enhance customer service, reduce administrative costs and improve troubleshooting efficiency. Additional functionality and integration is available for customers who have chosen Microsoft Operations Manager (MOM) as their unattended monitoring solution.

*Quest Migration Suite for Active Directory.* The Quest Migration Suite for Active Directory is a ZeroIMPACT™ solution for planning and executing migration projects to Active Directory from Windows NT or Novell NDS. It supports thorough migration planning and Active Directory pruning and grafting – with no interruption to business workflow. It's distributed processing and robust project management features simplify migration processes.

*Quest Migration Suite for Exchange.* The Quest Migration Suite for Exchange is also a ZeroIMPACT solution that helps plan and execute migration projects to Exchange 2000/2003 from Exchange 5.5 or 2000. In addition this product enables customers to migrate from a Domino/Notes or GroupWise environment to Exchange. It helps to ensure seamless migration processes and provides a centralized place for project management as well as analysis tools and reporting mechanisms.

*Quest InTrust.* Quest InTrust offers auditing and policy compliance to help systems administrators securely collect, store and report on event data to meet the needs of external regulations, internal policies and best practices.

*Vintela Authentication Services.* Vintela Authentication Services, ("VAS") allows Unix and Linux to take advantage of the access, authentication and authorization within Active Directory. This product functionally extends Active Directory's security, compliance and authentication capabilities into the extended enterprise.

### **Services**

#### **Customer Support Services**

A high level of product maintenance and technical support is critical to the successful marketing and sale of our products and the development of long-term customer relationships. We have a reputation for providing a high level of customer support and believe this is a competitive differentiator. Initial enrollment in our customer support program for

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one year is bundled with a sale of a software license and entitles a customer to problem resolution services, new functional enhancements of a product, and ongoing compatibility with new releases of the database, application or other platforms supported by the product; annual renewals are offered thereafter. We also offer multi-year support. In 2006 we made infrastructure investments including the implementation of knowledge management software and upgraded our global support system as part of a process to increase our support services capabilities and address the growing list of our products. Customer support is provided domestically through our offices in Aliso Viejo and internationally through our offices in Europe, Canada and Singapore (which was opened in 2006).

### **Professional Consulting and Training Services**

Our professional services include pre- and post-sales consulting, as well as education and training. Our consulting services include a wide range of offerings such as assistance with optimization, migration, simplifying an infrastructure or increasing its responsiveness, and installation and systems integration for the rapid deployment of Quest products. We offer our consulting and training services with the initial deployment of our products as well as on an ongoing basis to address the continuing needs of our customers. Our professional services staff is located throughout North America, Europe and APAC, enabling us to perform installations and respond to customer demands rapidly across our global customer base.

We also have relationships with resellers, professional service organizations and system integrators including Accenture, Avanade, Cap Gemini and others, which include participation in the deployment of our products to customers. These relationships help promote Quest products and provide additional technical expertise to enable us to provide the full range of professional services our customers require to deploy our products.

We offer product education courses to train our business partners and customers on the implementation and use of our products. Product training is provided at our headquarters, on-line and at customer sites as well as other regional and international locations.

### **Sales, Marketing and Distribution**

We market and sell our products and services worldwide primarily through our direct sales organization, our telesales organization and, increasingly, via indirect sales channels with a group of value added resellers (VAR's) and distributors. At December 31, 2006, we had approximately 460 full-time direct sales representatives. Approximately 84% of our sales representatives are field sales personnel, who sell all of our products other than those sold by our telesales representatives. The remaining 16% of our sales representatives are telesales employees, who sell products such as our Oracle and J2EE development and certain Microsoft related products that are generally evaluated through Internet downloads rather than on-site technical demonstrations. We have approximately 260 pre-sales systems engineers who work with these field sales teams to provide technical assistance and demonstrations to sales prospects. We have continued to invest in this area to supplement our direct sales organization with indirect sales channels with companies such as Dell and IBM in addition to resellers focused on governmental business. This activity requires broad based programs to recruit, manage and expand our support operations to grow and expand these relationships. We also employ local resellers in certain international territories not covered by our local sales offices.

We have sales offices in many major cities of the United States, Europe, Asia and Australia to facilitate close contact between current and potential customers and our field sales organization. Sales originated outside of the United States are generally denominated in the foreign currency of the country of origin. Our European operation, which has received considerable focus and investment, has been our fastest growing geographic region over the last several years. The APACJ region is our newest region and has seen considerable investment in 2006 including the recent build-out of our technical support center in Singapore and hiring of sales and support personnel for us to build capabilities within the marketplace.

Our marketing efforts are designed to create awareness, generate leads, and assist the worldwide sales organization with converting leads into closed sales. We have three general "go to market" messages, Achieving Compliance, Managing Complex Applications and Simplifying Identity Management which are supported by key initiatives throughout our sales organization and are utilized by sales teams to get on the "radar screen" of customers. These initiatives are focused on critical issues' facing today's IT buyers and are meant to exemplify how Quest products can be integrated to address customer requirements around these issues. We use a full complement of marketing vehicles including industry trade shows and conferences, user groups and discussion forums, educational white papers and knowledge briefs, electronic and print advertising, webcasts, direct marketing via electronic and postal mailings, and online advertising. Strategic and channel partners often assist us with the development, funding and execution of our marketing programs. Targeted campaigns and sales programs are developed based on objective, audience and product mix and are executed in our regions around the world to maximize revenue opportunities as quickly as possible.

For information regarding our segment revenue and revenue by geographic area, please refer to Note 14 of our Notes to Consolidated Financial Statements.

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### **Research and Development**

We believe that strong research and product development capabilities are essential to enhancing our core technologies and developing additional products. Innovative capabilities, strong product engineering and rich user interfaces are typical Quest attributes. We target ease of implementation and ease of use in designing our products. Our commitment to ongoing product development is reflected in our investments in research and development, which were \$110.6 million, \$89.1 million and \$83.6 million for the years ended December 31, 2006, 2005 and 2004, respectively. We have actively recruited key software engineers and developers with expertise in the areas of Oracle technologies, Java, Microsoft infrastructure technologies, ERP and CRM systems. We have also built-up these competencies through small and medium-sized acquisitions and majority owned investments which have provided us with expertise in virtualization management technologies. In addition to the U.S., we have significant product development operations in Canada, Australia, Russia and Israel.

### **Competition**

The market for enterprise systems management solutions is intensely competitive and characterized by rapidly changing technology and evolving standards. We expect competition to continue to increase both from existing competitors and new market entrants. We believe that our ability to compete effectively depends on many factors, including:

- the ease of use, performance, features, price and reliability of our products as compared to those of our competitors;
- the value proposition of our products in terms of return on investment and/or reduced cost of ownership;
- the timing and market acceptance of new products and enhancements to existing products developed by us and our competitors;
- the quality of our customer support; and
- the effectiveness of our sales and marketing efforts.

We compete in some instances with the platform vendors of databases, applications, infrastructure and other systems that our products are designed to support. If these vendors include similar or equivalent functionality relative to our software as standard features of their underlying product, our revenues could be adversely affected. For example, competition with Oracle over the last several years has materially reduced license revenues generated by certain of our Database Management products including SharePlex and Quest Central for Oracle and has negatively impacted the growth rate of license revenues associated with our Oracle Database Development tools. Microsoft has continually upgraded the functionality of its platform offerings, which we believe will increase competitive pressure for our products in the future.

We also compete with other vendors of database, application and windows management tools. Public and private companies with whom we compete include:

- Oracle, BMC Software and CA in the database management product area;
- IBM/Tivoli, Hewlett Packard/Mercury, CA, BMC Software and Symantec in the application management product area; and
- Symantec, NetPro and NetIQ in the Microsoft management product area.

Some of our competitors and potential competitors have greater name recognition, a larger installed customer base company-wide and significantly greater financial, technical, marketing, and other resources than we do. Competitors may also be able to respond more quickly to new or emerging technologies and changes in customer requirements or devote greater resources to the development, promotion and sale of their products than we can.

Because there are relatively low barriers to entry in the software market, we may encounter additional competition as other established and emerging companies enter our field and introduce new products and technologies. Venture capitalists and others have funded numerous database, application and windows management companies. Accordingly, it is likely that new competitors or alliances among current and new competitors will emerge and see their offerings rapidly gain acceptance.

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There can be no assurance that we will be able to compete successfully against current and future competitors. Increased competition could result in price reductions, fewer customer orders, reduced gross margins and loss of market share, any of which could materially affect our business, operating results or financial condition.

### **Seasonality**

We have experienced seasonality in our orders and revenue, which has resulted in seasonality in our earnings. We tend to experience a higher volume of transactions and associated revenues in our third and fourth quarters ending September 30 and December 31, respectively, and within the last few weeks of a quarter, as a result of our customers' spending patterns and, to a lesser extent, the structure of our sales commission program. As a result of this seasonality for license transactions, we tend to have higher orders and revenues in the fourth quarters of a year than orders and revenues in the first quarter of the following year. We expect this seasonality to continue in the future.

### **Proprietary Rights**

We rely on a combination of patents, copyrights, trademarks, service marks, trade secret laws, and contractual restrictions to establish and protect proprietary rights in our products and services. The source code for our products is protected both as a trade secret and as an unpublished copyrighted work. Despite our precautions, it may be possible for a third party to copy or otherwise obtain and use our products or technology without authorization. In addition, the laws of various countries in which our products may be sold may not protect our products and intellectual property rights to the same extent as the laws of the U.S. Our competitors may independently develop technologies that are substantially equivalent or superior to our technology.

We rely on software that we license from third parties for certain components of our products and services to enhance our products and services and meet evolving customer needs. The failure to license any necessary technology, or to maintain our existing licenses, could result in reduced demand for our products.

Because the software industry is characterized by rapid technological change, we believe that factors such as the technological and creative skills of our personnel, new product developments, frequent product enhancements, name recognition, and reliable product maintenance are more important to establishing and maintaining a technology leadership position than the various legal protections of our technology.

We hold 9 patents issued in the United States and have 29 patent applications (including continuation and divisional applications) and 5 provisional patent applications on file with the United States Patent and Trademark Office for various technologies incorporated into our products. We intend to continue to file patent applications as appropriate in the future. We cannot be sure, however, that any of our pending patent applications will be allowed, that any issued patents will protect our intellectual property or will not be challenged by third parties, or that the patents of others will not seriously harm our ability to do business. In addition, others may independently develop similar or competing technologies or design around any of our patents. We do not believe we are significantly dependent on any of our patents as we do not generally license our patents to other companies and do not receive any revenue as a direct result of our patents.

Although we believe that our products and services and other proprietary rights do not infringe upon the proprietary rights of third parties, third parties may assert intellectual property infringement claims against us in the future. Any such claims may result in costly, time-consuming litigation and may require us to enter into royalty or cross-license arrangements.

### **Employees**

As of December 31, 2006, we employed 2,843 full-time employees, including 1,147 in sales and marketing, 83 in professional services, 1,075 in research and development, 216 in customer service and support and 322 in general and administrative, including information services personnel. We believe that our future success will depend in large part upon our continuing ability to attract and retain highly skilled managerial, sales, marketing, customer support, research and development and general and administrative personnel. Like other software companies, we face intense competition for such personnel, and we have at times experienced and continue to experience difficulty in recruiting and retaining qualified personnel. None of our employees are represented by a labor union; we have never experienced any work stoppages and we believe that our relationships with our employees are good.

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### Website

Our website is located at [www.quest.com](http://www.quest.com). We make available, free of charge on or through our website, our annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and all amendments to those reports as soon as reasonably practicable after such material is electronically filed with or furnished to the Securities and Exchange Commission. Information contained on our website is not part of this annual report on Form 10-K.

### Item 1A. *Risk Factors*

An investment in our shares involves risks and uncertainties. You should carefully consider the factors described below before making an investment decision in our securities. The risks described below are the risks that we currently believe are material risks of the business and the industry in which we compete.

Our business, financial condition and results of operations could be adversely affected by any of the following risks. If we are adversely affected by such risks, then the trading price of our common stock could decline, and you could lose part or all of your investment.

#### **Matters relating to or arising from our stock option investigation, including regulatory proceedings, litigation matters and potential additional expenses, may adversely affect our business and results of operations**

As described in the Explanatory Note to this Report, Part II, Item 7. "Management's Discussion and Analysis of Financial Condition and Results of Operations" and in Note 2 of our Notes to Consolidated Financial Statements included in this Report, we are restating our consolidated financial statements for periods through March 31, 2006 to reflect the findings of a voluntary, independent investigation of our stock option granting practices and related accounting. This investigation was conducted by A Special Committee of the Board of Directors with the assistance of independent outside legal counsel and outside forensic accounting consultants. To date, we have incurred significant expenses related to legal, accounting, tax and other professional services in connection with the investigation, the related restatements and related regulatory inquiries or proceedings and litigation matters, and may incur significant expenses in the future with respect to such matters. These events, even if resolved favorably, may be time-consuming, expensive and disruptive to normal business operations, and the outcomes of regulatory proceedings or litigation matters are difficult to predict and could have a material adverse effect on our business, results of operations and financial condition.

Although we believe we have made appropriate judgments in determining the financial and tax impacts of our historical stock option granting practices, we cannot provide assurance that the Securities and Exchange Commission ("SEC") or the Internal Revenue Service ("IRS") will agree with the manner in which we have accounted for and reported, or not reported, the financial and tax impacts. For a discussion of the judgments underlying the revised measurement dates, see "Management's Discussion and Analysis of Financial Condition and Results of Operations" in Part II, Item 7 of this Report. If the SEC or the IRS disagrees with our financial or tax adjustments or related disclosures and such disagreement results in material changes to our historical financial statements, we may be required to further restate our prior financial statements, amend prior filings with the SEC or take other action that is not currently contemplated.

In June 2006 we received an informal request for information from the Securities and Exchange Commission regarding our stock option practices. In January 2007 we were informed that the SEC issued a formal order of investigation in the matter. We have also been informally contacted by the U.S. Attorney's Office for the Central District of California and have been asked to voluntarily produce documents relating to our stock option granting practices. We are cooperating with the SEC and the U.S. Attorney's Office in connection with these matters, but can not predict if, when or how they will be resolved or what, if any, actions we may be required to take as part of any resolution of these matters. Any action by the SEC, the U.S. Attorney's Office or other governmental agency could result in civil or criminal sanctions against us and/or certain of our current and former officers, directors and employees.

Additionally, as discussed in Note 13 of Notes to Consolidated Financial Statements, included in Item 15 of this Report, we currently are engaged in civil litigation with parties that have alleged a variety of claims against Quest and certain of our current and former officers and directors relating to our stock option grant practices and related accounting. Although we and the other defendants intend to defend these claims vigorously, there are many uncertainties associated with any litigation, and we cannot assure you that these actions will be resolved without substantial costs and/or settlement charges. We have entered into indemnification agreements with each of our present and former directors and executive officers under which Quest is required to indemnify each such directors or executive officers against expenses, including attorneys' fees, judgments, fines and settlements, paid by such individual in connection with the pending litigation (other than indemnified liabilities arising from willful misconduct or conduct that is knowingly fraudulent or deliberately dishonest).

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The resolution of the pending investigations by the SEC and U.S. Attorney's Office, the defense of our pending civil litigation and any additional litigation relating to our past stock option grant practices or related restatement of our financial statements could result in significant costs and diversion of the attention of management and other key employees.

### **If we do not maintain compliance with Nasdaq listing requirements, our common stock could be delisted, which could, negatively impact the trading market for our securities and impact our ability to maintain equity-based stock incentive programs for our employees**

As a result of the stock option investigation and the restatement of our consolidated financial statements we could not timely file certain of our periodic reports with the SEC and, accordingly, our Common Stock has remained subject to delisting from the Nasdaq Global Select Market. We still have not yet filed our Quarterly Reports on Form 10-Q for the quarters ended March 31, 2007, June 30, 2007 and September 30, 2007 and will not have achieved full compliance with SEC reporting requirements until these reports are filed, as well as any other periodic reports which may hereafter become due. In November 2007, the Nasdaq Board of Directors advised the Company that we will be required to comply with the Nasdaq filing requirements by January 9, 2008. In addition, we were unable to solicit proxies for an annual meeting of shareholders in 2006 because we could not provide an annual report to shareholders, and have not been in compliance with the Nasdaq requirement to hold an annual meeting of shareholders. We have also not held a 2007 annual meeting of shareholders. Our intention is to hold an annual meeting of shareholders as soon as practicable following the filing of all of our delinquent periodic reports.

Our common stock could be delisted if we do not file our remaining delinquent reports with the SEC, if we are required to further restate or amend our filings or if we otherwise do not maintain compliance with applicable listing requirements. If our securities are delisted from the Nasdaq Global Select Market, they would subsequently be transferred to the National Quotation Service Bureau, or "Pink Sheets". The trading of our common stock through the Pink Sheets might reduce the price of our common stock and the levels of liquidity available to our stockholders. In addition, the trading of our common stock through the Pink Sheets could materially and adversely affect our access to the capital markets and our ability to raise capital through alternative financing sources on terms acceptable to us, or to raise capital at all. Securities that trade through the Pink Sheets are no longer eligible for margin loans, and a company trading through the Pink Sheets cannot avail itself of federal preemption of state securities or "blue sky" laws, which adds substantial compliance costs to securities issuances, including pursuant to employee option plans, stock purchase plans and private or public offerings of securities. Increased compliance burdens can also be expected to impact our ability to maintain and administer stock option programs and other forms of equity incentives for our employees, which could also impair our ability to recruit and retain key employees. If we are delisted in the future from the Nasdaq Global Select Market and transferred to the Pink Sheets, we could also be subject to other negative implications, including the potential loss of confidence by suppliers, customers and employees and the loss of institutional investor interest in our securities. Any or all of the foregoing consequences of delisting could adversely affect our business and results of operations.

### **We had material weaknesses in internal control over financial reporting and cannot assure you that material weaknesses will not be identified in the future. If our internal control over financial reporting or disclosure controls and procedures are not effective, there may be errors in our financial statements that could require a restatement or our filings may not be timely and investors may lose confidence in our reported financial information, which could lead to a decline in our stock price**

Section 404 of the Sarbanes-Oxley Act of 2002 requires us to evaluate the effectiveness of our internal control over financial reporting as of the end of each year, and to include a management report assessing the effectiveness of our internal control over financial reporting in each Annual Report on Form 10-K. Section 404 also requires our independent registered public accounting firm to attest to, and report on, management's assessment of our internal controls over financial reporting. In assessing the findings of the Special Committee's review and the restatement set forth in this Report, our management concluded that there were material weaknesses, as defined in the Public Company Accounting Oversight Board's Auditing Standard No. 2, in our internal controls over financial reporting as of December 31, 2006. See the discussion included in Part II, Item 9A of this Report for additional information regarding our internal control over financial reporting.

Our management does not expect that our internal control over financial reporting will prevent all error or all fraud. A control system, no matter how well designed and operated, can provide only reasonable, not absolute, assurance that the control system's objectives will be met. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. Controls can be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the controls. Over time, controls may become inadequate because changes in conditions or deterioration in the degree of compliance with policies or procedures may occur. Because of the inherent limitations in a cost-effective control system, misstatements due to error or fraud may occur and not be detected.

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We cannot assure you that all significant deficiencies and material weaknesses identified in this Report will be adequately remedied or will be fully remedied by any specific date, although we believe that our material weakness in internal controls relating to revenue recognition has been remedied as of the date of filing this Report. In addition, we can provide no assurances that significant deficiencies or material weaknesses in our internal control over financial reporting will not be identified in the future. Any failure to maintain or implement required new or improved controls, or any difficulties we encounter in their implementation, could result in significant deficiencies or material weaknesses, cause us to fail to timely meet our periodic reporting obligations, or result in material misstatements in our financial statements. Any such failure could also adversely affect the results of periodic management evaluations and annual auditor attestation reports regarding the effectiveness of our internal control over financial reporting required under Section 404 of the Sarbanes-Oxley Act of 2002 and the rules promulgated thereunder. The existence of a material weakness could result in errors in our financial statements that could result in a restatement of financial statements, cause us to fail to timely meet our reporting obligations and cause investors to lose confidence in our reported financial information, leading to a decline in our stock price.

### **We may incur additional expenses in order to assist our employees with potential federal and state income tax liabilities which may arise under Section 409A of the Internal Revenue Code**

As a result of our stock option investigation, we have determined that many of our outstanding stock option awards are deemed to have been granted at an exercise price below the fair market value of our stock on the actual accounting measurement date. The primary adverse tax consequences are: (1) that the re-measured options vesting after December 31, 2004 are potentially subject to option holder excise tax under Section 409A of the Internal Revenue Code (and, as applicable, similar excise taxes under state law); and (2) certain incentive stock options previously granted, could be deemed granted at below market value producing incremental payroll tax liabilities. We have recorded approximately \$0.6 million of expenses in the year ended December 31, 2006 relating to the anticipated settlement by the Company of federal and applicable state income taxes on behalf of the Company's employees for tainted options that were exercised during 2006. Employees of the Company who continue to hold tainted options may be subject to additional taxes, penalties and interest under Section 409A if no action is taken to cure the options from exposure under Section 409A before December 31, 2008.

Regarding potential future liabilities associated with Section 409A, we have yet to determine whether we will either implement a plan to assist the affected employees for the amount of this tax, adjust the terms of the original option grant, or adjust the terms of the original option grant and pay the affected employees an amount to compensate such employees for this lost benefit. As such, no additional expense has been recorded in the consolidated financial statements.

### **Our future success may be impaired and our operating results will suffer if we cannot respond to rapid market, competitive and technological conditions in the software industry**

The market for our software products and services is characterized by:

- rapidly changing technology;
- frequent introduction of new products and services and enhancements to existing products and services by platform vendors of database, application and Windows products and by our competitors;
- increasing complexity and interdependence of software applications;
- consolidation of the software industry;
- changes in industry standards and practices; and
- changes in customer requirements and demands.

To maintain our competitive position, we must continue to enhance our existing products and develop new products and services, functionality, and technology that address the increasingly sophisticated and varied needs of our customers and prospective customers, which requires significant investment in research and development resources and capabilities, involves significant technical and business risks and requires substantial lead-time and significant investments in product development. If we fail to anticipate new technology developments, customer requirements, industry standards, or if we are unable to develop new products and services that adequately address these new developments, requirements, and standards in a timely manner, or if we are incapable of timely bringing new or enhanced products to market, our products and services may become obsolete, we may not generate suitable returns from our research and development investments, and our ability to compete may be impaired, our revenue could decline, and our operating results may suffer.

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During the past three years, a large portion of our revenue growth has been attributable to the growth of our Microsoft Systems Management products and services, and we have relied upon sustained revenue and cash flow generation from our database management products in order to fund sales, marketing and research and development initiatives associated with our other product areas. We cannot provide any assurance that the revenues we derive from these product areas will continue to grow. In addition, over the last few years we have committed significant resources to development of new and enhanced application management products and have expanded our sales and services organizations to address anticipated business opportunities presented by our expanding application management product and services lines. We cannot provide any assurance that this strategy will be successful or that the release of our enhanced application management products or other new products or services will increase our revenue growth rate.

### **Our quarterly operating results may fluctuate in future periods and, as a result, we may fail to meet expectations of investors and analysts, causing our stock price to fluctuate or decline**

Our revenues and operating results may vary significantly from quarter-to-quarter due to a number of factors. These factors include the following:

- the size and timing of customer orders. See “Variations in the size and timing of our customer orders and differing nature of our products and services could expose us to revenue fluctuations and higher operating costs;”
- the discretionary nature of our customers’ purchasing decisions and budget cycles;
- the timing of revenue recognition for sales of software products and services;
- the extent to which our customers renew their maintenance contracts with us;
- exposure to general economic conditions and reductions in corporate or public sector IT spending;
- changes in our level of operating expenses and our ability to control costs;
- our ability to attain market acceptance of new products and services and enhancements to our existing products;
- our ability to introduce new products or enhancements to existing products and services in a timely manner;
- our ability to maintain our field and inside sales organizations with adequate numbers of sales and services personnel, and to minimize our costs of sales and marketing through efficient allocation of sales resources and methods to products having different sales characteristics and profiles;
- the introduction of new or enhanced products and services by our competitors and changes in the pricing policies of these competitors;
- the relative growth rates of competing operating system, database and application platforms and competitive conditions among vendors of these platforms;
- the unpredictability of the timing, level of sales and subsequent revenue recognition of our expanded efforts within our indirect sales channels;
- costs related to acquisitions of technologies or businesses, including acquired in-process research and development and amortization costs for intangible assets and possible impairments and uncertainties arising from the integration of products, services, employees and operations of acquired companies; and
- the timing of releases of new versions of third-party software products that our products support or with which our products compete.

In addition, the timing of our software product revenues is difficult to predict and can vary substantially from product-to-product and customer-to-customer. We budget our operating expenses on our expectations regarding future revenue levels. The timing of larger orders and customer buying patterns are difficult to forecast. Therefore, we may not learn of shortfalls in revenue or earnings or other failures to meet our expectations until late in a particular quarter. As a result, if total revenues for a particular quarter are below our expectations, we would not be able to proportionately reduce operating expenses for that quarter.

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We have experienced seasonality in our orders and revenues, which may result in seasonality in our earnings. The fourth quarter of the year typically has the highest orders and revenues for the year and higher orders and revenues than the first quarter of the following year. We believe that this seasonality results primarily from the budgeting cycles of our customers being typically higher in the third and fourth quarters and, to a lesser extent, from the structure of our sales commission program. In addition, the tendency of some of our customers to wait until the end of a fiscal quarter to finalize orders has resulted in higher order volumes towards the end of the quarter. We expect this seasonality to continue in the future.

Due to these factors, we believe that period-to-period comparisons of our results of operations are not necessarily meaningful and should not be relied upon as indications of future performance. Fluctuations in our results of operations are also likely to affect the market price of our common stock, if our operating results differ from expectations of investors or securities analysts, and may not be related to or indicative of our long-term performance.

### **Variations in the size and timing of our customer orders and differing nature of our products and services could expose us to revenue fluctuations and higher operating costs**

Our license revenues in any quarter are substantially dependent on orders booked and delivered in that quarter. Our revenues in a given quarter could be adversely affected if we are unable to complete one or more large license transactions or if the contract terms were to prevent us from recognizing revenue during that quarter. The sales cycles for certain of our software products can last from three to nine months, or longer, and often require pre-purchase evaluation periods and customer education, which can affect timing of orders. Further, we have often booked a large amount of our sales in the last month, weeks or days of each quarter and delays in the closing of sales near the end of a quarter could cause quarterly revenue to fall short of anticipated levels. Finally, while a portion of our revenues each quarter is recognized from previously deferred revenue, our quarterly performance will depend primarily upon current order volumes to generate revenues for that quarter. These factors may cause significant periodic variation in our license revenues. In addition, we incur or commit to operating expenses based on anticipated revenue levels, and generally do not know whether revenues in any quarter will meet expectations until the end of that quarter.

Our product portfolio is engineered for a broad variety of operating system, database and application platforms, and having a diverse set of functions and features. Some products, such as our database management products and other component products, are directed at database administrators and are generally sold at lower price points, and we strive to generate demand for these products through our telesales organization and marketing programs designed to maximize lead generation and website traffic. Sales of other, enterprise-wide products, primarily SharePlex and Foglight, require substantial time and effort from our sales and support staff as well as involvement by our professional services organizations and, to an increasing degree, our systems integrator partners. Large individual sales, or even small delays in customer orders, can cause significant variation in our revenues and adversely affect our results of operations for a particular period. Historically, we have not placed significant reliance on large sales transactions in any given quarter, with a substantial volume of our revenues being driven from smaller transactions. However, if we encounter difficulty sustaining our component product volumes, and cannot generate a sufficient number of large customer orders, or if customers delay or cancel such orders in a particular quarter, our revenues and operating results may be adversely affected. For these reasons, we face increasing complexity in building and sustaining the optimum combination of field and inside sales personnel to address the various and changing sales and distribution characteristics of our products, which in turn impacts our ability to manage and minimize our sales and marketing costs.

We rely heavily on our direct sales activities for license and services revenues, including renewals of annual maintenance contracts. We have in the past restructured or made other adjustments to our sales force in response to management changes, product changes, performance issues and other internal considerations. We recently made some adjustments to our coverage model to increase focus on global and other major accounts. We've also recently increased headcount in our telesales and sales associate groups. These changes can result in a temporary lack of focus and reduced productivity, which could have temporary negative effects on our license or services revenues.

Accordingly, if our revenue growth rates slow or our revenues decline, or if we fail to efficiently correlate our sales and marketing resources to our various products and their differing sales and distribution strategies, our operating results could be seriously impaired because many of our expenses are relatively fixed in nature and cannot be easily or quickly changed.

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### **Many of our products are vulnerable to direct competition from Oracle and other platform vendors**

We compete with Oracle in the market for database management solutions and the competitive pressure continues to increase. We expect that Oracle's commitment to and presence in the database management product market will increase in the future and therefore substantially increase competitive pressures. We believe that Oracle will continue to incorporate database management technology into its server software offerings and expand their development products possibly at no additional cost to its users. Competition from Oracle with certain of our Database Management products including SharePlex and Quest Central for Oracle has increased over the last two years and has continued to increase with Oracle's introduction of the next version of its database, known as Oracle 11g. Oracle 11g has enhanced capabilities in the functions competitive with SharePlex, Quest Central for Oracle and with the Oracle monitoring capabilities of Foglight including monitoring capabilities from the entire application stack. We believe increased competition from Oracle has materially depressed our SharePlex and Quest Central for Oracle revenues over the last four years. Oracle recently released SQL Developer which competes with TOAD, our market leading Database Development product for Oracle databases which contributes significantly to our revenues and net income.

In addition to the increasing competitive pressure from Oracle, Microsoft has continually upgraded the functionality of its platform offerings, which we also believe will increase competitive pressure for our Microsoft products in the future.

In some cases these types of platform vendor-provided tools are bundled with the platform and in other cases they are separately chargeable products, albeit at significantly lower price points. The inclusion of the functionality of our software as standard features of the underlying database solution or application supported by our products or sale at much lower cost could erode our revenues, particularly if the competing products and features were of comparable capability to our products. Even if the functionality provided as standard features or lower costs by these system providers is more limited than that of our software, there can be no assurance that a significant number of customers would not elect to accept more limited functionality in lieu of purchasing our products. Moreover, there is substantial risk that the mere announcements of competing products or features by large competitors such as Oracle could result in the delay or cancellation of customer orders for our products in anticipation of the introduction of such new products or features.

### **Our migration products for Microsoft's Active Directory and Exchange are vulnerable to fluctuations in the rate at which customers migrate to these products**

Our products for the migration, administration and management of Microsoft's Active Directory and Exchange products currently contribute approximately one-quarter of our Windows platform revenue, but migration license sales declined slightly in 2006. Our ability to sell licenses for our Active Directory and Exchange migration products depends in part on the rate at which customers migrate to newer versions of Microsoft's Active Directory or to newer versions of Microsoft Exchange, and from other messaging platforms to Exchange. If these migration rates were to materially decrease, our license revenues from these migration products would likely decline.

### **Many of our products are dependent on database or application technologies of others; if these technologies lose market share or become incompatible with our products, or if these vendors introduce competitive products or acquire or form strategic relationships with our competitors, the demand for our products could suffer**

We believe that our success has depended in part, and will continue to depend in part for the foreseeable future, upon our relationships with providers of major database and enterprise software programs, including Oracle, IBM, Microsoft and SAP. Our competitive advantage consists in substantial part on the integration between our products and products provided by these major software providers, and our extensive knowledge of their products and technologies. If these companies for any reason decide to promote technologies and standards that are not compatible with our technologies, or if they lose market share for their database or application products, our business, operating results and financial condition would be materially adversely affected. Furthermore, these major software vendors could attempt to increase their presence in the markets we serve by either introducing products that compete with our products or acquiring or forming strategic alliances with our competitors. These companies have longer operating histories, larger installed bases of customers and substantially greater financial, distribution, marketing and technical resources than we do, as well as well-established relationships with many of our present and potential customers, and may be in better position to withstand and respond to the current factors impacting this industry. As a result, we may not be able to compete effectively with these companies in the future, which could materially adversely affect our business, operating results and financial condition.

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### **If we fail to manage our operations and grow revenue or fail to continue to effectively control expenses, our future operating results could be adversely affected**

Historically, the scope of our operations, the number of our employees and the geographic area of our operations and our revenue have grown rapidly. In addition, we have acquired both domestic and international companies. This growth and the assimilation of acquired operations and their employees could continue to place a significant strain on our managerial, operational and financial resources. To manage our current growth and any future growth effectively, we need to continue to implement and improve additional management and financial systems and controls. We may not be able to manage the current scope of our operations or future growth effectively and still exploit market opportunities for our products and services in a timely and cost-effective way.

We cannot assure you that our operating expenses will be lower than our estimated or actual revenues in any given quarter. If we experience a shortfall in revenue in any given quarter, we likely will not be able to further reduce operating expenses quickly in response. Any significant shortfall in revenue could immediately and adversely affect our results of operations for that quarter. Also, due to the fixed nature of many of our expenses and our current expectation for revenue growth, our income from operations and cash flows from operating and investing activities could be lower than in recent years.

### **Failure to develop and sustain additional distribution channels in the future may adversely affect our ability to grow revenues**

We intend to direct additional efforts to drive domestic and international revenue growth through sales of our products and services through indirect distribution channels, such as global hardware and software vendors, systems integrators, or value-added resellers. Our ability to increase future revenues depends on our ability to expand our indirect distribution channels. If we fail in our efforts to maintain, expand and diversify our indirect distribution channels, our business, results of operations and financial condition could be adversely affected. Increasing activity in indirect distribution channels will present a number of additional risks, including:

- we may face conflicts between the activities of our indirect channels and our direct sales and marketing activities, which may result in lost sales and customer confusion;
- our channel partners can cease marketing and distributing our products and services with limited or no notice and with little or no penalty;
- our channel partners may not be able to effectively sell our products and services;
- our channel partners may experience financial difficulties that might lead to delays, or even default, in their payment obligations;
- we may not be able to recruit additional channel partners, or replace any of our existing ones; and
- our channel partners may also offer competitive products and services, and may not give priority to marketing our products or services.

### **Intense competition in the markets for our products could adversely affect our results of operations**

The markets for our products are highly competitive. As a result, our future success will be affected by our ability to, among other things, outperform our competitors in meeting the needs of current and prospective customers and identifying and addressing new technological and market opportunities. Our competitors may develop more advanced technology, adopt more aggressive pricing policies and undertake more effective sales and marketing campaigns and may be able to leverage more extensive financial, technical or partner resources. If we are unable to maintain our competitive position, our revenues may decline and our operating results may be adversely affected.

### **Our operating results may be negatively impacted by fluctuations in foreign currency exchange rates**

Our international operations are generally conducted through our international subsidiaries, with the associated revenues and related expenses, and balance sheets, denominated in the currency of the country in which the international subsidiaries operate. As a result, our operating results may be harmed by fluctuations in exchange rates between the U.S. Dollar and other foreign currencies. The foreign currencies to which we currently have the most significant exposure are the Canadian Dollar, the British Pound, the Euro and the Australian Dollar. To date, we have not used derivative financial instruments to hedge our exposure to fluctuations in foreign currency exchange rates.

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### **Our international operations and our planned expansion of our international operations expose us to certain risks**

We maintain research and development operations primarily in Canada, Australia, Russia and Israel, and continue to expand our international sales activities, with particular focus in Asia Pacific (including Japan), as part of our business strategy. As a percentage of total revenues, revenues outside of North America were 35%, 33% and 31% for the years ended December 31, 2006, 2005 and 2004, respectively. As a result, we face increasing risks from our international operations, including, among others:

- difficulties in staffing, managing and operating our foreign operations;
- difficulties in coordinating the activities of our geographically dispersed and culturally diverse operations;
- difficulties in adapting our existing foreign operations, particularly in Asia, to the control structure and requirements of a US public entity given those Asian countries historical environment and their cultural approach to conducting business;
- longer payment cycles and difficulties in collecting accounts receivable;
- seasonal reductions in business activity during the summer months in EMEA and in other periods in other countries;
- increased financial accounting and reporting burdens and complexities;
- difficulties in hedging foreign currency transaction exposures;
- limitations on future growth or inability to maintain current levels of revenue from international operations if we do not invest sufficiently in our international operations;
- potentially adverse tax consequences;
- potential loss of proprietary information due to piracy, misappropriation or weaker laws regarding intellectual property protection;
- delays in localizing our products;
- political unrest or terrorism, particularly in areas in which we have facilities;
- our ability to adapt and conform to accepted local business practices and customs, including providing letters of credit or other forms of support to or for the benefit of our subsidiaries or resellers;
- compliance with a wide variety of complex foreign laws and treaties, including employment restrictions; and
- compliance with licenses, tariffs and other trade barriers.

Operating in international markets also requires significant management attention and financial resources and will place additional burdens on our management, administrative, operational and financial infrastructure. We cannot be certain that investment and additional resources required in establishing facilities in other countries will produce desired levels of revenue or profitability. In addition, we have limited experience in developing localized versions of our products and marketing and distributing them internationally.

### **Acquisitions of companies or technologies may result in disruptions to our business and diversion of management attention**

We have in the past made and we expect to continue to make acquisitions of complementary companies, products or technologies. Acquisitions require us to assimilate the operations, products and personnel of the acquired businesses and train, retain and motivate key personnel from the acquired businesses. We may be unable to maintain uniform standards, controls, procedures and policies if we fail in these efforts. Similarly, acquisitions may subject us to liabilities and risks that are not known or identifiable at the time of the acquisition or may cause disruptions in our operations and divert management's attention from day-to-day operations, which could impair our relationships with our current employees, customers and strategic partners. We may have to use cash, incur debt or issue equity securities to pay for any future acquisitions. Use of cash or debt may affect our liquidity and use of cash would reduce our cash reserves and reduce our

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financial flexibility. The issuance of equity securities for any acquisition could be substantially dilutive to our shareholders. In addition, our profitability may suffer because of acquisition-related costs or amortization costs for intangible assets with indefinite useful lives. In consummating acquisitions, we are also subject to risks of entering geographic and business markets in which we have no or limited prior experience. If we are unable to fully integrate acquired businesses, products or technologies with our existing operations, we may not receive the intended benefits of an acquisition.

### **Accounting for equity investments in companies may affect our operating results**

We have made equity investments in other software companies and a private equity fund. We regularly consider opportunities to make equity investments in other companies focused on software development or marketing activities, and expect from time to time to complete additional investments. These investments are risky because the market for the products and technologies being developed by these companies are typically in the early stages and may never materialize. In addition, we have made at least one investment in a private software company that has required us to consolidate the results of operations of this company into ours and we may determine in the future to invest in additional companies at similar levels. Estimating the fair value of our equity investments is inherently subjective and may contribute to volatility in our reported results of operations. We have recognized accounting charges due to the impairment of the value of our investments in the past and may need to do so again in the future if we cannot substantiate the fair value of our strategic equity investments. If we are required to consolidate the operating results of these companies, use the equity method of accounting, or write down the value of our cost-method investments, our operating results may be adversely affected.

### **We face risks associated with governmental contracting**

We derive a portion of our revenues from contracts with the United States government and its agencies and from contracts with state and local governments or agencies. Demand and payment for our products and services are impacted by public sector budgetary cycles and funding availability, with funding reductions or delays adversely impacting public sector demand for our products and services. Public sector customers may also change the way they procure new contracts and may adopt new rules or regulations governing contract procurement, including required competitive bidding or use of “open source” products, where available. These factors may limit the growth of or reduce the amount of revenues we derive from the public sector, which could negatively affect our results of operations.

### **We may not generate increased business from our current customers, which could slow our revenue growth in the future**

Most of our customers initially make a purchase of our products for a single department or location. Many of these customers may choose not to expand their use of our products. If we fail to generate expanded business from our current customers, our business, operating results and financial condition could be materially adversely affected. In addition, as we deploy new modules and features for our existing products or introduce new products, our current customers may choose not to purchase this new functionality or these new products. Moreover, if customers elect not to renew their maintenance agreements, our service revenues would be materially adversely affected.

### **Failure to develop or leverage strategic relationships could harm our business by denying us selling opportunities and other benefits**

Our development, marketing, and distribution strategies rely increasingly on our ability to form strategic relationships with software and other technology companies. These business relationships often consist of cooperative marketing programs, joint customer seminars, lead referrals, and cooperation in product development. Many of these relationships are not contractual and depend on the continued voluntary cooperation of each party with us. Divergence in strategy or change in focus by, or competitive product offerings by, any of these companies may interfere with our ability to develop, market, sell, or support our products, which in turn could harm our business. Further, if these companies enter into strategic alliances with other companies or are acquired, they could reduce their support of our products. Our existing relationships may be jeopardized if we enter into alliances with competitors of our strategic partners. In addition, one or more of these companies may use the information they gain from their relationship with us to develop or market competing products.

### **Failure to adequately protect our intellectual property rights could harm our competitive position**

Our success and ability to compete are dependent on our ability to develop and maintain the proprietary aspects of our technology. We generally rely on a combination of trademark, trade secret, patent, copyright law and contractual restrictions to establish and protect our proprietary rights in our products and services.

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Despite our efforts to protect our proprietary rights, unauthorized parties may attempt to copy aspects of our products or to obtain and use information that we regard as proprietary. Litigation may be necessary in the future to enforce our intellectual property rights, to protect our trade secrets, and to determine the validity and scope of the proprietary rights of others. Any such resulting litigation, whether successful or unsuccessful, could result in substantial costs and diversion of management and financial resources, which could harm our business.

Our means of protecting our proprietary rights may prove to be inadequate and competitors may independently develop similar or superior technology. Policing unauthorized use of our products is difficult, and we cannot be certain that the steps we have taken will prevent misappropriation of our technology, particularly in foreign countries where the laws may not protect our proprietary rights as fully as in the United States. We also believe that, because of the rapid rate of technological change in the software industry, trade secret and copyright protection are less significant than factors such as the knowledge, ability and experience of our employees, frequent product enhancements and the timeliness and quality of customer support services.

### **Third parties may claim that our software products or services infringe on their intellectual property rights, exposing us to litigation that, regardless of merit, may be costly to defend**

Our success and ability to compete are also dependent upon our ability to operate without infringing upon the proprietary rights of others. Third parties may claim that our current or future products infringe their intellectual property rights. Any such claim, with or without merit, could have a significant effect on our business and financial results. Any future third party claim could be time consuming, divert management's attention from our business operations and result in substantial litigation costs, including any monetary damages and customer indemnification obligations, which may result from such claims. In addition, parties making these claims may be able to obtain injunctive or other equitable relief affecting our ability to license the products that incorporate the challenged intellectual property. As a result of such claims, we may be required to obtain licenses from third parties, develop alternative technology or redesign our products. We cannot be sure that such licenses would be available on terms acceptable to us, if at all. If a successful claim is made against us and we are unable to develop or license alternative technology, our business and financial results and position could be materially adversely affected.

### **Our business may be adversely affected if our software contains errors or security flaws**

The software products we offer are inherently complex. Despite testing and quality control, we cannot be certain that errors or security flaws will not be found in current versions, new versions or enhancements of our products after commencement of commercial shipments. Significant technical challenges also arise with our products because our customers purchase and deploy our products across a variety of computer platforms and integrate them with a number of third-party software applications and databases. If new or existing customers have difficulty deploying our products or require significant amounts of customer support, our operating margins could be harmed. Moreover, we could face possible claims and higher development costs if our software contains undetected errors or security flaws or if we fail to meet our customers' expectations. As a result of the foregoing, we could experience:

- loss of or delay in revenues and loss of market share;
- loss of customers;
- damage to our reputation;
- failure to achieve market acceptance;
- diversion of development resources;
- increased service and warranty costs;
- legal actions by customers against us which could, whether or not successful, increase costs and distract our management; and
- increased insurance costs.

The detection and correction of any security flaws can be time consuming and costly. In addition, a product liability claim, whether or not successful, could harm our business by increasing our costs and distracting our management.

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### **We incorporate software licensed from third parties into some of our products and any significant interruption in the availability of these third-party software products or defects in these products could reduce the demand for, or prevent the shipping of, our products**

Certain of our software products contain components developed and maintained by third-party software vendors. We expect that we may have to incorporate software from third-party vendors in our future products. We may not be able to replace the functionality provided by the third-party software currently offered with our products if that software becomes obsolete, defective or incompatible with future versions of our products or is not adequately maintained or updated. Any significant interruption in the availability of these third-party software products or defects in these products could harm our sales unless and until we can secure an alternative source. Although we believe there are adequate alternate sources for the technology licensed to us, such alternate sources may not provide us with the same functionality as that currently provided to us.

### **Natural disasters or power outages could disrupt our business**

A substantial portion of our operations is located in California, and we are subject to risks of damage and business disruptions resulting from earthquakes, floods, wildfires and similar events, as well as from power outages. We have in the past experienced limited and temporary power outages in our California facilities due to power shortages, and we expect in the future to experience additional power losses. While the impact to our business and operating results has not been material, we cannot assure you that natural disasters or power outages will not adversely affect our business in the future. Since we do not have sufficient redundancy in our networking infrastructure, a natural disaster or other unanticipated problem could have an adverse effect on our business, including both our internal operations and our ability to communicate with our customers or sell and deliver our products.

### **Failure to attract and retain personnel may negatively impact our business**

Our success and ability to compete depends largely on the continued contributions of our key management, sales, engineering, marketing, support, professional services and finance personnel. We have recently had moderate turnover in our sales and research and development organizations, significant turnover in the management of our accounting and finance department, and many key positions are held by people who are new to the Company or to their roles. If these people are unable to quickly become familiar with the issues they face in their roles or are not well suited to their new roles, then this could result in the Company having problems in executing its strategy or in reporting its financial results. We are uniquely dependent upon the talents, relationships and contributions of a few executives and have no guarantee of their retention. We have been targeted by recruitment agencies seeking to hire our key management, finance, engineering, sales and marketing and professional services personnel.

We historically have used stock options as a significant component of our employee compensation program in order to align employees' interests with the interests of our shareholders, encourage employee retention and provide competitive compensation packages. During the pendency of our stock option investigation and related restatement, we were unable to continue granting stock options to new and existing employees and did not permit exercises of outstanding stock options. These actions have impacted our overall competitive posture with respect to employee compensation and retention of qualified personnel. If we are unable to hire or retain qualified personnel, or if newly hired personnel fail to develop the necessary skills or fail to reach expected levels of productivity, our ability to develop and market our products will be weakened.

### **Item 1B. *Unresolved Staff Comments***

None.

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Our corporate and administrative headquarters and certain research and development, sales and marketing and support personnel are located at two buildings that comprise our 170,000 square foot facility that we own in Aliso Viejo, California. We also lease properties throughout the United States and foreign countries to house additional research and development, sales and marketing, general and administrative and support personnel. Our largest leased facilities include:

<u>Location</u>	<u>Area Leased (sq. ft.)</u>	<u>Lease Expiration</u>
St. Petersburg, Russia	46,985	May 2010
Dublin, Ohio	41,618	April 2010
Toronto, Canada	33,768	December 2008
Maidenhead, United Kingdom	29,090	October 2010
Halifax, Canada	26,640	August 2013
Ottawa, Canada	24,054	May 2008
Melbourne, Australia	21,481	March 2010
Cologne, Germany	21,087	July 2010

We believe that our properties are in good condition, adequately maintained and suitable for the conduct of our business. Certain of our lease agreements provide options to extend the lease for additional specified periods. For additional information regarding our obligations under leases, see Note 13 of our Notes to Consolidated Financial Statements.

**Item 3. *Legal Proceedings***

The information set forth under Note 13 of our Notes to Consolidated Financial Statements, included in Part IV, Item 15 of this Report, is incorporated herein by reference. For an additional discussion of certain risks associated with legal proceedings, see the section entitled "Risk Factors" in Item 1A of this Report.

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

No matters were submitted to a vote of security holders during the fourth quarter of 2006.

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**PART II**

**Item 5. Market for the Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities**

**Market Information**

Our common stock is listed on The Nasdaq Global Select Market (formerly the NASDAQ National Market) under the symbol “*QSFT*.” Due to the Special Committee investigation of our historical stock option practices and the related restatements of our historical consolidated financial statements and ongoing impact of the resulting compensation expense adjustments, (see Note 2 of our Notes to Consolidated Financial Statements), we did not timely file our quarterly reports for the quarterly periods ended June 30, 2006, September 30, 2006, March 31, 2007, June 30, 2007 and September 30, 2007 or this Report, as required by the continued listing requirements of The Nasdaq Global Select Market. Therefore, the Company's stock remains subject to delisting from The Nasdaq Global Select Market.

The following table sets forth the high and low sale prices on The Nasdaq Global Select Market for our common stock for the periods indicated.

	<b>High</b>	<b>Low</b>
<b>2006:</b>		
First Quarter	\$ 16.95	\$ 14.34
Second Quarter	18.20	12.50
Third Quarter	14.88	11.17
Fourth Quarter	16.04	13.02
<b>2005:</b>		
First Quarter	\$ 16.15	\$ 13.03
Second Quarter	14.01	11.44
Third Quarter	15.43	12.80
Fourth Quarter	15.95	13.33

**Holders**

On November 15, 2007, the closing sale price of our common stock on The Nasdaq Global Select Market was \$16.65 per share. As of November 15, 2007, there were 178 holders of record of our common stock (not including beneficial holders of shares held in “*street name*”).

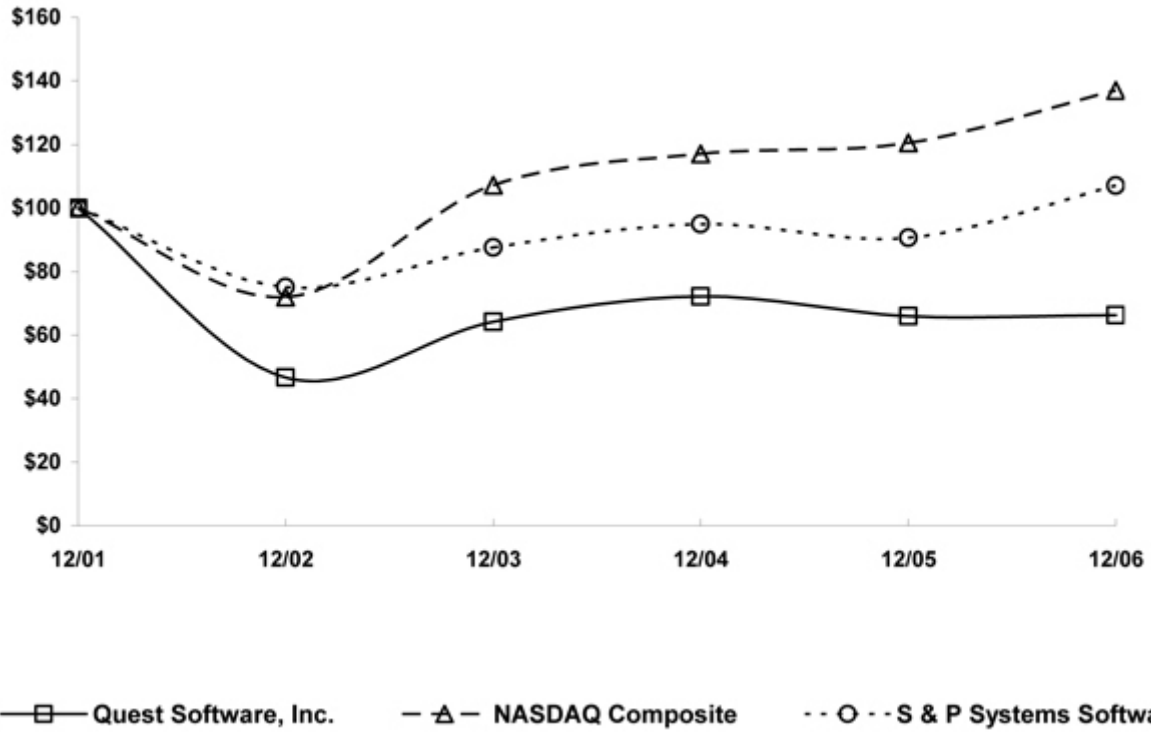
**Dividends**

We have never declared or paid any cash dividends on our common stock and do not expect to do so in the foreseeable future. We currently intend to retain all available funds for use in the operation and expansion of our business. Any future determination to pay dividends will be at the discretion of our board of directors and will depend on our results of operations, financial condition, contractual and legal restrictions and other factors the board deems relevant.

**Performance Graph**

The following graph shows a comparison of cumulative total shareholder return, calculated on a dividend reinvested basis, for Quest Software, the NASDAQ Composite Index (the “NASDAQ Index”), and the S&P Systems Software Index (the “Industry Index”). The graph assumes \$100 was invested in each of the Common Stock of Quest Software, the NASDAQ Index and the Industry Index on December 31, 2001. Note that historic stock price performance is not necessarily indicative of future stock price performance.

**COMPARISON OF 5 YEAR CUMULATIVE TOTAL RETURN\***  
Among Quest Software, Inc., The NASDAQ Composite Index  
And The S & P Systems Software Index



\* \$ 100 invested on 12/31/01 in stock or index-including reinvestment of dividends. Fiscal year ending December 31.

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**Item 6.**      *Selected Financial Data*

The following selected consolidated financial data is qualified by reference to and should be read in conjunction with the consolidated financial statements and the related notes and “Management’s Discussion and Analysis of Financial Condition and Results of Operations.” The income statement data for the years ended December 31, 2006, 2005 and 2004, and the balance sheet data as of December 31, 2006 and 2005, were derived from the audited consolidated financial statements included in this Report.

The consolidated balance sheets as of December 31, 2005, 2004, 2003 and 2002 and the consolidated statements of income for the years then ended have been restated as set forth in this Report. The information set forth below is not necessarily indicative of results of future operations, and should be read in conjunction with Item 7, “Management’s Discussion and Analysis of Financial Condition and Results of Operations” and the consolidated financial statements and related notes thereto included in this Report to fully understand factors that may affect the comparability of the information presented below. The restatement of the Company’s financial statements is more fully described in the “Explanatory Note” immediately preceding Part I, Item 1; Part II, Item 7, “Management’s Discussion and Analysis of Financial Condition and Results of Operations”; and in Note 2, “Restatement of Previously Issued Financial Statements” in our Notes to Consolidated Financial Statements. The as restated amounts reflect the required retrospective adoption of a change in accounting for planned major maintenance activities on our corporate aircraft, which was sold in November 2006. See Note 1 of our Notes to Consolidated Financial Statements.

The Company has not amended its previously filed Annual Reports on Form 10-K or Quarterly Reports on Form 10-Q for the periods affected by this restatement. The financial information that was presented in previous filings or otherwise reported for these periods is amended by the information in this Annual Report on Form 10-K and with respect to the quarter ended March 31, 2006, in our Quarterly Report on Form 10-Q for the quarter ended March 31, 2007. The financial statements and related financial information contained in such previously filed reports should no longer be relied upon.

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	Year ended December 31,		
	2006	2005 As Restated	2004 As Restated
(in thousands, except per share amounts)			
<b>Consolidated Income Statement Data:</b>			
Revenues:			
Licenses	\$ 290,247	\$ 256,131	\$ 224,647
Services	271,342	215,873	165,147
Total revenues	561,589	472,004	389,794
Cost of revenues:			
Licenses	5,570	5,005	3,962
Services	49,773	38,381	30,530
Amortization of purchased technology	15,932	11,476	8,902
Total cost of revenues	71,275	54,862	43,394
Gross profit	490,314	417,142	346,400
Operating expenses:			
Sales and marketing	247,500	203,851	172,138
Research and development	110,612	89,078	83,622
General and administrative	65,821(1)	48,474	41,142
Amortization of other purchased intangible assets	6,758	7,179	5,212
In-process research and development	960	7,840	6,980
Litigation loss provision	—	—	16,000
Total operating expenses	431,651	356,422	325,094
Gain on sale of Vista Plus product suite (2)	—	39	29,574
Gain on sale of corporate aircraft	3,987	—	—
Income from operations	62,650	60,759	50,880
Other income (expense), net	13,005	(1,046)	9,272
Income before income tax provision	75,655	59,713	60,152
Income tax provision	16,670	27,257	7,901
Net income	\$ 58,985	\$ 32,456	\$ 52,251
Basic net income per share	\$ 0.58	\$ 0.33	\$ 0.55
Diluted net income per share	\$ 0.57	\$ 0.32	\$ 0.53
Weighted average shares outstanding:			
Basic	101,380	97,621	94,622
Diluted	104,103	101,030	97,841
<b>Consolidated Balance Sheet Data:</b>			
Cash, cash equivalents and marketable securities	\$ 390,160	\$ 242,961	\$ 297,579
Total assets	1,161,537	989,947	870,454
Current and long-term portion of deferred revenue	235,559	174,803	126,799
Short-term obligations	104,936	89,982	105,469
Long-term obligations	2,129	1,730	1,769
Total shareholders' equity	818,913	723,432	636,417

(1) Includes \$6.6 million associated with the investigation of our historical stock option grant practices. We also recorded \$1.5 million in incremental stock-based compensation expense resulting from modifications to certain former employee stock option grants as a result of our inability to currently honor the exercise of certain options which would have otherwise expired. See Note 11 of our Notes to Consolidated Financial Statements.

(2) See Note 5 of our Notes to Consolidated Financial Statements.

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	Year ended December 31,					
	2003			2002		
	As Previously Reported	Adjustments	As Restated (2)	As Previously Reported	Adjustments	As Restated (2)
(in thousands, except per share amounts)						
<b>Consolidated Income Statement Data:</b>						
Revenues:						
Licenses	\$ 179,560	\$ (109)	\$ 179,451	\$ 160,636	\$ 538	\$ 161,174
Services	124,728	135	124,863	94,946	(253)	94,693
Total revenues	304,288	26	304,314	255,582	285	255,867
Cost of revenues:						
Licenses	4,312	4	4,316	3,539	7	3,546
Services	21,365	1,285	22,650	17,913	1,452	19,365
Amortization of purchased technology						
	7,675	—	7,675	5,744	—	5,744
Total cost of revenues	33,352	1,289	34,641	27,196	1,459	28,655
Gross profit	270,936	(1,263)	269,673	228,386	(1,174)	227,212
Operating expenses:						
Sales and marketing	144,460	9,596	154,056	128,570	11,016	139,586
Research and development	67,448	9,498	76,946	60,051	13,223	73,274
General and administrative	29,656	6,153	35,809	24,971	7,124	32,095
Amortization of other purchased intangible assets	3,390	—	3,390	2,037	—	2,037
In-process research and development						
	—	—	—	2,900	—	2,900
Litigation loss provision	—	—	—	—	—	—
Total operating expenses	244,954	25,247	270,201	218,529	31,363	249,892
Income (loss) from operations	25,982	(26,510)	(528)	9,857	(32,537)	(22,680)
Other income, net (1)	7,637	(48)	7,589	8,651	119	8,770
Income (loss) before income tax provision	33,619	(26,558)	7,061	18,508	(32,418)	(13,910)
Income tax provision (1)	12,103	(9,977)	2,126	8,124	(7,780)	344
Net income (loss)	\$ 21,516	\$ (16,581)	\$ 4,935	\$ 10,384	\$ (24,638)	\$ (14,254)
Basic net income (loss) per share	\$ 0.23	\$ (0.18)	\$ 0.05	\$ 0.12	\$ (0.28)	\$ (0.16)
Diluted net income (loss) per share	\$ 0.23	\$ (0.18)	\$ 0.05	\$ 0.11	\$ (0.27)	\$ (0.16)
Weighted average shares outstanding:						
Basic	92,081	—	92,081	90,065	—	90,065
Diluted	94,231	361	94,592	92,820	(2,755)	90,065
<b>Consolidated Balance Sheet Data:</b>						
Cash, cash equivalents and marketable securities						
	\$ 278,366	\$ —	\$ 278,366	\$ 207,546	\$ —	\$ 207,546
Total assets (1)	667,811	(481)	667,330	591,281	(8,147)	583,134
Current and long-term portion of deferred revenue						
	83,373	151	83,524	63,210	285	63,495
Short-term obligations (1)	58,585	10,027	68,612	44,148	8,704	52,852
Long-term obligations	1,677	32,032	33,709	5,941	26,766	32,707
Total shareholders' equity (1)	524,176	(42,691)	481,485	477,982	(43,902)	434,080

(1) Adjustments to these line items include adjustments for the required retrospective adoption of a change in accounting for planned major maintenance activities on our corporate aircraft. See Note 1 of our Notes to Consolidated Financial Statements.

(2) This table presents the effects of the restatement for periods not derived from the accompanying audited financial statements.

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### **Item 7. *Management's Discussion and Analysis of Financial Condition and Results of Operations***

The following discussion of our financial condition and results of operations ("MD&A") should be read in conjunction with the consolidated financial statements and notes to those statements included elsewhere in this Report, and gives effect to the restatement discussed below and in Note 2 of our Notes to Condensed Consolidated Financial Statements. Certain statements in this Report, including statements regarding our business strategies, operations, financial condition and prospects are forward-looking statements. Use of the words "believe," "expect," "anticipate," "will," "contemplate," "would" and similar expressions that contemplate future events may identify forward-looking statements.

Numerous important factors, risks and uncertainties affect our operations and could cause actual results to differ materially from those expressed or implied by these or any other forward-looking statements made by us or on our behalf. Readers are urged to carefully review and consider the various disclosures made in this Report, including those described under "Risk Factors," and in other filings with the SEC that attempt to advise interested parties of certain risks and factors that may affect our business. Readers are cautioned not to place undue reliance on these forward-looking statements, which are based on current expectations and reflect management's opinions only as of the date thereof. We do not assume any obligation to revise or update forward-looking statements. Finally, our historic results should not be viewed as indicative of future performance.

#### **Restatement**

Subsequent to the issuance of the Company's 2005 consolidated financial statements, the Company's management determined that incorrect measurement dates were used for financial accounting purposes for certain stock option grants made in prior periods and that other stock option and non-stock option related errors in its historical financial statements require correction, as described in more detail below. As a result, the consolidated financial statements as of December 31, 2005 and for the years ended December 31, 2005 and 2004 have been restated from the amounts previously reported to correct these errors. The after tax effect to net income of all adjustments amounted to \$(1.3) million, \$9.6 million and \$(4.9) million for the years ended December 31, 2006, 2005 and 2004, respectively.

#### ***Background and Scope of the Investigation***

On May 17, 2006, a financial analyst at Deutsche Bank published a report entitled "Infrastructure SW Update: Analyzing potential for backdated stock options." The report analyzed the likelihood of various software companies having historically back dated equity awards. Quest Software was identified in this report as one company with characteristics similar to other companies which had previously announced stock option investigations. After reviewing the Deutsche Bank report, our General Counsel and then Chief Financial Officer initiated an internal review of the facts and circumstances of our historical stock option granting practices and related documentation. On May 22, 2006, the Board of Directors was briefed on the existence of the Deutsche Bank report and preliminary results of the internal review.

On May 26, 2006, our Board formed a Special Committee of independent directors to conduct an investigation of our historical stock option granting practices and related accounting. The Special Committee was initially comprised of Kevin M. Klausmeyer and Augustine L. Nieto II, both members of the Audit Committee, with the understanding that Mr. Nieto would serve temporarily until another independent, disinterested member was appointed. On June 8, 2006, H. John Dirks joined our Board and was appointed to the Audit Committee and the Special Committee, replacing Mr. Nieto as a member of the Special Committee. The Special Committee retained outside legal counsel, Duane Morris LLP, and Duane Morris retained forensic accounting consultants, Navigant Consulting, Inc., to assist in the investigation.

The Special Committee's investigation covered facts, circumstances and timing of stock option grants made by the Company from June 1998 to December 2005. The Special Committee and its advisors reviewed voluminous electronic and hard copy documents, including files of the Company's current and former employees, officers and directors involved in the administration and approval of, as well as in the accounting for, stock option grants made under the Company's stock option programs. In addition to the documents reviewed, the Special Committee's lawyers conducted interviews with more than 20 individuals that had knowledge of our stock option granting practices, including current and former employees, officers and directors.

#### ***Historical Stock Option Granting Practices***

Prior to January 1, 2006, we accounted for our stock option grants under Accounting Principles Board Opinion No. 25 ("APB No. 25") and had provided the required disclosures pursuant to the provisions of Statement of Financial Accounting Standards, or SFAS No. 123, *Accounting for Stock-Based Compensation* ("SFAS 123"). On January 1, 2006, we adopted

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SFAS No. 123R, *Share-Based Payment* (“SFAS 123R”), under the modified prospective method. For the accounting measurement date revisions made, we revised the historical pro forma footnote disclosures made in accordance with SFAS 123. Additionally, we restated our consolidated financial statements for the three months ended March 31, 2006 to reflect the impact of revised accounting measurement dates on compensation expense recognized in accordance with SFAS 123R.

As permitted by the terms of our stock incentive plans, the Board of Directors was vested with the authority to administer and grant stock options under the plans, and the Board of Directors had delegated general authority for stock option plan administration to the Compensation Committee of the Board. Until August 2003, all employee stock option grants were required to be approved by the Board of Directors or the Compensation Committee. Beginning in August 2003 and as permitted by the terms of our stock incentive plans, the Board of Directors delegated authority, subject to specific parameters, to our Chief Executive Officer as a “Secondary Committee” to approve stock option awards to employees other than officers or directors of the Company. Option grants to officers and directors and other grants outside of the parameters discussed below continued to require Compensation Committee approval in order to complete the required granting actions.

From June 1998 through December 2005, the exercise price for all stock option grants was typically set at the closing sale price of our Common Stock on the original stated grant date, as reported by Nasdaq. During this period, we made the following types of grants of stock options to employees, including officers, and members of our Board of Directors:

- Annual, broad-based grants to large numbers of employees (referred to as annual grants);
- Grants to newly hired employees and grants to existing employees from time to time (referred to as new hire or merit grants);
- Options granted or assumed in connection with acquisitions; and
- Options granted to non-employee members of our Board of Directors according to the automatic grant program of our 1999 Stock Incentive Plan.

For our stock option grants dated from June 1998 through early 2001, we generally sought approval of the entire Board of Directors, including all new hire, merit and annual grants. Prior to September 1999, we did not have a defined process for determining the date on which we made grants, and no regular granting pattern could be established from our review of the facts and circumstances of those granting actions. Accordingly, the Special Committee concluded that required granting actions for stock option grants during the pre-IPO period between June 1998 and June 1999 were not completed with the required specificity and finality until June 9, 1999. On this date, we adopted our 1999 Stock Incentive Plan in contemplation of our IPO, which was completed in August 1999.

Beginning in late 1999, we changed our stock option granting practices by implementing a practice where we typically dated new hire and merit grants to employees on a monthly basis, where the grant date for any given new hire would be based on the month during which the new hire signed an employment offer letter or started employment with the Company. When option grants were granted to existing employees as merit grants, they were approved using the same practice and included in the monthly new-hire grant procedure. Option grants for these grants for a given month were dated as of the trading date during that month on which the closing price for our Common Stock reported by Nasdaq was determined to be the lowest monthly closing price, and the exercise price established for those option grants was the closing sale price of the Common Stock on such date. We made annual or broad-based, company-wide grants in 2000, 2001 and 2002 to executive and non-executive employees as of grant dates determined on the same basis as new hire or merit grants. The Special Committee also determined that approvals for certain option grants made in connection with acquisitions were obtained in connection with new hire or merit grants during this period, and that the period within which new hire and merit grant dates were determined was expanded from monthly to quarterly on a few occasions.

All discretionary employee grants required approval by the Board of Directors or the Compensation Committee to complete the required granting actions. For most grants we did not obtain approval from the Board of Directors or Compensation Committee (most often by means of a form of unanimous written consent that reflected an “as of” approval date), until after the end of the period (the particular month or quarter) within which the original grant date was intended.

Beginning with our April 2001 granting action, we sought Compensation Committee approval for all discretionary stock option grants to employees and other eligible participants, including consultants. In May 2002, we changed our stock option granting practices by determining grant dates and exercise prices as of the date when the required granting actions were actually completed. As a result, our April 2002 monthly new hire and merit grant was the last monthly grant for which the originally stated grant date was determined using the methodology of determining a grant price on a monthly or quarterly basis.

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In August 2003, the Board of Directors established a Secondary Committee under the terms of our 1999 Stock Incentive Plan and 2001 Stock Incentive Plan, consisting of Vincent C. Smith, our Chairman of the Board and Chief Executive Officer, and delegated authority to the Secondary Committee to approve awards of stock options to employees within specific parameters. The delegation provided authority to grant up to 50,000 options to any employee in connection with his or her hiring into the Company, and up to 20,000 options to existing employees; provided, however, that no authority was delegated with respect to option grants to officers or directors of the Company. Compensation Committee approval continued to be a required granting action for all stock option grants outside of the parameters of the delegated authority. For grants outside the scope of delegated authority, the Compensation Committee approved such grants at a meeting or by unanimous written consent form.

Prior to the restatement discussed below, we used the originally stated grant dates as set forth above as the measurement date for financial accounting purposes. Accordingly, in each case the exercise price was determined to be equal to the closing stock price of our Common Stock as reported by Nasdaq on that date. In the restatement, we revised the accounting measurement dates for many grants and recorded stock-based compensation expense when the revised measurement date resulted in intrinsic value.

### ***Findings of the Investigation and Measurement Date Determinations***

The Special Committee performed a detailed review of all stock option grants awarded from August 13, 1999 (the date of the Company's initial public offering) through June 30, 2003 and all annual grants from July 1, 2003 through December 2005, covering grants to purchase 30,739,235 shares of Common Stock made in 7,287 awards on 39 granting dates. The Special Committee also performed limited testing on a sample of stock option grants made prior to the initial public offering covering grants to purchase 10,632,744 shares of Common Stock made in 762 awards on 38 granting dates. The Special Committee also performed limited testing on a sampling of new hire and merit stock option grants awarded after June 30, 2003 covering grants to purchase 5,082,350 shares of Common Stock representing 61% of all new hire and merit options granted during this period.

We classified option grants subject to the investigation into three time periods: (1) June 1998 through August 1999 (the "Pre-IPO Period"); (2) September 1999 through April 30, 2002; and (3) May 1, 2002 through December 2005. Because annual, broad-based grants were made in a process substantially similar to new hire and merit grants, we did not separately classify option grants by the nature of their granting process. Based on the facts obtained as a result of the Special Committee investigation, we identified grants for which we used an incorrect measurement date for financial accounting purposes, as defined under Generally Accepted Accounting Principles in the United States, or GAAP. To determine the correct accounting measurement dates for these grants we followed the guidance in APB No. 25, which deems the "measurement date" to be the first date on which all of the following are known with finality: (1) the identity of the individual employee who is entitled to receive the option grant; (2) the number of options that the individual employee is entitled to receive; and (3) the option's exercise price.

The Special Committee performed a grant date by grant date analysis of approximately 38 option grant dates during the Pre-IPO Period, 36 option grant dates between the IPO and June 30, 2003 and all 3 annual grants from July 1, 2003 through December 2005 for compliance with APB No. 25. Where we determined that we did not complete the required granting actions by the original grant date, we used judgment to determine corrected accounting measurement dates for all awards included within the granting action on each grant date consistent with what the evidence suggested was our practice or process. If the revised measurement date was not the same date we used previously, we made accounting adjustments as required, which resulted in stock-based compensation and related tax effects when an option had intrinsic value on the revised accounting measurement date.

The Special Committee reviewed a variety of documents and information in connection with its investigation including but not limited to the following:

- minutes of meetings of the Board of Directors and the Compensation Committee;
- actions by unanimous written consent signed by directors, together with evidence relating to the date such consents were requested and/or signed and returned;
- information contained in employee personnel files;
- electronic mail messages and other electronic files retrieved from our computer system and in back up media;
- information concerning the date or dates on which a stock option was entered into our stock option tracking system, Equity Edge;

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- information concerning the date on which a notice of stock option grants (and accompanying stock option agreement) was signed on behalf of Quest by an executive officer, which we considered to represent the Company's contractual commitment to complete the particular grant;
- correspondence, memoranda and other documentation supporting the option grant; and
- information obtained during interviews conducted by the Special Committee's legal counsel of numerous individuals, including current and former officers, directors, employees and outside professionals.

A total of 3,382 awards covering grants to purchase 22,553,293 shares of Common Stock required measurement date changes, of which options to purchase 3,604,950 shares of Common Stock were granted to employees who were executive officers of the Company at the time of their respective grant dates. None of our non-employee directors received stock option grants requiring measurement date corrections.

The Special Committee determined that both current and former senior management contributed to the Company's lack of controls and inappropriate grant practices. Specifically, the Special Committee determined that two former Chief Financial Officers and a former Corporate Controller, failed to perform the responsibilities of their positions and contributed to the Company's lack of controls and inappropriate grant practices. One former Chief Financial Officer resigned from the Company for unrelated reasons in January 2001. The other Chief Financial Officer resigned from the Company on November 18, 2006, after declining to be interviewed by the Special Committee. The Corporate Controller was reassigned from his accounting management role in October 2006.

The Special Committee made no finding of fraud or intentional misconduct by any current or former employees, officers or directors, and concluded that no further changes in the company's executive officers will be recommended.

The following table summarizes certain information with respect to option awards requiring accounting measurement date changes:

<u>Time Period</u>	<u>Number of Granting Dates</u>	<u>Number of Awards</u>	<u>Number of Shares</u>
Pre-IPO Period	35	757	10,519,744
Initial Public Offering through April 30, 2002	21	2,567	11,255,299
After April 30, 2002	11	58	778,250
Total	<u>67</u>	<u>3,382</u>	<u>22,553,293</u>

A summary of incremental pre-tax stock-based compensation expense related to options awarded in each time period covering the period from June 1998 through December 31, 2005 ("restatement period") resulting from a change in the accounting measurement date (in thousands), is as follows:

<u>Time Period</u>	<u>Pre-Tax Stock-based Compensation Expense, Net of Forfeitures</u>
Pre-IPO Period	\$ 23,288
Initial Public Offering through April 30, 2002	113,306
After April 30, 2002	319
Cumulative effect for options vested through December 31, 2005	<u>\$ 136,913</u>

### ***Pre-IPO Period Grants***

During the course of the investigation, information and documentation relating to stock option grants made prior to the Company's initial public offering was evaluated. The Special Committee determined that accounting measurement dates for most of the stock option grants during the period from June 23, 1998 through August 11, 1999 were incorrectly determined. These instances involved an aggregate of 757 stock option grants awarded to employees covering 10,519,744 shares of Common Stock. Specifically, the Special Committee discovered evidence that required details of 588 awards covering 9,373,344 shares covered by all grants between June 1998 and June 9, 1999 did not have the required level of finality or were not supported by sufficient documentation until June 9, 1999, the date on which the Company's 1999 Stock Incentive Plan was adopted by the Company and approved by its shareholders.

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For the stock option grants awarded between June 10, 1999 through August 11, 1999, the Company was unable to locate evidence of completion of required granting actions (specifically, approval of the stock option grants by the Company's Board of Directors or Compensation Committee). These instances involved an aggregate of 169 stock option grants to employees to purchase an aggregate of 1,146,400 shares of the Company's Common Stock. None of these stock options were granted to executive officers or senior officers who participated in the stock option granting processes associated with these grants. The Company has been honoring these stock options awards and settling them with stock and intends to continue doing so. Measurement date determinations for these option grants were made on the basis of all available relevant information and reflect the Company's reasonable conclusion as to the most likely option granting actions that occurred and related facts and circumstances. Specifically, we used evidence of the dates on which the Notices of Grant were executed on behalf of the Company as the best evidence of the granting actions actually completed, and used those dates as the revised measurement dates for financial reporting purposes.

Corrections to the accounting measurement dates for option grants during the Pre-IPO Period resulted in the recording of additional pre-tax stock-based compensation of \$23.3 million.

### *Post IPO Grants - September 1999 through April 2002*

In the fourth quarter of 1999, the Company initiated a practice of processing option grants to newly-hired employees and merit or promotion grants to existing employees on a monthly basis, starting with the grants dated September 1999, and to determine a single grant date for stock options granted within each of those particular months. The Special Committee found evidence demonstrating that stock option grants made in any given month were routinely made as of the trading date associated with the lowest closing sale price reported by Nasdaq for our Common Stock from September 1999 through April 2002, with only a few grants during such period made on other dates. The Special Committee also found evidence that the option grant dating practice expanded to quarterly, rather than monthly, grant date determinations.

For stock option grants during this time period, the Special Committee determined that:

- administrative approvals for required granting actions were generally documented by unanimous written consents of the Board or the Compensation Committee, and were dated "as of" the date corresponding to the trading date in a given month or quarter on which the Company's last sale price was determined to be the lowest in that period;
- all of such unanimous written consents were prepared after the selected grant dates and were executed by members of the Board or Compensation Committee at a later time, in some cases as much as up to three months after the selected grant date; and
- in certain cases, the lists reflecting stock option grants processed by the Company's stock plan administrator were different than the lists provided to and approved by either the Board or Compensation Committee, as the case may be.

For each of the 21 discretionary grants affected by the Special Committee's findings during this period, the Special Committee determined an accounting measurement date based on information and documentation evidencing the date as of which the related action by unanimous written consent ("UWC") had been signed by all of the directors or, in the case of Compensation Committee action, members of the Compensation Committee. However, in many cases, the Company was unable to locate definitive and complete documentation evidencing the date on which the last required approval of a UWC was signed by certain directors and received by the Company. For these stock option grants, the Company's measurement date determinations were made on the basis of all available relevant information and reflect the Company's reasonable conclusion as to the most likely option granting actions that occurred based on related facts and circumstances. For grants where there was insufficient evidence to determine when all required written consents were actually obtained, but there was evidence of the dates of receipt of individual written consents (such as contemporaneous electronic messages to or from individuals involved in the granting activities or facsimile header dates on signed unanimous written consent forms), we used this information as evidence of when the Compensation Committee approval was obtained, and used that date as the revised measurement date for financial reporting purposes. In other cases where we could not locate evidence of the date or dates on which required granting approvals were obtained, we used evidence of the dates on which the Notices of Grant were executed on behalf of the Company as the best evidence of the granting actions actually completed, and used those dates as the revised measurement dates for financial reporting purposes. We believe that these grants were communicated to employees in a timely manner. In some cases, we awarded option grants that were different in amount than that approved by the required granting actions or to employees whose awards were not included in lists approved by the Board of Directors or Compensation Committee. In each of these circumstances, we evaluated the existing information related to each individual grant and we established a new accounting measurement date when we determined that the terms of the award were fixed with finality, which was generally the date on which the related Notice of Grant was signed on behalf of the Company.

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Section 16 Insiders received stock options covering an aggregate of 2,904,950 shares of Common Stock in these grant events, which collectively resulted in \$24.0 million of additional compensation expense over the restatement period. See the discussion under the heading “Remedial Actions” below with respect to actions taken by the Company with respect to option awards to Section 16 Insiders. Employees other than Section 16 Insiders received options to purchase an aggregate of 8,350,349 shares in these grant events. Corrections to the measurement dates for all of the misdated grants during the period from September 1999 through April 2002 resulted in the recording of additional stock-based compensation expense of \$113.3 million.

### *Sensitivity Analysis*

Revised measurement dates for certain grants awarded during the period from September 1999 to September 2000 could not be determined with certainty. We therefore made judgments to establish the revised dates. These awards were made on six dates and covered options to purchase approximately 467,000 shares of Common Stock, or approximately one-half of the total number of shares covered by stock options granted during this period. For these grants, we have recorded pre-tax compensation expense adjustments of approximately \$8.4 million. We determined the revised measurement dates for these awards based upon the dates upon which the Company signed the Notices of Grant which was deemed for measurement date purposes, to be the dates on which the grants were completed. Had we used different judgments regarding the timing of the revised measurement dates, the stock-based compensation expense charges we recorded in the restatement would have been different.

We prepared a sensitivity analysis to determine the hypothetical minimum and maximum compensation expense charge that we might have recorded for these grants if we had used different judgments to determine the revised measurement dates. We applied our sensitivity methodology on a grant date by grant date basis to examine the largest hypothetical variations in stock-based compensation expense within a range of possible measurement dates for each grant event, which ranged from the originally recorded grant date to the revised measurement date. While we believe the evidence and methodology used to determine the revised measurement dates to be the most appropriate, we also believe that illustrating the differences in stock-based compensation expense using these alternative date ranges provides incremental insight into the extent to which hypothetical stock-based compensation expense would have fluctuated if we chose other measurement dates.

After developing the range for each grant event included in our sensitivity analysis, we selected the highest and lowest closing sale price of our Common Stock within the date range to determine the range of potential compensation expense adjustments for the grants. We then compared these aggregated amounts to the stock-based compensation expense that we recorded for the stock option grants analyzed. If we had used the highest closing sale price of our Common Stock within the date range for these grant events, our stock-based compensation expense adjustment relating to these grants would have increased by approximately \$4.3 million, from \$8.4 million to \$12.7 million. Conversely, had we used the lowest closing sale price of our Common Stock within the date range for the grants analyzed, we would not have recorded a stock-based compensation expense adjustment for these specific grants, as the fair market value of our common stock on those dates would have been at or below the actual exercise price of the options awarded.

### *Post IPO Grants - May 1, 2002 through December 2005*

The Special Committee performed a detailed review of all stock option grants awarded between May 1, 2002 and June 30, 2003 and all annual grants awarded between May 1, 2002 and December 2005. Measurement date exceptions were noted for 45 grants covering options to purchase 294,750 shares, for which an additional stock-based compensation expense of approximately \$278,000 has been recorded in the restated financial statements included in this Report. Based on the significant improvements in the Company’s stock option granting practices during this period, the Special Committee determined to conduct limited sampling and testing of new hire and merit stock option grants awarded after June 30, 2003. The Special Committee sampled 88 new hire and merit grants, covering 5,082,350 shares of Common Stock (61% of all shares covered

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by new hire and merit option grants). The remaining new hire and merit stock option grants occurring during the period from July 1, 2003 through December 31, 2005 were not individually reviewed and did not appear to have any unusual pricing or other characteristics indicating a need for full individual review. Sampling and other analysis indicated that these remaining grants consisted of new hire and merit grants to non-officer employees. Various tests were performed to determine whether these remaining grants had any unique pricing or other characteristics. None were identified, although measurement date exceptions were noted for 13 grants covering options to purchase 483,500 shares, for which an additional stock-based compensation expense of approximately \$41,000 has been recorded in the restated financial statements included in this Report. Given the immaterial number of shares and limited income statement impact, along with the absence of unique pricing or other characteristics, additional review procedures were not deemed necessary for these remaining grants occurring after June 30, 2003 and were therefore not applied.

### *Other Stock Option Related Adjustments*

In addition to adjustments to our reported stock-based compensation expenses resulting from corrections to accounting measurement dates, the restatement also reflects stock-option related adjustments arising from a variety of other issues discovered during our investigation:

- We recorded compensation expense as a result of modifications to stock options made or deemed to have been made to certain employees in connection with their termination of employment or extended leaves of absence. Typically such modifications related to, or resulted in, extensions of the time periods following cessation of service within which these employees could exercise vested stock options. We have recorded incremental pre-tax stock-based compensation expense associated with such modifications in the aggregate amount of \$2.0 million.
- We identified certain stock option grants awarded to non-executive employees which were repriced or otherwise modified in circumstances which required variable accounting treatment. We also identified an option grant awarded to a non-employee consultant deemed to have been granted in exchange for services. We have recorded incremental pre-tax stock-based compensation expense associated with these stock option awards in the aggregate amount of \$4.3 million.
- We determined that our accounting treatment for a restricted stock issuance in 2000 was incorrect. We issued 339,200 shares of common stock to an employee in connection with his initial employment with the Company as Vice President, Marketing, and accepted this employee's secured promissory note in the principal amount of \$15.8 million as payment of the purchase price for the shares. In June 2002, we determined that we should have treated the promissory note as a non-recourse obligation and, accordingly, treated the transaction as a stock option for financial reporting purposes. We also determined that we should not have accrued approximately \$1.4 million of interest income on the promissory note that we accrued from 2000 through March 31, 2002 but deemed the error to be immaterial to our results of operations. We have recorded an adjustment to our beginning retained earnings balance as of January 1, 2004 to reverse the interest income previously recorded on this promissory note.
- We incorrectly calculated the intrinsic value of unvested stock options assumed by the Company in connection with certain acquisition transactions. As a result, we have reduced the stock-based compensation expense resulting from the amounts of unearned compensation recorded in connection with those acquisitions in the aggregate amount of \$2.3 million.
- We determined that volatility assumptions used previously to estimate the fair value of our stock option grants required correction. As a result, we revised our fair value estimates based on corrected volatility assumptions for the period beginning January 1, 2001 and ending December 31, 2005.

All but \$0.7 million of the foregoing adjustments were recorded in periods preceding 2004. As a result, most of the impact of these adjustments is reflected in the adjustment of our opening accumulated deficit balance at January 1, 2004 in the consolidated financial statements included in this Report.

We may also incur additional expenses as a result of certain federal and state income tax consequences of the findings of our stock option investigation. We have determined that many of our outstanding stock option awards are deemed to have been granted at an exercise price below the fair market value of our stock on the actual accounting measurement date. The primary adverse tax consequence is that the re-measured options vesting after December 31, 2004 are potentially subject to option holder excise tax under Section 409A of the Internal Revenue Code (and, as applicable, similar excise taxes under state law). We have recorded approximately \$0.6 million of expenses in the year ended December 31, 2006 relating to the anticipated settlement by the Company of federal and applicable state income taxes on behalf of the Company's employees for tainted options that were exercised during 2006. Employees of the Company who continue to hold tainted options that

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vested after December 31, 2004 or are still unvested may be subject to additional taxes, penalties and interest under Section 409A if no action is taken to cure the options from exposure under Section 409A before December 31, 2008. The Company has yet to determine whether it will either implement a plan to assist the affected employees for the amount of this tax, adjust the terms of the original option grant, or adjust the terms of the original option grant and pay the affected employees an amount to compensate such employees for this lost benefit with respect to the unexercised options that vested after December 31, 2004.

### **Remedial Actions**

The following remedial steps were directed or recommended by the Special Committee in December 2006:

- For stock options which required measurement date changes granted to officers of the Company (“Section 16 Insiders”) who, at the time of grant, were required to file the reports required pursuant to Section 16 of the Securities Exchange Act of 1934 (“Executive Options”), the Special Committee required amendments to those Executive Options to increase the exercise price of any such stock options which remain outstanding to the market value of our Common Stock as reported by Nasdaq on the revised accounting measurement date. The Executive Options held by our Section 16 Insiders were amended as set forth in the table below, without the payment of any consideration by the Company:

<u>Officer</u>	<u>Original Grant Date</u>	<u>Options Outstanding</u>	<u>Original Exercise Price</u>	<u>Amended Exercise Price</u>
Vincent C. Smith	April 4, 2001	300,000	\$ 14.81	\$ 26.51
Vincent C. Smith	October 1, 2001	485,000	\$ 10.74	\$ 24.40
Douglas F. Garn	April 14, 2000	80,000	\$ 26.50	\$ 55.25
Douglas F. Garn	April 4, 2001	300,000	\$ 14.81	\$ 26.51
Douglas F. Garn	October 1, 2001	72,900	\$ 10.74	\$ 24.40
M. Brinkley Morse	April 4, 2001	100,000	\$ 14.81	\$ 26.51
M. Brinkley Morse	October 1, 2001	300,000	\$ 10.74	\$ 24.40
Kevin E. Brooks	October 1, 2001	5,000	\$ 10.74	\$ 24.40
Anthony Foley	April 29, 2002	34,000	\$ 11.91	\$ 12.96

The increase to the exercise prices of such options held by Messrs. Smith, Garn, Morse, and Brooks also had the effect of eliminating potential tax consequences to them under Section 409A of the Internal Revenue Code and comparable provisions of applicable state tax law.

- The Special Committee also directed the Company to request repayment from Section 16 Insiders of an amount representing the estimated after-tax gain realized by such Section 16 Insiders from exercises of Executive Options, except for Anthony Foley, and Eyal Aronoff (whose payment was subject to a cap of \$200,000). As of the date of this report, the Company has received repayments totaling \$157,831. Mr. Smith and Mr. Morse have never exercised any stock options granted to them by the Company and had no such gain to repay.

<u>Officer</u>	<u>Gain To Repay</u>
Eyal Aronoff	\$ 200,000
Douglas F. Garn	\$ 64,000
David M. Doyle	\$ 59,056
Kevin E. Brooks	\$ 34,775

- The Special Committee also determined to adopt a variety of process and corporate governance changes, including changes adopted in connection with the proposed settlement of the Company’s shareholder derivative litigation. The proposed corporate governance measures include, among other things, implementing certain policies, procedures and guidelines for stock option grants, adopting additional standards of director independence, adopting the “majority vote” standard for uncontested elections of directors, incorporating term limits for independent directors (16 years) and for audit committee members (10 consecutive years), and incorporating additional policies, procedures and guidelines. In addition, the Board approved certain amendments to the Company’s 1999 Stock Incentive Plan and 2001 Stock Incentive Plan. The stock option plan amendments include a new requirement that the exercise price for all nonqualified stock options (ie., stock options which do not qualify for “incentive stock option” treatment under applicable provisions of the

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Internal Revenue Code of 1986, as amended) must be not less than the market value of Quest's common stock on the grant date. Prior to this change, the exercise price for nonqualified stock options was required by the plans to be established by the applicable Plan Administrator. The Company's Board of Directors also approved related updates to the written charters of the Board's Audit Committee, Compensation Committee and Nominating & Corporate Governance Committee, and a related update to the Company's Corporate Governance Guidelines.

### *Non-Stock Option Related Adjustments*

The Company has determined that additional errors in its historical financials statements require correction in this restatement. Many of these errors were identified by the Company or its auditors in connection with the restatement related procedures. Other adjustments include items identified in prior periods, but deemed them not to be material to the Company's results of operations, and are included in this restatement. A summary of the impact of these adjustments to pre-tax income for the years ended December 31, 2005 and 2004 (in thousands), is as follows:

(Increase) Decrease in Pre-Tax Income Category	Year Ended December 31,	
	2005	2004
<b>Revenue Adjustments</b>		
Financial system programming error	\$ (134)	\$ (717)
Incorrect interpretation of complex orders	2,442	434
Inconsistent application of company policies	1,178	—
Other	688	(48)
Total Revenue Adjustments	4,174	(331)
<b>Expense Adjustments</b>		
Incorrect application of SFAS No. 144	566	795
Incorrect interpretation of complex orders	(239)	(65)
Incorrect application of company policies	(10)	(31)
Other	(115)	5
Total Expense Adjustments	202	704
<b>Other Income (Expense), Net Adjustments</b>		
Incorrect application of SFAS No. 52	(113)	(114)
Other	(24)	—
Total Other Income (Expense), Net Adjustments	(137)	(114)
<b>Total All Adjustments</b>	<b>\$ 4,239</b>	<b>\$ 259</b>

### **Revenue Adjustments**

Based upon a review of more than 100,000 software license and services transactions over the restatement period, the Company identified several instances where previously reported revenues were required to be corrected and recognized across various and appropriate reporting periods. There were several categories of revenue adjustments, but most were attributable to the following three categories of errors:

First, a programming error made at the time of our financial system's initial implementation in 2000, resulted in a systematic miscalculation of the timing of revenue recognition across certain of the Company's orders that contained a post-contract technical support services (referred to as PCS) line item. The error was identified and corrected in 2005 however we failed to evaluate the impact of the programming error and its effect on previously reported revenues. This error caused a shift in the timing of revenue recognition for all affected orders across numerous quarters and years, resulting in periodic quarterly over- and understatements of revenue.

Second, incorrect interpretations with respect to the timing of revenue recognition for certain complex orders resulted in an overstatement of license and/or PCS revenue either early in the contract or around the time of initial customer purchase and an understatement of the corresponding revenue either later in the contract or over a ratable period designated in the contract.

Third, inconsistent application of the Company's revenue recognition policies in geographies outside North America resulted in an overstatement of license and PCS revenue at and around the time of initial customer purchase and an understatement of the corresponding revenue at the time of cash collection.

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### Operating Expenses and Other Income (Expense), Net Adjustments

The Company also identified several instances where previously reported operating expenses or other income (expense), net items were required to be corrected and recognized across various reporting periods.

The first item related to an incorrect application of SFAS No. 144, "Accounting for the Impairment or Disposal of Long Lived Assets," where we performed our impairment analysis of acquired technology at the acquisition level as opposed to a product-by-product level approach, which resulted in an understatement of intangibles amortization expense related to acquired assets in the period that the impairment occurred and a corresponding overstatement of the related expense over that asset's remaining estimated useful life.

The second item related to the incorrect revaluation of monetary assets and liabilities in foreign subsidiaries as required by SFAS No. 52, "Foreign Currency Translation," which resulted in the periodic misstatement (both over and under) of the other income (expense), net line item on the income statement with the corresponding offsetting impact to monetary asset and liability accounts on the balance sheet (primarily cash and accounts receivable).

In addition to the revenue, operating expenses and other income (expense), net items covered specifically above, there were several additional adjustments also included in these restatement items that were grouped into the "other" categories given their minimal individual impact. Many of these adjustments include certain errors that were not previously recorded because in each case, and in the aggregate, the underlying errors were not considered by management to be material to our consolidated financial statements.

All the items identified above generally affect the timing pattern of revenue, expense and income recognition. As such, they do not generally change the cumulative revenues, expenses, pre-tax operating income, liquidity or cash flow of the Company.

### Impact of Errors on Previously Issued Consolidated Financial Statements

As a result of the findings of the Special Committee's investigation with respect to employee stock options and the other adjustments described in this Report, our consolidated financial statements for the years ended December 31, 2005 and 2004 have been restated. The restated consolidated financial statements include unaudited financial information for interim periods of 2005 and 2006 consistent with Article 10-01 of Regulation S-X. We recorded additional stock-based compensation expense and other accounting adjustments, and related tax adjustments, affecting our previously-reported financial statements for 1999 through 2003, the effects of which are summarized in cumulative adjustments to our common stock (additional paid-in capital), unearned compensation, accumulated deficit and note receivable from sale of common stock accounts as of January 1, 2004, in the amounts of \$80.6 million, \$48.2 million, \$92.5 million and \$17.2 million, respectively. See the Consolidated Statements of Shareholders' Equity, included in Part IV, Item 15 of this Report.

The financial information presented in this Item 7 has been adjusted to reflect the incremental impact resulting from the restatement adjustments discussed above, as follows (in thousands):

### Summary of Impact of Restatement Adjustments

Year Ended	(Increase) Decrease in Pre-Tax Income			Tax Effect of Adjustments		Total Adjustments, Net of Tax
	Stock Option Related Adjustments (1)	Other Adjustments	Total Adjustments, Pre-Tax	Option Related Payroll Tax Adjustments(3)	Income Tax Effect of All Adjustments	
1999	\$ 10,060	\$ —	\$ 10,060	\$ —	\$ (2,782)	\$ 7,278
2000	21,731	1,579	23,310	6,221	(5,066)	24,465
2001	24,270	2,195	26,465	1,268	(8,370)	19,363
2002	30,679	(248)	30,431	2,103	(7,825)	24,709
2003	25,860	240	26,100	635	(10,048)	16,687
Cumulative effect on January 1, 2004 opening accumulated deficit	112,600	3,766	116,366	10,227	(34,091)	92,502(4)
2004	19,814	259	20,073	(7,433)	(17,563)	(4,923)
2005	9,869	4,239	14,108	(889)	(3,582)	9,637
<b>Total</b>	<b>\$ 142,283</b>	<b>\$ 8,264</b>	<b>\$ 150,547</b>	<b>\$ 1,905</b>	<b>\$ (55,236)</b>	<b>\$ 97,216</b>

- (1) Comprised of \$136.9 million of stock-based compensation expense adjustments arising from measurement date corrections and \$5.4 million of other stock option related adjustments.
- (2) Other non-stock option related adjustments to revenue, operating expenses, and other income (expense), net.
- (3) Relates to potential payroll tax liabilities for incentive stock options deemed to be granted at below market value and is included with the appropriate compensation expense.
- (4) The cumulative effect does not include the cumulative impact of the retrospective adoption of a change in accounting for planned major maintenance activities on our corporate aircraft. See Note 1 of our Notes to Consolidated Financial Statements.

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### Overview

#### *Our Company and Business Model*

Quest Software, Inc. delivers innovative products that help IT organizations get more performance from their computing environment. Our product areas are Application Management, Database Management and Windows Management. The focus of our products is based upon generating higher levels of performance, manageability and productivity throughout our customers' IT infrastructure and with products and services that enable them to manage the investments they have made within their IT environment.

Our initial core competency as a database management company was built upon deep expertise within the Oracle database platform where we assembled a portfolio of products to manage and speed the development on the platform. As customers required heterogeneous database management tools, we broadened our product portfolio to deliver complementary solutions and expanded our offerings to address other database platforms, including DB2 and SQL Server. Today, most of our database management revenue is derived from products focused on the Oracle platform. In the last several years however, Oracle has increased the functionality of their database products creating a stronger competitive offering which has impaired our license growth for certain products. This has negatively impacted our database management product growth. On the other hand, our database development product group led by TOAD, continues to be the most significant revenue contributor of our Oracle database products. In early 2006 Oracle introduced SQL Developer, a free tool which competes with TOAD. While TOAD distinguishes itself as a feature-rich heterogeneous database platform tool, we invested in sales and marketing resources to broaden our customer footprint with TOAD and strengthen our feature set of this key product. While doing this we simultaneously sought to stimulate our broader database-driven product revenues by placing more emphasis on the SQL Server Database, a Microsoft product. Given the rapid growth of SQL Server within the market, our strategy has been to foster continued development on this platform and to build increased management capabilities into our offerings in support of the platform. While databases typically front large application deployments, they logically interact with other elements of the application infrastructure. This logical linkage and reliance on the database led Quest into its next product focal point known as application management.

From our acquisition of Foglight Software in January 2000 and then Sitraka in October 2002, to our current offerings for application management, we have made significant investments in developing and supporting products for this market. Foglight remains our flagship product and largest revenue component of our application management offerings. As our customers face the need to manage more complex applications with service oriented architectures, our products for identifying application outages and performance have become important tools. Much of 2006 was an investment year for our application management products. Our R&D team was focused on developing the next version of Foglight by reconstructing the product, integrating the previously acquired Sitraka technology and other end-user aspects into an integrated solution which was brought to market during 2007.

After establishing a market presence in both the database and application management markets, we sought to broaden our portfolio further into the Windows management tools market in early 2000 with our acquisition of Fastlane Technologies. In 2004, we acquired Aelita Software. Our acquisition of Aelita, combined with internally developed products, solidified our position as one of Microsoft's leading ISV's. We market and support management tools for three key Microsoft platforms – Active Directory, Exchange and SQL Server, and our products address both migration and management of the Windows platform. Our migration business comprises a set of products which support migration from other competitive platforms to its' comparable Microsoft platform, as well as migrations from earlier to the most current version of Microsoft platforms. In addition, we offer products which complement the core platform tools which are natively used by customers to manage these platforms once they are in a production environment.

As our Windows products emerged and continued to grow in market popularity, the composition of our overall revenue profile changed from being primarily derived from the Oracle database platform tools to a more balanced profile with our Windows products. During 2006, as most large scale migrations were completed earlier, the primary driver of our revenue growth shifted from our migration products to the management group of products in our Windows portfolio. The management portfolio was bolstered in 2005 with products acquired through Vintela and Imceda which covered SQL Server and Active Directory.

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We derive revenues from three primary sources: (1) software licenses, (2) post-contract technical support services (referred to as PCS) and (3) professional consulting and training services (referred to as PSO). Our software licensing model is primarily based on perpetual license fees, and our license fees are typically calculated either on a per-server basis or a per-seat basis.

PCS contracts entitle a customer to telephone or internet support and unspecified maintenance releases, updates and enhancements. First-year PCS contracts are typically sold with the related perpetual software license and renewed on an annual basis thereafter at the customer's option. Annual PCS renewal fees are priced as a percentage of the net initial customer purchase price (which includes both the fee for a perpetual license and first year PCS). Revenue is allocated to first year PCS based on vendor-specific objective evidence ("VSOE") of fair value and amortized over the term of the maintenance contract, typically 12 months although at times we sell PCS with terms of greater than 12 months.

Over the last few years revenues generated by our PCS offerings have become a larger contributor to the total revenue base of the company. As our PCS customer base grows, the PCS renewal rate has a larger influence on the PCS revenue growth rate and the amount of new software license revenues has a diminishing effect. Therefore, the growth rate of total revenues does not necessarily correlate directly to the growth rate of new software license revenues in a given period. The primary determinant of changes in our PCS revenue profile is the rate at which our customers renew their annual maintenance and support agreements. If our PCS renewal rates were to decline materially, our PCS revenues and total revenues would likely decline materially as well. Although we do not currently expect our PCS renewal rates to deteriorate, there can be no assurance they will not.

We also provide PSO services which relate to installation of our products and do not include significant customization to or development of the underlying software code. Revenue is allocated to PSO services based on VSOE of fair value and recognized as the services are performed. Such revenues represent 13.5%, 13.4% and 12.1% of total services revenues for the twelve months ended December 31, 2006, 2005 and 2004, respectively.

Our primary expenses are our personnel costs, which include compensation, benefits and payroll related taxes, which are a function of our world-wide headcount. We estimate that these personnel related costs represented approximately 67% of total expenses in 2006. Our headcount at the end of fiscal 2006 was approximately 2,850 compared to approximately 2,750 at the end of fiscal 2005. Total stock-based compensation expense increased from \$12.4 million in 2005 to \$27.0 million in 2006, representing a 118% year-over-year increase, primarily because of our adoption of Statement of Financial Accounting Standards No. 123(R), *Share-Based Payment* ("SFAS 123R").

We invest heavily in research and development in order to design, develop and enhance a wide variety of products and technologies. We have also maintained an approach of using acquisitions as a strategy to obtain incremental products and technology that will be attractive to our customers. In addition, we are primarily a direct-sales driven organization that expends significant selling costs in order to secure new customer license sales and the follow-on PCS revenue stream that can continue forward beyond the initial license sale.

Our foreign currency gains or losses are predominantly attributable to translation gains or losses on our net balances of monetary assets and liabilities in our foreign subsidiaries, including accounts receivable and cash, which were primarily denominated in the Euro, and to a lesser extent, the British Pound and Canadian Dollar. The foreign currency translation adjustments to these balance sheet items are calculated by comparing the currency spot rates at the end of a quarter to the spot rates at the end of the previous quarter. On this basis, we recorded, in other income (expense), net, a net gain of \$4.4 million in 2006 and a net loss of \$5.6 million in 2005, representing a year-over-year change of 179%. While currency fluctuations between 2005 and 2006 significantly impacted our other income (expense), net, foreign currency exchange rates did not materially affect our income from operations in 2006. The impact of currency rate changes was less than 1% on our income from operations, meaning the strengthening foreign currencies increased revenues and expenses by less than 1% each in 2006.

### ***Our 2006 Results***

As discussed in more detail throughout our MD&A:

- From 2005 to 2006, total revenues increased 19.0% to \$561.6 million and total expenses increased 22.3% to \$502.9 million, resulting in operating margin of 11.2%. Income from operations increased from \$60.8 million to \$62.7 million and net income increased from \$32.5 million to \$59.0 million.

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- Our Windows Management products were the primary product contributors to revenue growth from 2005 to 2006. Our Database Development product family also contributed significantly to total revenues and revenue growth in 2006. Total revenues from our North American operations increased by \$52.8 million, or 16.8%, while total revenues from the rest of world operations increased by \$36.8 million, or 23.5%.
- Sales of perpetual software licenses and services from acquired company products (products from our acquisitions of Imceda, Vintela, Vizioncore, Xaffire, and AfterMail) were significant contributors to revenue growth in 2006. The contribution from these acquired products to our total revenue growth in 2006 was approximately \$30.0 million or 35%. Results of operations from all acquisitions are included in our consolidated income statements from the respective dates of acquisition. For more information concerning our acquisitions during the periods presented herein, see Note 5 of our Notes to Consolidated Financial Statements.

## **Recently Issued Accounting Pronouncements**

See Note 1 of our Notes to Consolidated Financial Statements for information regarding recently issued accounting pronouncements.

## **Critical Accounting Policies and Estimates**

Our consolidated financial statements are based on the selection and application of generally accepted accounting principles, which require us to make estimates and assumptions about future events that affect the amounts reported in our financial statements and the accompanying notes. Future events and their effects cannot be determined with certainty. Therefore, the determination of estimates requires the exercise of judgment. Actual results could differ from those estimates and any such differences may be material to our financial statements. We believe that the policies set forth below may involve a higher degree of judgment and complexity in their application than our other accounting policies and represent the critical accounting policies and estimates used in the preparation of our financial statements. If different assumptions or conditions were to prevail, the results could be materially different from our reported results. Historically, our assumptions, judgments and estimates relative to our critical accounting policies and estimates have not differed materially from actual results. Our significant accounting policies are presented within Note 1 of our Notes to Consolidated Financial Statements. Management has discussed the development and selection of these critical accounting policies and estimates with the Audit Committee of our Board of Directors and the Audit Committee has reviewed the related disclosures.

### ***Revenue Recognition***

Our revenue recognition policy is one of our critical accounting policies because revenue is a key component of our results of operations and is based on complex rules that require us to make significant judgments and estimates. In applying our revenue recognition policy we must determine which portions of our revenue are recognized currently (generally perpetual software licenses) and which portions must be deferred (generally PCS and PSO). In addition, we analyze various factors including our pricing policies, the credit-worthiness of our customers, accounts receivable aging data and contractual terms and conditions in helping us make judgments about revenue recognition. Changes in judgments on any of these factors could materially impact the timing and amount of revenue and costs recognized.

We recognize revenue pursuant to the requirements of Statement of Position 97-2, "*Software Revenue Recognition*" ("SOP 97-2"), issued by the American Institute of Certified Public Accountants ("AICPA"), as amended by SOP 98-9, *Modification of SOP 97-2, "Software Revenue Recognition, With Respect to Certain Transactions"* and the related Technical Practice Aids of the AICPA. In accordance with SOP 97-2, we recognize revenue when all of the following criteria are met: (1) there is persuasive evidence of an arrangement; (2) we deliver the products; (3) fees are fixed or determinable and license agreement terms are free of contingencies or uncertainties that may alter the agreement such that they may not be complete and final; and (4) collection is probable.

We initially capture value for our products by selling a perpetual software license to end customers. The fee for the first year of PCS is included in, or bundled with, the perpetual software license at the time of initial sale. As such, the combination at initial sale of a perpetual software license and one year of PCS represents a "multiple-element" arrangement for revenue recognition purposes.

When all four of our revenue recognition criteria are met the multiple-element aspect of our arrangements means the only revenue recognized upfront, at the time of initial sale, is the residual revenue allocated to the perpetual software license. The revenue associated with the fair value of the undelivered PCS and/or PSO included in the initial sale is deferred and is subsequently recorded to revenue ratably over the support term and as such services are performed, respectively. The fair value of the undelivered elements is determined based on VSOE of fair value.

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Revenue for our standalone sale of annual PCS renewals in years two, three and beyond is recognized ratably over the support term. Sales of PCS for multiple annual periods are treated similarly.

Revenue from our PSO is generally recognized as professional services are performed in accordance with the underlying service contracts.

Our PCS VSOE of fair value is determined by reference to the prices our end customers pay for this support when it is sold separately; that is, when we enter into an arms length, annual renewal transaction with end customers where the only offering sold is PCS. These standalone PCS renewal transactions are typically for one year in duration and are priced as a targeted percentage of the initial, discounted purchase price which includes both the upfront license fee and the first year of PCS. We bill these PCS renewal transactions in advance of the services provided. We also offer end customers the right to purchase PCS for multiple annual periods at discounted prices beyond the first year as they will be paying cash upfront, well in advance of the multi-year services performed.

Our PSO VSOE of fair value is determined by reference to our established pricing and discounting practices for these services when sold separately. Our PSO are typically sold as time-and-materials based contracts that range from five to fifteen days in duration. We sell PSO both standalone and as part of multiple-element arrangements.

Our VSOE of fair value is impacted by estimates and judgments that, if significantly different, could materially impact the timing and amount of revenue recognized in current and future periods. These estimates and judgments include, among other items:

- the ability to identify and validate VSOE of fair value for undelivered elements via the use of sampling techniques;
- the impact on sampling results of customer negotiating pressure on renewal rates;
- the impact on sampling results of PCS renewals on deals originally sold via indirect channels;
- the fair value of that undelivered element for sampled transactions; and
- where a customer's PCS renewal is in its product life cycle when numerous year's renewal efforts have been combined into one transaction (a co-term).

Historically, we have been able to establish VSOE of fair value for PCS and PSO but we may modify our pricing and discounting practices in the future. This could result in changes to our VSOE of fair value for these undelivered elements. If this were to occur, our future revenue recognition for multiple-element arrangements would differ significantly from our historical results. If we were unable to support at all through VSOE the fair value of our PCS or PSO, the entire amount of revenue from our initial, upfront sale of both a perpetual software license bundled with one year of PCS and any PSO would be deferred and recognized ratably over the life of the contract.

If we cannot objectively determine the fair value of any undelivered element (hardware, software, specific upgrade rights, etc.) in a bundled software and services arrangement, we defer revenue until all elements are delivered and services are performed, or until fair value can be objectively determined for any remaining undelivered elements.

In addition to perpetual software licenses, we sell a small amount of time-based software licenses (or term licenses) each year wherein customers pay a single fee for the right to use the software and receive PCS for a defined period of time. Approximately 2% of 2006 license revenue was generated by these time-based software licenses. All license and support revenues on these term licenses are deferred and recognized ratably over the license term.

We license our products primarily through our direct sales force, our telesales force and, increasingly, indirect channels including value added resellers and distributors. For our direct sales, we utilize written contracts as the means to establish the terms and conditions upon which our products and services are sold to our end customers. For our indirect sales, we accept orders from our resellers and distributors when we are informed that they have existing orders from an end customer. We utilize written contracts coupled with purchase orders as the means to establish the terms and conditions of these indirect sales transactions.

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Indirect sales through resellers, which are a growing proportion of our transaction volume, are generally handled via processes and policies that are similar to an end customer sale. Our practice until January 1, 2007 was to defer revenue recognition on indirect sales transactions of significant size until receipt of payment (assuming all other revenue recognition criteria had been satisfied) as collectability was not reasonably assured. Because of a change in circumstances involving improved cash collection histories with certain resellers we modified our revenue recognition practices to recognize revenue upon delivery of the software when all other revenue recognition criteria are satisfied. The modified practice, which now allows for the earlier recognition on most of our reseller transactions, has been implemented effective January 1, 2007.

Substantially all of our software license arrangements do not include acceptance provisions. Since such acceptance provisions are not contained in our software license arrangements as standard provisions and the incidence of returns in accordance with such acceptance provisions cannot be reasonably estimated, if a contract does include such a provision we recognize revenue upon the earlier of receipt of written customer acceptance or expiration of the acceptance period.

We evaluate arrangements with governmental entities containing “fiscal funding” or “termination for convenience” provisions, when such provisions are required by law, to determine the probability of possible cancellation. We consider multiple factors, including the history with the customer in similar transactions, and the planning, budgeting and approval processes undertaken by the governmental entity. If we determine upon execution of these arrangements that cancellation is not likely, we then recognize revenue once all of the criteria described above have been met. If such a determination cannot be made, revenue is recognized upon the earlier of cash receipt or approval of the applicable funding provision by the governmental entity.

We assess whether fees are fixed or determinable at the time of sale and recognize revenue if all other requirements have been met. Our standard payment terms are 30 days but may vary based on the country in which the agreement is executed. We generally deem payments that are due within 6 months to be fixed and determinable based on collections history and thereby satisfy the required revenue recognition criteria.

For additional information regarding our revenue recognition accounting policies see Note 1 of our Notes to Consolidated Financial Statements.

### ***Asset Valuation***

Asset valuation includes assessing the recorded value of certain assets, including accounts receivable, goodwill and other intangible assets. We use a variety of factors to assess valuation, depending upon the asset.

- Accounts receivable – We maintain an allowance for sales returns and cancellations as well as an allowance for bad debt. Regarding our allowance for sales returns and cancellations, our standard form license and PCS and/or service agreements do not typically or expressly provide for product returns or cancellations as a matter of right unless we have breached the product warranty and are unable to cure the breach. Our product warranties are typical industry warranties that a product will perform in accordance with established written specifications. However, we maintain the sales returns and cancellations allowance to cover the circumstances where the company accepts returns or cancellations on a discretionary basis even though not contractually obligated to do so. This allowance also covers estimated losses for our customer’s unwillingness to make required payments. The allowance for bad debt is for estimated losses resulting from our customer’s inability to make required payments related to enforceable contracts. To support both these allowances, we are required to make significant estimates of future software license returns, of cancellations for both PCS and of PSO, and of write-offs of customer accounts as bad debts – all related to current period revenues. The amount of our reserves is based on these estimates, the contractual terms and conditions of our contracts, our accounts receivable aging and our historical collection experience with a customer base. If significant product performance issues were to arise resulting in our accepting sales returns, additional allowances may be required which would result in a reduction of revenue in the period such determination was made. While such return, cancellation and bad debt write-off amounts have historically been within our planned expectations and the allowances established we cannot guarantee that our sales returns and allowances will be adequate to cover future performance issues of our customer base and allowances may be required which would result in additional general and administrative expense in the period such determination was made.
- Goodwill – We test goodwill for impairment at the reporting unit level on an annual basis in the fourth quarter or more frequently if we believe indicators of impairment exist. Goodwill impairment is deemed to exist if the net book value of a reporting unit exceeds its estimated fair value. We performed our annual impairment review in the fourth quarter of 2006 and determined that the carrying value of each reporting unit was less than the estimated fair value of the reporting units. In calculating the fair value of the reporting units (licenses and services), the Market Approach and Income Approach were the methodologies deemed the most reliable and were the primary methods used for our impairment analysis. We will continue to perform annual impairment reviews during the fourth quarter of each year or earlier if indicators of potential impairment exist. Future impairment reviews could result in significant charges against earnings to write down the value of goodwill.

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- Amortizing Intangible assets – These assets are recorded at their estimated fair value and include technology, customer lists, maintenance contracts, trademarks and non-compete agreements acquired and are being amortized using the straight-line method over estimated useful lives ranging from two to seven years.

We make estimates of fair value based upon assumptions believed to be reasonable. These estimates are based on historical experience and information obtained from the management of the acquired companies and are inherently uncertain. Critical estimates in valuing certain of the intangible assets include but are not limited to: future expected cash flows from license sales, maintenance agreements, consulting contracts, customer contracts and acquired developed technologies and patents; expected costs to develop the in-process research and development into commercially viable products and estimated cash flows from the projects when completed; the acquired company's brand and market position, as well as assumptions about the period of time the acquired brand will continue to be used in the combined company's product portfolio; acquired company key personnel's willingness and ability to compete; and discount rates. Unanticipated events and circumstances may occur which may affect the accuracy or validity of such assumptions, estimates or actual results.

The net carrying amount of amortizing intangible assets was considered recoverable at December 31, 2006. In accordance with SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, these intangible assets are reviewed for events or changes in circumstances, which indicate that their carrying value may not be recoverable. We periodically review the carrying value of these assets to determine whether or not impairment to such value has occurred. In the event that in the future it is determined that the other intangible assets value has been impaired, an adjustment will be made in that corresponding period resulting in a charge against earnings for the write-down.

- Investments in Non-Consolidated Companies – All of our investments in non-consolidated companies are currently accounted for under the cost method, as we do not have the ability to exercise significant influence over these companies' operations. Significant influence is generally deemed to exist when we have an ownership interest in the voting stock of the investee of between 20% and 50%, although other factors, such as representation on the investee's Board of Directors, voting rights and the impact of commercial arrangements, are also typically considered in determining the appropriate accounting treatment. We periodically monitor our investments for impairment and will record reductions in carrying values if and when necessary. The evaluation process is based on information that we request from these privately-held companies. This information is not subject to the same disclosure regulations as U.S. public companies and, as such, the basis for these evaluations is subject to the timing and the accuracy of the data received from these companies. As part of this evaluation process, our review includes but is not limited to a review of each company's cash position, recent financing activities, financing needs, earnings and revenue outlook, operational performance, management or ownership changes, and impacts from competitive pressures. If we determine that the carrying value of our investment in a company is at an amount below fair value, an adjustment will be made in that corresponding period resulting in a charge against earnings for the write-down.

### *Accounting for Income Taxes*

As part of the process of preparing our financial statements, we are required to estimate our income taxes in each of the jurisdictions in which we operate. This process requires a significant amount of judgment, estimation and uncertainty and our estimate of income taxes can be highly sensitive to shifts between such tax jurisdictions. Additionally, our U.S. and foreign tax returns are subject to routine compliance reviews by the various tax authorities. Although we believe we have appropriate support for the positions taken on our tax returns, our income tax expense includes amounts intended to satisfy income tax assessments that could result from the examination of our tax returns. Determining the income tax expense for such contingencies requires a significant amount of judgment and estimation. We evaluate such tax contingencies in accordance with the requirements of SFAS No. 5, *Accounting for Contingencies*, and have accrued for income tax contingencies that meet both the probable and estimable criteria of SFAS No. 5. These estimates are updated over time as more definitive information becomes available from taxing authorities, completion of tax audits, expiration of statutes of limitation, or upon occurrence of other events. The amounts ultimately paid upon resolution of such contingencies could be materially different from the amounts previously included in our income tax expense and therefore could have a material impact on our consolidated results of operations. The tax contingency accrual is recorded as a component of our net income taxes payable/receivable balance.

We recognize deferred income tax assets and liabilities based upon the differences between the financial statement carrying amounts and the tax bases of assets and liabilities. Such deferred income taxes primarily relate to the timing of the recognition of certain revenue items and the timing of the deductibility of certain reserves and accruals for income tax purposes. We regularly review the deferred tax assets for recoverability and establish a valuation allowance when it is more likely than not that some portion or all of the deferred tax assets will not be realized. If we are unable to generate sufficient future taxable income, or if there is a material change in the actual effective tax rates or time periods within which the underlying timing differences become taxable or deductible, we could be required to establish an additional valuation allowance against the deferred tax assets, which could result in a substantial increase in our effective tax rate and have a materially adverse impact on our operating results. U.S. income taxes were not provided for on undistributed earnings from certain non-U.S. subsidiaries. Those earnings are considered permanently reinvested.

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### ***Accounting for Stock-Based Compensation***

Prior to January 1, 2006, we accounted for stock option grants in accordance with APB No. 25 and related Interpretations, as permitted by SFAS 123. Accordingly, we recognized compensation expense for stock option grants where the exercise price was lower than the fair market value of our common stock on the grant date. In accordance with SFAS 123 and SFAS 148, *Accounting for Stock-Based Compensation – Transition and Disclosure*, we provided pro forma net income or loss and net income or loss per share disclosures for each period prior to the adoption of SFAS 123R, as if we had applied the fair value-based method in measuring compensation expense for our stock-based compensation plans.

Effective January 1, 2006, we adopted the fair value recognition provisions of SFAS 123R utilizing the modified prospective transition method. As required by SFAS 123R, we estimate forfeitures of employee stock options and recognize compensation cost only for those awards expected to vest. Forfeiture rates are determined based on historical experience. Estimated forfeitures are adjusted to actual forfeiture experience as needed. Under the modified prospective approach, compensation expense recognized during the twelve months ended December 31, 2006 includes: (a) compensation expense for all stock-based awards granted prior to, but not yet vested, as of January 1, 2006, based on the grant date fair value estimated in accordance with the original provisions of SFAS 123, and (b) compensation expense for all stock-based awards granted on or after January 1, 2006, based on the grant date fair value estimated in accordance with the recognition provisions of SFAS 123R. In accordance with the modified prospective transition method, our audited consolidated financial statements for the twelve months ended December 31, 2005 have not been restated to reflect, and do not include, the impact of SFAS 123R.

SFAS 123R requires us to calculate the pool of excess tax benefits (the “APIC Pool”), available as of January 1, 2006, to absorb tax deficiencies recognized in subsequent periods, assuming we had applied the provisions of the standard in prior periods. We applied the provisions of SFAS 123R in calculating the APIC Pool, which was calculated using the long-haul method.

We estimate the fair value of options granted using the Black-Scholes option valuation model and the assumptions shown in Note 1 of our Notes to Consolidated Financial Statements. Determining the fair value of stock-based awards at the grant date requires judgment, including estimating the expected term, expected volatility, risk-free interest rate and dividend yield. We may use different assumptions under the Black-Scholes option valuation model in the future, which could materially affect our net income or loss and net income or loss per share.

See also “*Restatement of Previously Issued Financial Statements*” above and Note 2 of our Notes to Consolidated Financial Statements for the discussion of the restatement related to our stock option grants.

### ***Determining Functional Currencies for the Purpose of Consolidation***

In preparing our consolidated financial statements, we are required to re-measure the financial statements of the foreign subsidiaries from their local currency into United States dollars. This process results in foreign currency re-measurement gains and losses included in “other income (expense), net” in the consolidated income statements.

Under the relevant accounting guidance, the treatment of these re-measurement gains or losses is dependent upon our determination of the functional currency of each subsidiary. The functional currency is determined based on the judgment of management and involves consideration of all relevant economic facts and circumstances affecting the subsidiary. The currency in which the subsidiary transacts a majority of its transactions (including transfer pricing arrangements, billings, financing, payroll and other expenditures) is one consideration of determining the functional currency; however, any dependency upon the parent and the nature of the subsidiary’s operations are also considered.

Other income (expense), net includes any gain or loss associated with the re-measurement of a subsidiary’s financial statements when the functional currency of a subsidiary is the United States dollar. However, if the functional currency is deemed to be the local currency, any gain or loss associated with the translation of these financial statements into the United States dollar would be included within accumulated other comprehensive income (loss) on our consolidated balance sheets. If we determine that there has been a change in the functional currency of a subsidiary to the local currency, any translation gains or losses arising after the date of change would be included within shareholders’ equity as a component of accumulated other comprehensive income (loss).

Based on our assessment of the factors discussed above, we consider the United States dollar to be the functional currency for each of our international subsidiaries. As a result of this determination, assets and liabilities in these subsidiaries are re-measured at current exchange rates, except for property and equipment and deferred revenue, which are re-measured at historical exchange rates. Revenues and expenses are re-measured at weighted average exchange rates in effect during the

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year except for revenue and costs related to the above mentioned balance sheet items which are re-measured at historical exchange rates. Accordingly, we had a net foreign currency re-measurement gain of \$4.4 million, a net loss of \$5.6 million and a net gain of \$3.4 million for the years ended December 31, 2006, 2005 and 2004, respectively, recorded to other income (expense), net in the respective periods. Had we determined that the functional currency of our subsidiaries was the local currency, these translation gains and losses would have been included in our statement of shareholders' equity as a component of comprehensive income for each of the years presented.

The magnitude of these gains or losses is dependent upon movements in the exchange rates of the foreign currencies in which we transact business against the United States dollar and the significance of the assets, liabilities, revenues and expenses denominated in foreign currencies. The company operates in a number of currencies worldwide, most notably in the Euro, the United Kingdom Pound Sterling, Canadian Dollar, Australian Dollar and Russian Ruble. Any future re-measurement gains or losses could differ significantly from those we have experienced in recent years. In addition, if we determine that a change in the functional currency of one of our subsidiaries has occurred at any point in time, we would be required to include any translation gains or losses from the date of change in accumulated other comprehensive income (loss) on our consolidated balance sheets.

### Results of Operations

Except as otherwise indicated, the following are percentage of total revenues:

	Year Ended December 31,		
	2006	2005	2004
<b>Revenues:</b>			
Licenses	51.7%	54.3%	57.6%
Services	48.3	45.7	42.4
Total revenues	<u>100.0</u>	<u>100.0</u>	<u>100.0</u>
<b>Cost of revenues:</b>			
Licenses	1.0	1.1	1.0
Services	8.9	8.1	7.8
Amortization of purchased technology	2.8	2.4	2.3
Total cost of revenues	<u>12.7</u>	<u>11.6</u>	<u>11.1</u>
Gross profit	87.3	88.4	88.9
<b>Operating expenses:</b>			
Sales and marketing	44.1	43.2	44.2
Research and development	19.7	18.9	21.5
General and administrative	11.7	10.3	10.6
Amortization of other purchased intangible assets	1.2	1.5	1.3
In-process research and development (1)	0.2	1.7	1.8
Litigation loss provision	—	—	4.1
Total operating expenses	<u>76.9</u>	<u>75.6</u>	<u>83.5</u>
Gain on sale of Vista Plus product suite (1)	—	—	7.6
Gain on sale of corporate aircraft	0.7	—	—
Income from operations	11.1	12.8	13.0
Other income (expense), net	2.3	(0.2)	2.5
Income before income tax provision	<u>13.4</u>	<u>12.6</u>	<u>15.5</u>
Income tax provision	3.0	5.8	2.0
Net income	<u>10.4%</u>	<u>6.8%</u>	<u>13.5%</u>

(1) See Note 5 of our Notes to Consolidated Financial Statements.

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### Comparison of Fiscal Years Ended December 31, 2006 and 2005

#### Revenues

Total revenues and year-over-year changes are as follows (in thousands, except for percentages):

	2006	2005	Increase	
			Dollars	Percentage
<b>Revenues:</b>				
Licenses				
North America	\$ 179,114	\$ 161,933	\$ 17,181	10.6%
Rest of World	111,133	94,198	16,935	18.0%
Total license revenues	<u>290,247</u>	<u>256,131</u>	<u>34,116</u>	<u>13.3%</u>
Services				
North America	188,835	153,226	35,609	23.2%
Rest of World	82,507	62,647	19,860	31.7%
Total service revenues	<u>271,342</u>	<u>215,873</u>	<u>55,469</u>	<u>25.7%</u>
Total revenues	<u>\$ 561,589</u>	<u>\$ 472,004</u>	<u>\$ 89,585</u>	<u>19.0%</u>

*Licenses Revenues* — Licenses revenues from sales of our Windows Management products, including those products with technology acquired from Vintela in July 2005 and Aftermail in January 2006 were significant drivers of our licenses revenues growth in both North America and Rest of World. Sales of our Imceda and Vizioncore products also contributed to growth in license revenues. Licenses revenues growth in these product areas was offset slightly by reduced licenses revenues from sales of our Application Management products and our Oracle Database Management products.

*Services Revenues* — The largest component of services revenues is PCS revenue. Services revenues also include fees for PSO. Our Windows Management product line and our Oracle Database Development products primarily drove growth in services revenues. PCS revenues from renewals of annual maintenance agreements have continued to grow. Revenues from PSO increased \$7.6 million or 26.1%. PSO as a percentage of total service revenues represented approximately 13.5% in the twelve months ended December 31, 2006 and 2005.

#### Cost of Revenues

Total cost of revenues and year-over-year changes are as follows (in thousands, except for percentages):

	2006	2005	Increase	
			Dollars	Percentage
<b>Cost of Revenues:</b>				
Licenses	\$ 5,570	\$ 5,005	\$ 565	11.3%
Services	49,773	38,381	11,392	29.7%
Amortization of purchased technology	15,932	11,476	4,456	38.8%
Total cost of revenues	<u>\$ 71,275</u>	<u>\$ 54,862</u>	<u>\$ 16,413</u>	<u>29.9%</u>

*Cost of Licenses* — Cost of licenses primarily consists of third-party software royalties, product packaging, documentation, duplication, delivery and personnel costs. Cost of licenses as a percentage of license revenues was 1.9% and 2.0% for the twelve months ended December 31, 2006 and 2005, respectively. The absolute dollar increase is primarily the result of increased license sales of royalty-bearing products.

*Cost of Services* — Cost of services primarily consists of personnel, outside consultants, facilities and systems costs used in providing PCS and PSO. Cost of services does not include development costs related to bug fixes and upgrades which are classified in research and development and which are not separately determinable. Personnel related costs increased by approximately \$4.4 million, primarily due to significant growth in technical support headcount (average headcount in 2006 increased by 90% over the prior year) and from a \$0.7 million increase in stock-based compensation expense. Fees paid to outside professional services consultants in connection with new system implementation support increased by \$4.7 million in the twelve months ended December 31, 2006 over the comparable period in 2005 as the demand for our professional services exceeded our ability to provide these services. Cost of services as a percentage of service revenues were 18.3% and 17.8% in the twelve months ended December 31, 2006 and 2005, respectively.

*Amortization of Purchased Technology* — Amortization of purchased technology includes amortization of the fair value of purchased technology associated with acquisitions made since 2002. The 38.8% increase in amortization of purchased technology is primarily due to our acquisitions of AfterMail and Charonware in 2006 and by a \$2.3 million impairment charge recorded in the fourth quarter of 2006 for a portion of purchased technology acquired in 2002. We expect amortization of purchased technology within the cost of revenues arising from acquisitions completed prior to December 31, 2006 to be approximately \$12.0 million in the year ending December 31, 2007.

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### Operating Expenses

Year-over-year changes in the principal components of our operating expenses are as follows (in thousands, except for percentages):

	2006	2005	Increase/(Decrease)	
			Dollars	Percentage
Operating Expenses:				
Sales and marketing	\$ 247,500	\$ 203,851	\$ 43,649	21.4%
Research and development	110,612	89,078	21,534	24.2%
General and administrative	65,821	48,474	17,347	35.8%
Amortization of other purchased intangible assets	6,758	7,179	(421)	(5.9)%
In-process research and development	960	7,840	(6,880)	(87.8)%
Total operating expenses	<u>\$ 431,651</u>	<u>\$ 356,422</u>	<u>\$ 75,229</u>	21.1%

*Sales and Marketing* — Sales and marketing expenses consist primarily of compensation and benefit costs for sales and marketing personnel, sales commissions, related facilities and information systems (“IS”) costs, and costs of trade shows, travel and entertainment and various discretionary marketing programs. Sales and marketing expense increased \$43.6 million during the twelve months ended December 31, 2006 as compared to the same period in 2005. Personnel related costs increased approximately \$32.7 million, of which \$3.2 million is due to higher stock-based compensation expense. The increase in personnel related costs was primarily due to significant growth in headcount within our direct sales, system engineering, telesales groups and product marketing and commissions on the increased amount of sales in 2006 compared to 2005. Average headcount in sales and marketing increased 19% in 2006 over the prior year.

*Research and Development* — Research and development expenses consist primarily of compensation and benefit costs for software developers who develop new products, bug fixes and upgrades to existing products and at times provide engineering support for PCS services, software product managers, quality assurance and technical documentation personnel, associated facilities and IS costs and payments made to outside software development consultants in connection with our ongoing efforts to enhance our core technologies and develop additional products. Research and development expense increased \$21.5 million during the twelve months ended December 31, 2006 as compared to the same period in 2005. Personnel related costs increased approximately \$17.9 million, of which \$6.6 million related to higher stock-based compensation expense. The increase in personnel related costs was also due to significant growth in headcount within our quality assurance and product development areas.

*General and Administrative* — General and administrative expenses consist primarily of compensation and benefit costs for our executive, finance, legal, human resources, administrative and IS personnel, and professional fees for audit, tax and legal services, associated facilities and IS costs. General and administrative expense increased \$17.3 million during the twelve months ended December 31, 2006 as compared to the same period in 2005. Personnel related costs increased approximately \$11.5 million, of which \$4.1 million related to higher stock-based compensation expense. The increase in personnel related costs was primarily due to additional headcount hired to support the company’s growth.

Fees associated with the investigation of our historical stock option grant practices and related accounting being conducted by the special committee of independent directors, contributed \$6.6 million to the overall increase in general and administrative expenses. We also recorded \$1.5 million in incremental stock-based compensation expense resulting from modifications to certain former employee stock option grants, as discussed in more detail in Note 11 of our Notes to Consolidated Financial Statements. Restatement related costs recorded in general and administrative expenses were \$6.9 million through the nine months ended September 30, 2007.

The increase to personnel costs and fees related to the stock option investigation were offset slightly by a reduction to bad debt expense of approximately \$0.9 million.

*Amortization of Other Purchased Intangible Assets* — Amortization of other purchased intangible assets includes the amortization of customer lists, trademarks, non-compete agreements and maintenance contracts associated with acquisitions. The decrease in amortization expense from 2005 to 2006 was due to certain other purchased intangible assets related to our acquisition of Aelita Software in 2004 that were fully amortized by the end of the first quarter of 2006. We expect amortization of other purchased intangible assets reflected on our December 31, 2006 balance sheet to be approximately \$6.1 million for the year ending December 31, 2007.

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*In-Process Research and Development* — In-process research and development (“IPR&D”) expenses related to in-process technology acquired from AfterMail and Charonware in 2006 and Wingra Technologies, LLC and Vintela in 2005, respectively. These costs were charged to operations as the technologies had not reached technological feasibility and did not have alternative future uses at the date of acquisition.

### Other Income (Expense), Net

Other income (expense), net includes interest income on our investment portfolio, gains and losses from foreign exchange fluctuations and gains or losses on other financial assets as well as a variety of other non-operating expenses, such as costs incurred with operating and maintaining our corporate aircraft which was sold in the fourth quarter of 2006 and the minority interest in Vizioncore. Other income (expense), net increased to a \$13.0 million gain in 2006 from a \$1.0 million loss in 2005. Interest income was \$11.2 million and \$6.8 million in the twelve months ended December 31, 2006 and 2005, respectively. We had a \$4.4 million foreign currency gain in 2006 compared to a \$5.6 million foreign currency loss in 2005. Our foreign currency gains or losses are predominantly attributable to translation gains or losses on net monetary assets, including accounts receivable and cash, which were primarily denominated in the Euro, and to a lesser extent, the British Pound and Canadian Dollar.

### Income Tax Provision

During the twelve months ended December 31, 2006, the provision for income taxes decreased to \$16.7 million from \$27.3 million in the comparable period of 2005, representing a decrease of \$10.6 million. The effective income tax rate decreased to 22.0% in 2006, compared to 45.6% in 2005. In 2006, the Company realized an overall foreign tax benefit from losses in certain higher-tax jurisdiction, and a shift of profitability to lower tax jurisdictions. Included in income tax expense for the twelve months ended December 31, 2005, is a tax provision of approximately \$2.3 million related to our repatriation of approximately \$43.5 million of qualified earnings under the applicable provisions of the American Jobs Creation Act of 2004, and approximately \$2.4 million of additional expense related to a non-deductible IPR&D charge of \$6.8 million.

### *Comparison of Fiscal Years Ended December 31, 2005 and 2004*

#### Revenues

Total revenues and year-over-year changes are as follows (in thousands, except for percentages):

	2005	2004	Increase	
			Dollars	Percentage
Revenues:				
Licenses				
North America	\$ 161,933	\$ 148,877	\$ 13,056	8.8%
Rest of World	94,198	75,770	18,428	24.3%
Total license revenues	<u>256,131</u>	<u>224,647</u>	<u>31,484</u>	<u>14.0%</u>
Services				
North America	153,226	121,299	31,927	26.3%
Rest of World	62,647	43,848	18,799	42.9%
Total service revenues	<u>215,873</u>	<u>165,147</u>	<u>50,726</u>	<u>30.7%</u>
Total revenues	<u>\$ 472,004</u>	<u>\$ 389,794</u>	<u>\$ 82,210</u>	<u>21.1%</u>

*Licenses Revenues* — Growth in license revenues is primarily a result of increased software license sales within our Windows Management and Database Management product lines, which increased by approximately 35% and 11%, respectively, from the twelve months of 2004 to the comparable period in 2005. Approximately 57%, or \$17.3 million, of the 2004 to 2005 license revenue growth derived from products acquired in 2005.

*Services Revenues* — Our Windows Management product line and our Database Development products primarily drove the growth in services revenues. PCS revenues from renewals of annual maintenance agreements have continued to grow and revenues from PSO increased \$9.1 million or 45.6%. PSO as a percentage of total service revenues represented approximately 13% and 12% in the twelve months ended December 31, 2005 and 2004, respectively. Our North American operating results for the first three quarters of 2004 included approximately \$7.3 million in services revenues from our Vista Plus output management product line, which we sold in September 2004. Excluding the Vista Plus service revenues from our 2004 results, our North American service revenues increased by approximately 34%.

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### Cost of Revenues

Total cost of revenues and year-over-year changes are as follows (in thousands, except for percentages):

	2005	2004	Increase	
			Dollars	Percentage
Cost of Revenues:				
Licenses	\$ 5,005	\$ 3,962	\$ 1,043	26.3%
Services	38,381	30,530	7,851	25.7%
Amortization of purchased technology	11,476	8,902	2,574	28.9%
Total cost of revenues	<u>\$ 54,862</u>	<u>\$ 43,394</u>	<u>\$ 11,468</u>	26.4%

*Cost of Licenses* — Cost of licenses as a percentage of license revenues were 2.0% and 1.8% for the twelve months ended December 31, 2005 and 2004, respectively. Cost of licenses as a percent of total revenues was approximately 1% in both the twelve months ended December 31, 2005 and 2004. The absolute dollar increase is primarily the result of increased license sales of royalty-bearing products.

*Cost of Services* — The 25.7% increase in cost of services was primarily due to an increase of \$4.6 million in personnel related costs as a result of significant growth in headcount (average headcount in 2005 increased by 21% over the prior year) and an increase of \$1.6 million in fees paid to outside professional services consultants in connection with new system implementation support as the demand for our professional services exceeded our ability to provide these services, offset partially by a \$0.6 million reduction in stock-based compensation in the twelve months ended December 31, 2005 over the comparable period in 2004. Cost of services as a percentage of service revenues were 17.8% and 18.5% in the twelve months ended December 31, 2005 and 2004, respectively.

*Amortization of Purchased Technology* — Amortization of purchased technology includes amortization of the fair value of purchased technology associated with acquisitions made from 2001 through the end of 2005. The amount amortized during the twelve months ended December 31, 2005 increased primarily as a result of our acquisitions of Imceda and Vintela. We also recorded impairment charges of \$0.6 million and \$0.8 million in 2005 and 2004, respectively.

### Operating Expenses

Year-over-year changes in the principal components of our operating expenses are as follows (in thousands, except for percentages):

	2005	2004	Increase/(Decrease)	
			Dollars	Percentage
Operating Expenses:				
Sales and marketing	\$ 203,851	\$ 172,138	\$ 31,713	18.4%
Research and development	89,078	83,622	5,456	6.5%
General and administrative	48,474	41,142	7,332	17.8%
Amortization of other purchased intangible assets	7,179	5,212	1,967	37.7%
In-process research and development	7,840	6,980	860	12.3%
Litigation loss provision	—	16,000	(16,000)	(100.0)%
Total operating expenses	<u>\$ 356,422</u>	<u>\$ 325,094</u>	<u>\$ 31,328</u>	9.6%

*Sales and Marketing* — The 18.4% increase in sales and marketing expense was primarily due to an increase of \$24.9 million in personnel related costs, such as labor, commissions, bonuses, vacation, reward programs and payroll taxes, of which \$2.6 million is due to higher stock-based compensation expense. This increase in personnel related expense was attributable to significant growth in headcount, including the additional headcount from the acquisitions of Imceda and Vintela, and to increased commissions on the increased amount of sales. Average headcount in sales and marketing increased 25% in 2005 over the prior year. Marketing communications, programs, conferences, and road/trade show expenses increased by approximately \$2.1 million. A portion of the overall increase was offset by a reduction of approximately \$1.8 million in depreciation expense related to our sales force automation system, implemented during 2001 and fully depreciated by the end of the third quarter in 2004. Sales and marketing expenses as a percentage of total revenues were 43.2% and 44.2% in 2005 and 2004, respectively.

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*Research and Development* — The 6.5% increase in research and development expense was primarily due to an increase of \$2.6 million in personnel related costs. The increase in labor cost was partially offset by a reduction of \$3.0 million to stock-based compensation expense. This increase in personnel related expenses was attributable to an increase in the number of employees engaged in research and development activities in 2005, resulting from both direct hiring and acquisitions, including the acquisitions of Imceda and Vintela, as well as increased compensation levels. Research and development expenses as a percentage of total revenues were 18.9% and 21.5% for the twelve months ended December 31, 2005 and 2004, respectively.

*General and Administrative* — The 17.8% increase in general and administrative expense was primarily due to an increase of \$4.8 million in personnel related costs. The increase in labor cost was partially offset by a reduction of \$1.1 million to stock-based compensation expense. This increase in personnel related expenses was attributable to an increase in the number of employees engaged in general and administrative activities in 2005, resulting primarily from direct hiring, as well as increased cash compensation levels. Average headcount in general and administrative increased 25% in 2005 over the prior year. Higher accounting and tax fees related to our ongoing SOX 404 compliance efforts also contributed approximately \$0.9 million, or 12.3% of the increase in general and administrative expenses. Other consulting fees for matters unrelated to SOX 404 increased by approximately \$0.9 million. Legal costs decreased by approximately \$1.5 million as a result of the settlement or dismissal of material litigation matters in the first quarter of 2005. General and administrative expenses as a percentage of total revenues were 10.3% and 10.6% for the twelve months ended December 31, 2005 and 2004, respectively.

*Amortization of Other Purchased Intangible Assets* — The 37.7% increase in amortization of other purchased intangible assets during 2005 was primarily due to our acquisitions of Imceda and Vintela.

*In-Process Research and Development* — In-process research and development expenses relate to in-process technology acquired from Wingra Technologies, LLC in January 2005, our acquisition of Vintela in July 2005 and our acquisitions of Aelita and Lecco in March and April of 2004, respectively. These costs were charged to operations as the technologies had not reached technological feasibility and did not have alternative future uses at the date of acquisition.

*Litigation Loss Provision* — Litigation loss provision relates to a litigation settlement fully accrued for in 2004 and paid in March 2005.

### **Other Income (Expense), Net**

Other income (expense), net decreased from a \$9.3 million gain in 2004 to a \$1.0 million loss in 2005. Interest income was \$6.8 million and \$7.3 million in the twelve months ended December 31, 2005 and 2004, respectively. We had a foreign currency loss of \$5.6 million in 2005 compared to a foreign currency gain of \$3.4 million in 2004. Our foreign currency losses were predominantly attributable to translation losses on net monetary assets, including accounts receivable and cash, which were primarily denominated in the Euro, and to a lesser extent, the British Pound. On this basis the U.S. Dollar strengthened against the Euro and the British Pound during 2005. Other income (expense), net includes several other components, of which the majority relates to costs incurred with operating and maintaining our corporate aircraft, which was sold in the fourth quarter of 2006.

### **Income Tax Provision**

During the twelve months ended December 31, 2005, the provision for income taxes increased to \$27.3 million from \$7.9 million in the comparable period of 2004, representing an increase of \$19.4 million. The effective income tax rate increased to 45.6% in 2005, compared to 13.1% in 2004. Included in income tax expense for the twelve months ended December 31, 2005, is a tax provision of approximately \$2.3 million related to our repatriation of approximately \$43.5 million of qualified earnings under the applicable provisions of the American Jobs Creation Act of 2004. Additional increases are largely a result of: (1) a shift in the profitability from entities located in lower tax jurisdictions to entities located in higher tax jurisdictions; and (2) the release of U.S. jurisdiction valuation allowances for the year ended December 31, 2004.

### **Inflation**

Inflation has not had a significant effect on our results of operations or financial position for the years ended December 31, 2006, 2005 and 2004.

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### Liquidity and Capital Resources

Cash and cash equivalents and marketable securities were approximately \$390.2 million and \$243.0 million as of December 31, 2006 and 2005, respectively. Cash and cash equivalents consisted of cash and highly liquid investments purchased with original maturities of three months or less. Marketable securities consisted primarily of short-term investment-grade bonds and United States government and agency securities with original maturities of greater than three months. Our investment objectives were to preserve principal and provide liquidity, while at the same time maximizing market return without significantly increasing risk. We generally hold investments in marketable securities until maturity.

Summarized annual cash flow information is as follows (in thousands):

	2006	2005	2004
Cash provided by operating activities	\$ 148,377	\$ 101,910	\$ 96,109
Cash used in investing activities	(3,689)	(103,419)	(75,646)
Cash provided by financing activities	24,781	32	32,421
Effect of exchange rate changes	(4,330)	4,342	(2,194)
Net increase in cash and cash equivalents	<u>\$ 165,139</u>	<u>\$ 2,865</u>	<u>\$ 50,690</u>

### Operating Activities

Our primary source of operating cash flows was the collection of accounts receivable from our customers. Our primary use of cash from operating activities was for compensation and personnel-related expenditures. We intend to continue to fund our operating expenses through cash flows from operations.

The analyses of the changes in our operating assets and liabilities are as follows:

- Accounts receivable increased from \$107.3 million at December 31, 2005 to \$133.0 million at December 31, 2006 primarily due to an increase in daily sales, which resulted in an increase in operating assets, reflecting a use of cash of \$17.7 million for the twelve months ended December 31, 2006. The remaining change in accounts receivable of \$8.0 million, relating to the impact of non-cash foreign currency translation adjustments, is presented as part of the "effect of exchange rate changes on cash and cash equivalents" section of our consolidated statements of cash flows. Day's sales outstanding ("DSO") was approximately 70 days as of both December 31, 2006 and 2005, and our daily sales increased to \$1.8 million for the quarter ended December 31, 2006 compared to \$1.6 million for the quarter ended December 31, 2005. Collection of accounts receivable and related DSO could fluctuate in future periods due to the timing and amount of our revenues and their linearity and the effectiveness of our collection efforts.
- Deferred revenue increased in each period resulting in an increase in operating liabilities, reflecting a cash inflow of \$60.5 million, \$44.0 million and \$40.7 million for the twelve months ended December 31, 2006, 2005 and 2004 respectively. The increase in deferred revenue was due primarily to growth in our software PCS customer base.
- The primary cash outflow within operating assets and liabilities during the twelve months ended December 31, 2006 was \$26.4 million paid for taxes. The timing of these tax payments resulted in an increase in income taxes payable, reflecting a cash inflow of \$12.7 million for the twelve months ended December 31, 2006.
- The primary cash outflow within operating assets and liabilities during the twelve months ended December 31, 2005 was \$17.7 million paid for taxes and \$16.0 million related to a litigation settlement. We made no such litigation payment during 2006. The timing of tax payments resulted in an increase in income taxes payable, reflecting a cash inflow of \$5.4 million for the twelve months ended December 31, 2005.
- The remaining net cash inflow for the twelve months ended December 31, 2006 of \$1.6 million was related to changes in our other operating asset and liability accounts (see our consolidated statements of cash flows included with this Report).

### Investing Activities

Our primary source of investing cash flows was proceeds from the sale of marketable securities, typically at maturity. Our primary uses of cash from investing activities were for purchases of marketable securities, cash payments for acquisitions and capital expenditures.

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Capital expenditures in 2006 included \$3.8 million for leasehold improvements and furniture and fixtures for the lease of our new EMEA headquarters office in Maidenhead, United Kingdom. We completed the sale of our corporate aircraft to a third party in 2006 for \$15.6 million in cash, net of \$0.3 million in transaction fees. Capital expenditures during the twelve months ended December 31, 2005 and 2004 included \$29.9 million and \$23.3 million, respectively, in cash to complete the purchase of our buildings in Aliso Viejo, California and related infrastructure improvements. We did not have such expenditures in 2006.

In 2006 we used \$21.3 million in cash to acquire two companies and to make minority cost-method investments in three early stage private companies. In 2005 we used \$120.6 million in cash related to five acquisitions. In 2004 we used \$96.7 million in cash related to three acquisitions offset by \$22.5 million in cash provided by the sale of our Vista Plus product suite. These acquisitions and disposition are more fully described in Note 5 of our Notes to Consolidated Financial Statements.

We will continue to purchase property and equipment needed in the normal course of our business. We also plan to use cash generated from operations and/or proceeds from investments in marketable securities to fund other strategic investment and acquisition opportunities that we continue to evaluate. We plan to use excess cash generated from operations to invest in short and long-term marketable securities consistent with past investment practices.

### *Financing Activities*

Our primary source of financing cash flows has historically been from the issuance of our common stock under our employee stock option plans, excess tax benefits related to stock-based compensation and proceeds from a repurchase agreement. We have also financed acquisitions and capital expenditures with net borrowings under a repurchase agreement in prior periods.

Excess tax benefits related to stock-based compensation were historically reported under net cash provided by operating activities but, under SFAS 123R going forward these amounts are required to be classified as a cash flow from financing activity. Excess tax benefits in years prior to adoption of SFAS 123R were presented in the operating activities section of the consolidated statements of cash flows and were \$7.8 million and \$4.8 million in 2005 and 2004, respectively. During the years ended December 31, 2005 and 2004, cash flows from financing activities were affected by proceeds from and repayment of our repurchase agreement as more fully described in Note 9 of our Notes to Consolidated Financial Statements.

Because we announced our determination to restate our previously issued financial statements and have become delinquent in our periodic reporting obligations under the Securities Exchange Act of 1934, as amended, we determined that we could no longer rely upon the Registration Statements on Form S-8 previously filed with the U.S. Securities Exchange Commission to register the shares of our common stock issuable upon exercise of stock options granted under our various stock option plans. Accordingly, we took action in the third quarter of 2006 to block exercises of all stock options based on our determination that doing so was necessary to prevent violations of applicable securities law and as a result, we do not expect to receive proceeds from the exercise of stock options until after all of our delinquent reports are filed with the SEC.

We completed our repatriation activity under the American Jobs Creation Act (AJCA) during 2005. This effort resulted in the tax efficient, one time return of \$43.5 million cash for funding acquisitions, purchase of real property, funding for research and development related activities and infrastructure and capital investments.

Based on our current operating plan, we believe that our existing cash, cash equivalents, investment balances and cash flows from operations will be sufficient to finance our operational cash needs through at least the next 12 to 24 months. Our ability to generate cash from operations is subject to substantial risks described under the caption "*Risk Factors*". One of these risks is that our future business does not stay at a level that is similar to, or better than, our recent past. Should a general economic downturn or similar event occur, or should the company's products become uncompetitive or less attractive to end customers, we may be unable to generate or sustain positive cash flow from operating activities. We would then be required to use existing cash, cash equivalents and investment balances to support our working capital and other cash requirements. Also, acquisitions are an important part of our business model. As such, significant amounts of cash could and will likely be used in the future for additional acquisitions or strategic investments. If additional funds are required to support our working capital requirements, acquisitions or other purposes, we may seek to raise funds through public or private equity or debt financing or from other sources. We can provide no assurance that additional financing will be available at all or, if available, that we would be able to obtain additional financing on terms favorable to us.

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### Contractual Obligations and Off-Balance Sheet Arrangements

As of December 31, 2006, our contractual obligations or commercial commitments include our facility lease commitments and operating leases for office facilities and certain items of equipment. In addition, we are committed to pay additional capital contributions to a private equity fund totaling \$0.4 million as capital calls are made. We do not have any other off-balance sheet arrangements that could reduce our liquidity.

The following table summarizes our obligations as of December 31, 2006 and the effect we expect such obligations to have on our liquidity and cash flows in future periods (in thousands):

Contractual Obligations	Payments due by period				
	Total	Less Than 1 Year	1-3 Years	3-5 Years	More Than 5 Years
Operating Lease Obligations	\$ 31,997	\$ 12,281	\$ 13,533	\$ 3,993	\$ 2,190
Capital Lease Obligations	224	126	87	11	—
Purchase Obligations	2,194	1,538	269	387	—
Total Contractual Cash Obligations	<u>\$ 34,415</u>	<u>\$ 13,945</u>	<u>\$ 13,889</u>	<u>\$ 4,391</u>	<u>\$ 2,190</u>

In addition to the cash commitments above, we have certain rights and obligations in the form of call and put options, the amount and likelihood of which are not currently determinable, to acquire the remaining equity interest in two entities for a purchase price to be determined by a formula that is based on multiples of revenue. We also entered into earn-out agreements with the shareholders of companies we acquired during the year ended December 31, 2006. The earn-out payments are based on the acquired company's products' total revenue growth over a specified period after the acquisition date. No earn-out payments were required to be paid in 2006 and the amount or likelihood of future payments based on future results is not determinable.

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We are a U.S. Dollar functional company and transact business in a number of different foreign countries around the world. In most instances, revenues are collected and operating expenses are paid in the local currency of the country in which we are transacting. Accordingly, we are exposed to both transaction and translation risk relating to changes in foreign exchange rates.

Our exposure to foreign exchange risk is composed of the combination of our foreign net profits and losses denominated in currencies other than the U.S. Dollar, as well as our net balances of monetary assets and liabilities in our foreign subsidiaries. These exposures have the potential to produce either gains or losses depending on the directional movement of the foreign currencies versus the U.S. Dollar and our operational profile in foreign subsidiaries. Our cumulative currency gains or losses in any given period may be lessened by the economic benefits of diversification and low correlation between different currencies, but there can be no assurance that this pattern will continue to be true in future periods. During 2006, we had a \$4.4 million foreign currency gain compared to a \$5.6 million foreign currency loss in 2005.

The foreign currencies to which we currently have the most significant exposure are the Euro, the Canadian Dollar, the British Pound and the Australian Dollar. To date, we have not used derivative financial instruments to hedge our foreign exchange exposures, nor do we use such instruments for speculative trading purposes. We regularly monitor the potential cost and benefits of hedging foreign exchange exposures with derivatives and there remains the possibility that our foreign exchange hedging practices could change accordingly in time.

**Interest Rate Risk**

Our exposure to market interest-rate risk relates primarily to our investment portfolio. We have not used derivative financial instruments to hedge the market risks of our investments. We place our investments with high-quality issuers and, by policy, limit the amount of credit exposure to any one issuer other than the United States government and its agencies. Our investments in marketable securities consist primarily of investment-grade bonds and United States government and agency securities. Investments purchased with an original maturity of three months or less are considered to be cash equivalents. We classify all of our investments as available-for-sale. Available-for-sale securities are carried at fair value, with unrealized gains and losses, net of tax, reported in a separate component of shareholders' equity.

We presently do not intend to liquidate our short and long-term investments prior to their scheduled maturity dates. However, in the event that we did liquidate these investments prior to their scheduled maturities and there were no changes in market interest rates, we could be required to recognize a realized loss on those investments when we liquidate. At December 31, 2006, we have an unrealized loss of \$0.8 million on our investments in debt securities compared to \$1.7 million at December 31, 2005. Our remaining investment positions and duration of the portfolio would not be materially affected by a 100 basis point shift in interest rates.

Information about our investment portfolio is presented in the table below, which states the amortized book value and related weighted-average interest rates by year of maturity (in thousands):

	<u>Amortized Book Value</u>	<u>Weighted Average Rate</u>
Investments maturing by December 31,		
2007 (1)	\$ 250,290	4.99%
2008	—	—
2009	—	—
2010	24,687	4.50%
Thereafter	—	—
Total portfolio	<u>\$ 274,977</u>	4.95%

(1) Includes cash and cash equivalents of \$170.1 million.

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The financial statements required by this item are included in Part IV, Item 15 of this Form 10-K and are presented beginning on page F-1.

The following tables set forth selected unaudited consolidated quarterly financial data for the eight quarters ended December 31, 2006 (in thousands, except per share amounts):

**CONSOLIDATED BALANCE SHEETS**

	As of			
	<u>Dec. 31, 2006</u>	<u>Sep. 30, 2006</u>	<u>Jun. 30, 2006</u>	<u>Mar. 31, 2006</u>
				As Restated (1)
<b>ASSETS</b>				
Current assets:				
Cash and cash equivalents	\$ 286,164	\$ 231,104	\$ 171,220	\$ 152,003
Short-term marketable securities	80,112	64,743	94,400	79,467
Accounts receivable, net of allowances of \$9,312, \$16,127, \$16,807 and \$15,347 at December 31, September 30, June 30 and March 31, respectively	132,983	93,177	80,855	69,891
Prepaid expenses and other current assets	14,899	13,571	12,425	14,180
Deferred income taxes	9,800	12,305	12,301	12,282
Total current assets	523,958	414,900	371,201	327,823
Property and equipment, net	75,817	76,908	76,190	86,933
Aircraft - held for sale	—	11,331	11,331	—
Long-term marketable securities	23,884	24,803	25,320	41,347
Amortizing intangible assets, net	48,136	55,408	59,764	64,774
Goodwill	445,059	443,672	442,600	442,600
Deferred income taxes	33,679	25,713	25,853	25,852
Other assets	11,004	10,722	9,816	6,315
Total assets	<u>\$ 1,161,537</u>	<u>\$ 1,063,457</u>	<u>\$ 1,022,075</u>	<u>\$ 995,644</u>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>				
Current liabilities:				
Accounts payable	\$ 5,182	\$ 5,616	\$ 4,750	\$ 4,468
Accrued compensation	35,973	30,579	30,237	28,436
Other accrued expenses	35,949	32,080	29,822	26,509
Income taxes payable	27,832	534	844	8,291
Current portion of deferred revenue	177,372	153,345	138,816	133,356
Total current liabilities	282,308	222,154	204,469	201,060
Long-term liabilities:				
Long-term portion of deferred revenue	58,187	45,455	40,075	38,844
Other long-term liabilities	2,129	2,098	2,148	2,270
Total long-term liabilities	60,316	47,553	42,223	41,114
Shareholders' equity:				
Preferred stock, no par value, 10,000 shares authorized; no shares issued or outstanding	—	—	—	—
Common stock, no par value, 200,000 shares authorized; 101,819, 101,819, 101,725, and 101,034 shares issued and outstanding at December 31, September 30, June 30, and March 31, respectively	815,437	823,930	816,689	801,904
Retained earnings (accumulated deficit)	4,293	(29,048)	(39,492)	(46,550)
Accumulated other comprehensive loss	(817)	(1,132)	(1,814)	(1,884)
Total shareholders' equity	818,913	793,750	775,383	753,470
Total liabilities and shareholders' equity	<u>\$ 1,161,537</u>	<u>\$ 1,063,457</u>	<u>\$ 1,022,075</u>	<u>\$ 995,644</u>

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## CONSOLIDATED INCOME STATEMENTS

	Quarters Ended			
	Dec. 31, 2006	Sep. 30, 2006	Jun. 30, 2006	Mar. 31, 2006 As Restated (1)
<b>Revenues:</b>				
Licenses	\$ 92,760 (2)	\$ 67,849	\$ 63,160	\$ 66,478
Services	74,536	68,866	65,226	62,714
Total revenues	167,296	136,715	128,386	129,192
<b>Cost of revenues:</b>				
Licenses	1,824	1,241	1,243	1,262
Services	13,387	12,148	12,767	11,471
Amortization of purchased technology	5,654(3)	3,450	3,480	3,348
Total cost of revenues	20,865	16,839	17,490	16,081
Gross profit	146,431	119,876	110,896	113,111
<b>Operating expenses:</b>				
Sales and marketing	67,444	60,813	59,698	59,545
Research and development	27,221	27,109	28,463	27,819
General and administrative (4)	17,010	18,001	16,177	14,633
Amortization of other purchased intangible assets	1,547	1,541	1,537	2,133
In-process research and development	110	550	—	300
Total operating expenses	113,332	108,014	105,875	104,430
Gain on sale of corporate aircraft	3,987	—	—	—
Income from operations	37,086	11,862	5,021	8,681
Other income, net	5,385	1,133	3,853	2,634
Income before income tax provision	42,471	12,995	8,874	11,315
Income tax provision	9,130	2,551	1,816	3,173
Net income	\$ 33,341	\$ 10,444	\$ 7,058	\$ 8,142
<b>Net income per share:</b>				
Basic	\$ 0.33	\$ 0.10	\$ 0.07	\$ 0.08
Diluted	\$ 0.32	\$ 0.10	\$ 0.07	\$ 0.08
<b>Weighted-average shares:</b>				
Basic	101,819	101,794	101,461	100,424
Diluted	104,615	104,090	104,794	104,018

- (1) For a detailed description of the restatement, see the section entitled "Restatement" in Management's Discussion and Analysis of Financial Condition and Results of Operations contained in this Report.
- (2) Includes approximately \$4.0 million in reversals of allowances for bad debts and for sales returns and cancellations.
- (3) Includes a charge of \$2.3 million related to a portion of purchased technology acquired in 2002 deemed impaired in the fourth quarter of 2006.
- (4) Includes costs associated with the investigation of our historical stock option grant practices, which totaled \$6.6 million for all of 2006.

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**CONSOLIDATED BALANCE SHEETS**

	As of			
	Dec. 31, 2005 As Restated (1)	Sep. 30, 2005 As Restated (1)	Jun. 30, 2005 As Restated (1)	Mar. 31, 2005 As Restated (1)
<b>ASSETS</b>				
Current assets:				
Cash and cash equivalents	\$ 121,025	\$ 90,756	\$ 121,645	\$ 121,935
Short-term marketable securities	74,398	34,798	123	30,645
Accounts receivable, net of allowances of \$18,410, \$16,794, \$16,411 and \$14,518 at December 31, September 30, June 30 and March 31, respectively	107,327	80,245	67,776	50,183
Prepaid expenses and other current assets	15,253	10,828	11,106	11,978
Deferred income taxes	12,295	7,324	1,056	6,206
Total current assets	<u>330,298</u>	<u>223,951</u>	<u>201,706</u>	<u>220,947</u>
Property and equipment, net	83,044	80,807	76,914	53,890
Long-term marketable securities	47,538	88,492	125,399	145,511
Amortizing intangible assets, net	67,615	68,871	56,981	41,193
Goodwill	429,949	427,017	376,985	329,643
Deferred income taxes	26,675	31,742	42,165	41,979
Other assets	4,828	4,313	4,038	3,192
Total assets	<u>\$ 989,947</u>	<u>\$ 925,193</u>	<u>\$ 884,188</u>	<u>\$ 836,355</u>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>				
Current liabilities:				
Accounts payable	\$ 3,756	\$ 2,785	\$ 5,779	\$ 4,819
Obligation under repurchase agreement	—	10,092	—	—
Accrued compensation	33,355	27,170	25,302	23,217
Other accrued expenses	33,340	27,102	27,745	22,125
Income taxes payable	19,531	11,227	13,445	10,650
Current portion of deferred revenue	136,371	116,045	110,249	100,892
Total current liabilities	<u>226,353</u>	<u>194,421</u>	<u>182,520</u>	<u>161,703</u>
Long-term liabilities:				
Long-term portion of deferred revenue	38,432	28,781	24,610	25,379
Other long-term liabilities	1,730	1,097	2,213	2,434
Total long-term liabilities	<u>40,162</u>	<u>29,878</u>	<u>26,823</u>	<u>27,813</u>
Shareholders' equity:				
Preferred stock, no par value, 10,000 shares authorized; no shares issued or outstanding	—	—	—	—
Common stock, no par value, 200,000 shares authorized; 99,761, 98,809, 97,644, and 96,295 shares issued and outstanding at December 31, September 30, June 30, and March 31, respectively	794,863	791,478	769,993	752,013
Accumulated deficit	(54,692)	(69,729)	(74,263)	(81,301)
Accumulated other comprehensive loss	(1,716)	(1,666)	(1,164)	(1,972)
Unearned compensation	(15,023)	(19,189)	(19,721)	(21,901)
Total shareholders' equity	<u>723,432</u>	<u>700,894</u>	<u>674,845</u>	<u>646,839</u>
Total liabilities and shareholders' equity	<u>\$ 989,947</u>	<u>\$ 925,193</u>	<u>\$ 884,188</u>	<u>\$ 836,355</u>

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CONSOLIDATED INCOME STATEMENTS

	Quarters Ended			
	Dec. 31, 2005 As Restated (1)	Sep. 30, 2005 As Restated (1)	Jun. 30, 2005 As Restated (1)	Mar. 31, 2005 As Restated (1)
<b>Revenues:</b>				
Licenses	\$ 83,715	\$ 64,355	\$ 53,253	\$ 54,808
Services	59,096	55,825	52,457	48,495
Total revenues	142,811	120,180	105,710	103,303
<b>Cost of revenues:</b>				
Licenses	1,693	1,151	1,192	969
Services	11,306	9,491	8,738	8,846
Amortization of purchased technology	3,175	3,357	2,714	2,230
Total cost of revenues	16,174	13,999	12,644	12,045
Gross profit	126,637	106,181	93,066	91,258
<b>Operating expenses:</b>				
Sales and marketing	60,898	51,870	46,153	44,930
Research and development	24,219	22,507	20,903	21,449
General and administrative	13,753	12,169	11,261	11,291
Amortization of other purchased intangible assets	2,222	2,183	1,498	1,276
In-process research and development	(110)	6,900	—	1,050
Total operating expenses	100,982	95,629	79,815	79,996
Gain on sale of Vista Plus product suite	—	39	—	—
Income from operations	25,655	10,591	13,251	11,262
Other income (expense), net	332	355	(752)	(981)
Income before income tax provision	25,987	10,946	12,499	10,281
Income tax provision	10,950	6,411	5,473	4,423
Net income	\$ 15,037	\$ 4,535	\$ 7,026	\$ 5,858
<b>Net income per share:</b>				
Basic	\$ 0.15	\$ 0.05	\$ 0.07	\$ 0.06
Diluted	\$ 0.15	\$ 0.04	\$ 0.07	\$ 0.06
<b>Weighted-average shares:</b>				
Basic	99,211	98,217	96,838	96,195
Diluted	103,004	102,113	99,419	99,543

- (1) For a detailed description of the restatement, see the section entitled “Restatement” in Management’s Discussion and Analysis of Financial Condition and Results of Operations contained in this Report.

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The following tables present the effects of adjustments made to our previously reported unaudited consolidated quarterly financial information for the quarterly periods in 2005 and 2006 (in thousands, except per share amounts):

### CONSOLIDATED BALANCE SHEETS

	As of March 31, 2006			As of December 31, 2005			As of September 30, 2005		
	As Previously Reported	Adjustments	As Restated(1)	As Previously Reported	Adjustments	As Restated(1)	As Previously Reported	Adjustments	As Restated(1)
<b>ASSETS</b>									
Current assets:									
Cash and cash equivalents	\$ 152,003	\$ —	\$ 152,003	\$ 121,025	\$ —	\$ 121,025	\$ 90,756	\$ —	\$ 90,756
Short-term marketable securities	79,467	—	79,467	74,398	—	74,398	34,798	—	34,798
Accounts receivable, net of	77,539	(7,648)	69,891	116,052	(8,725)	107,327	87,137	(6,892)	80,245
Prepaid expenses and other current	14,180	—	14,180	15,202	51	15,253	10,828	—	10,828
Deferred income taxes	11,891	391	12,282	11,905	390	12,295	13,110	(5,786)	7,324
Total current assets	335,080	(7,257)	327,823	338,582	(8,284)	330,298	236,629	(12,678)	223,951
Property and equipment, net	85,769	1,164	86,933	82,845	199	83,044	80,288	519	80,807
Long-term marketable securities	41,347	—	41,347	47,538	—	47,538	88,492	—	88,492
Amortizing intangible assets, net	66,031	(1,257)	64,774	68,975	(1,360)	67,615	70,208	(1,337)	68,871
Goodwill	442,890	(290)	442,600	430,239	(290)	429,949	428,570	(1,553)	427,017
Deferred income taxes	—	25,852	25,852	—	26,675	26,675	—	31,742	31,742
Other assets	6,315	—	6,315	4,828	—	4,828	4,313	—	4,313
Total	\$ 977,432	\$ 18,212	\$ 995,644	\$ 973,007	\$ 16,940	\$ 989,947	\$ 908,500	\$ 16,693	\$ 925,193
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>									
Current liabilities:									
Accounts payable	\$ 4,468	\$ —	\$ 4,468	\$ 3,756	\$ —	\$ 3,756	\$ 2,785	\$ —	\$ 2,785
Obligation under repurchase	—	—	—	—	—	—	10,092	—	10,092
Accrued compensatio	26,923	1,513	28,436	32,696	659	33,355	26,275	895	27,170
Other accrued expenses (2)	27,855	(1,346)	26,509	34,351	(1,011)	33,340	27,867	(765)	27,102
Income taxes payable	8,907	(616)	8,291	19,554	(23)	19,531	11,755	(528)	11,227
Current portion of deferred revenue	136,714	(3,358)	133,356	140,267	(3,896)	136,371	119,450	(3,405)	116,045
Total current liabilities	204,867	(3,807)	201,060	230,624	(4,271)	226,353	198,224	(3,803)	194,421
Long-term liabilities:									
Long-term portion of deferred revenue	36,540	2,304	38,844	34,980	3,452	38,432	25,805	2,976	28,781
Deferred income taxes	11,399	(11,399)	—	10,576	(10,576)	—	13,642	(13,642)	—
Other long-term liabilities	1,421	849	2,270	1,460	270	1,730	275	822	1,097
Total long-term liabilities	49,360	(8,246)	41,114	47,016	(6,854)	40,162	39,722	(9,844)	29,878
Shareholders' equity:									
Preferred stock	—	—	—	—	—	—	—	—	—
Common stock	693,722	108,182	801,904	676,285	118,578	794,863	669,027	122,451	791,478
Retained earnings (accumulated deficit) (2)	48,581	(95,131)	(46,550)	41,942	(96,634)	(54,692)	25,815	(95,544)	(69,729)
Accumulated other comprehensive loss	(1,884)	—	(1,884)	(1,716)	—	(1,716)	(1,666)	—	(1,666)
Unearned compensation	—	—	—	(3,930)	(11,093)	(15,023)	(5,408)	(13,781)	(19,189)
Note receivable from sale of common stock	(17,214)	17,214	—	(17,214)	17,214	—	(17,214)	17,214	—

Total shareholders' equity	<u>723,205</u>	<u>30,265</u>	<u>753,470</u>	<u>695,367</u>	<u>28,065</u>	<u>723,432</u>	<u>670,554</u>	<u>30,340</u>	<u>700,894</u>
Total liabilities and shareholders' equity	<u>\$ 977,432</u>	<u>\$ 18,212</u>	<u>\$ 995,644</u>	<u>\$ 973,007</u>	<u>\$ 16,940</u>	<u>\$ 989,947</u>	<u>\$ 908,500</u>	<u>\$ 16,693</u>	<u>\$ 925,193</u>

- (1) For a detailed description of the restatement, see the section entitled "*Restatement*" in Management's Discussion and Analysis of Financial Condition and Results of Operations contained in this Report.
- (2) Adjustments to these line items include adjustments for the retrospective adoption of a change in accounting for planned major maintenance activities on our corporate aircraft. See Note 1 of our Notes to Consolidated Financial Statements.

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**CONSOLIDATED INCOME STATEMENTS**

	Three Months Ended March 31, 2006			Three Months Ended December 31, 2005			Three Months Ended September 30, 2005		
	As Previously Reported	Adjustments	As Restated(1)	As Previously Reported	Adjustments	As Restated(1)	As Previously Reported	Adjustments	As Restated(1)
<b>Revenues:</b>									
Licenses	\$ 63,680	\$ 2,798	\$ 66,478	\$ 85,504	\$ (1,789)	\$ 83,715	\$ 65,515	\$ (1,160)	\$ 64,355
Services	63,839	(1,125)	62,714	59,128	(32)	59,096	55,761	64	55,825
Total	127,519	1,673	129,192	144,632	(1,821)	142,811	121,276	(1,096)	120,180
<b>Cost of revenues:</b>									
Licenses	1,262	—	1,262	1,693	—	1,693	1,151	—	1,151
Services	11,458	13	11,471	11,285	21	11,306	9,483	8	9,491
Amortization of purchased intangibles	3,451	(103)	3,348	3,151	24	3,175	3,083	274	3,357
Total	16,171	(90)	16,081	16,129	45	16,174	13,717	282	13,999
Gross profit	111,348	1,763	113,111	128,503	(1,866)	126,637	107,559	(1,378)	106,181
<b>Operating expenses:</b>									
Sales and marketing	58,949	596	59,545	60,306	592	60,898	51,002	868	51,870
Research and development	27,406	413	27,819	23,896	323	24,219	22,220	287	22,507
General and administrative	14,440	193	14,633	13,281	472	13,753	11,486	683	12,169
Amortization of other purchased intangibles	2,133	—	2,133	2,222	—	2,222	2,183	—	2,183
In-process research and development	300	—	300	(110)	—	(110)	6,900	—	6,900
Total	103,228	1,202	104,430	99,595	1,387	100,982	93,791	1,838	95,629
Gain on sale of Vista Plus product suite	—	—	—	—	—	—	—	39	39
Income from operations	8,120	561	8,681	28,908	(3,253)	25,655	13,768	(3,177)	10,591
Other income, net (2)	2,284	350	2,634	84	248	332	314	41	355
Income before income tax provision	10,404	911	11,315	28,992	(3,005)	25,987	14,082	(3,136)	10,946
Income tax provision (2)	3,765	(592)	3,173	12,864	(1,914)	10,950	8,118	(1,707)	6,411
Net income	\$ 6,639	\$ 1,503	\$ 8,142	\$ 16,128	\$ (1,091)	\$ 15,037	\$ 5,964	\$ (1,429)	\$ 4,535
Basic net income per share	\$ 0.07	\$ 0.01	\$ 0.08	\$ 0.16	\$ (0.01)	\$ 0.15	\$ 0.06	\$ (0.01)	\$ 0.05
Diluted net income per share	\$ 0.06	\$ 0.02	\$ 0.08	\$ 0.16	\$ (0.01)	\$ 0.15	\$ 0.06	\$ (0.02)	\$ 0.04
<b>Weighted average shares outstanding:</b>									
Basic	100,424	—	100,424	99,211	—	99,211	98,217	—	98,217
Diluted	103,755	263	104,018	102,680	324	103,004	101,624	489	102,113

(1) For a detailed description of the restatement, see the section entitled "Restatement" in Management's Discussion and Analysis of Financial Condition and Results of Operations contained in this Report.

- (2) Adjustments to these line items include adjustments for the retrospective adoption of a change in accounting for planned major maintenance activities on our corporate aircraft. See Note 1 of our Notes to Consolidated Financial Statements.

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**CONSOLIDATED BALANCE SHEETS**

	As of June 30, 2005			As of March 31, 2005		
	As Previously Reported	Adjustments	As Restated (1)	As Previously Reported	Adjustments	As Restated (1)
<b>ASSETS</b>						
Current assets:						
Cash and cash equivalents	\$ 121,642	\$ 3	\$ 121,645	\$ 121,544	\$ 391	\$ 121,935
Short-term marketable securities	123	—	123	30,645	—	30,645
Accounts receivable, net of allowances	73,327	(5,551)	67,776	54,456	(4,273)	50,183
Prepaid expenses and other current assets	11,106	—	11,106	11,978	—	11,978
Deferred income taxes (2)	13,092	(12,036)	1,056	13,107	(6,901)	6,206
Total current assets	219,290	(17,584)	201,706	231,730	(10,783)	220,947
Property and equipment, net	76,396	518	76,914	53,321	569	53,890
Long-term marketable securities	125,399	—	125,399	145,511	—	145,511
Amortizing intangible assets, net	58,044	(1,063)	56,981	41,964	(771)	41,193
Goodwill	379,548	(2,563)	376,985	332,339	(2,696)	329,643
Deferred income taxes	—	42,165	42,165	—	41,979	41,979
Other assets	4,038	—	4,038	3,192	—	3,192
Total assets	\$ 862,715	\$ 21,473	\$ 884,188	\$ 808,057	\$ 28,298	\$ 836,355
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>						
Current liabilities:						
Accounts payable	\$ 5,779	\$ —	\$ 5,779	\$ 4,819	\$ —	\$ 4,819
Accrued compensation	24,336	966	25,302	21,037	2,180	23,217
Other accrued expenses (2)	28,302	(557)	27,745	22,667	(542)	22,125
Income taxes payable	12,267	1,178	13,445	9,642	1,008	10,650
Current portion of deferred revenue	114,615	(4,366)	110,249	106,618	(5,726)	100,892
Total current liabilities	185,299	(2,779)	182,520	164,783	(3,080)	161,703
Long-term liabilities:						
Long-term portion of deferred revenue	20,553	4,057	24,610	19,975	5,404	25,379
Deferred income taxes	9,470	(9,470)	—	4,520	(4,520)	—
Other long-term liabilities	1,434	779	2,213	1,609	825	2,434
Total long-term liabilities	31,457	(4,634)	26,823	26,104	1,709	27,813
Shareholders' equity:						
Preferred stock	—	—	—	—	—	—
Common stock	647,151	122,842	769,993	629,500	122,513	752,013
Retained earnings (accumulated deficit) (2)	19,853	(94,116)	(74,263)	9,173	(90,474)	(81,301)
Accumulated other comprehensive loss	(1,164)	—	(1,164)	(1,972)	—	(1,972)
Unearned compensation	(2,667)	(17,054)	(19,721)	(2,317)	(19,584)	(21,901)
Note receivable from sale of common stock	(17,214)	17,214	—	(17,214)	17,214	—
Total shareholders' equity	645,959	28,886	674,845	617,170	29,669	646,839
Total liabilities and shareholders' equity	\$ 862,715	\$ 21,473	\$ 884,188	\$ 808,057	\$ 28,298	\$ 836,355

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CONSOLIDATED INCOME STATEMENTS

	Three Months Ended June 30, 2005			Three Months Ended March 31, 2005		
	As Previously Reported	Adjustments	As Restated (1)	As Previously Reported	Adjustments	As Restated (1)
<b>Revenues:</b>						
Licenses	\$ 54,612	\$ (1,359)	\$ 53,253	\$ 54,718	\$ 90	\$ 54,808
Services	52,514	(57)	52,457	48,630	(135)	48,495
Total revenues	107,126	(1,416)	105,710	103,348	(45)	103,303
<b>Cost of revenues:</b>						
Licenses	1,192	—	1,192	968	1	969
Services	8,685	53	8,738	8,675	171	8,846
Amortization of purchased technology	2,421	293	2,714	2,255	(25)	2,230
Total cost of revenues	12,298	346	12,644	11,898	147	12,045
Gross profit	94,828	(1,762)	93,066	91,450	(192)	91,258
<b>Operating expenses:</b>						
Sales and marketing	45,634	519	46,153	43,393	1,537	44,930
Research and development	20,640	263	20,903	21,120	329	21,449
General and administrative	10,565	696	11,261	9,702	1,589	11,291
Amortization of other purchased intangible assets	1,498	—	1,498	1,276	—	1,276
In-process research and development	—	—	—	1,050	—	1,050
Total operating expenses	78,337	1,478	79,815	76,541	3,455	79,996
Income from operations	16,491	(3,240)	13,251	14,909	(3,647)	11,262
Other expense, net (2)	(522)	(230)	(752)	(1,510)	529	(981)
Income before income tax provision	15,969	(3,470)	12,499	13,399	(3,118)	10,281
Income tax provision (2)	5,302	171	5,473	4,360	63	4,423
Net income	\$ 10,667	\$ (3,641)	\$ 7,026	\$ 9,039	\$ (3,181)	\$ 5,858
Basic net income per share	\$ 0.11	\$ (0.04)	\$ 0.07	\$ 0.09	\$ (0.03)	\$ 0.06
Diluted net income per share	\$ 0.11	\$ (0.04)	\$ 0.07	\$ 0.09	\$ (0.03)	\$ 0.06
<b>Weighted average shares outstanding:</b>						
Basic	96,838	—	96,838	96,195	—	96,195
Diluted	99,253	166	99,419	99,585	(42)	99,543

- (1) For a detailed description of the restatement, see the section entitled “*Restatement*” in Management’s Discussion and Analysis of Financial Condition and Results of Operations contained in this Report.
- (2) Adjustments to these line items include adjustments for the retrospective adoption of a change in accounting for planned major maintenance activities on our corporate aircraft. See Note 1 of our Notes to Consolidated Financial Statements.

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### **Item 9. *Changes In and Disagreements With Accountants on Accounting and Financial Disclosure.***

None.

### **Item 9A. *Controls and Procedures.***

As described in the Explanatory Note, Note 2 of our Notes to Consolidated Financial Statements and “Management’s Discussion and Analysis of Financial Condition and Results of Operations” in Part II, Item 7 of this Report we have restated our historical consolidated financial statements to record adjustments to stock-based compensation expense based on findings of a Special committee investigation of our stock option granting practices and related accounting. The restatement also reflects adjustments arising from a variety of other issues, including software revenue recognition issues.

Since February 2002, we have made improvements to our stock option granting practices, processes and controls. These improvements, along with certain changes in personnel, include:

- In response to the requirements of the Sarbanes-Oxley Act of 2002, we implemented documentation and accounting policies, processes and procedures, which led to a segregation of responsibilities, the addition of reviews and reconciliations and redefinition of the roles and responsibilities of the personnel involved in our stock option granting and accounting processes;
- Beginning in February 2002, we ceased the regular administrative practice of determining grant dates and exercise prices for new hire and merit grants on a monthly basis, which was based on the lowest trading price for our common stock during the month. We initiated a new practice of determining option grant dates and exercise prices on the date as of which all Compensation Committee members had signed and returned written consent forms approving the grants. To this end, we revised the form used for Unanimous Written Consents to include a date line for each director’s signature, and eliminated references to prior dates for grant date determinations;
- In August 2003, the Board of Directors established a Secondary Committee consisting of our CEO, and delegated authority to the Secondary Committee to approve awards of stock options to employees within specific parameters;
- The establishment of processes and procedures to increase communications between our financial reporting, accounting, and legal functions, senior management, and our audit committee; and
- The accounting for option awards were previously administered using a non-automated system, are now administered in Equity Edge.

### **Evaluation of Disclosure Controls and Procedures**

The Company maintains disclosure controls and procedures designed to provide reasonable assurance that information required to be disclosed in reports filed under the Securities Exchange Act of 1934 (the “Act”) is recorded, processed, summarized and reported within the specified time periods and accumulated and communicated to management, including its Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure.

Our management, with the participation of our Chief Executive Officer and Chief Financial Officer, evaluated the effectiveness of our disclosure controls and procedures as of December 31, 2006. Based on that evaluation, management concluded that, as of that date, the Company’s disclosure controls and procedures were not effective at the reasonable assurance level because of the identification of the material weaknesses in its internal control over financial reporting, described below, which the Company views as an integral part of its disclosure controls and procedures.

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### **Management's Report on Internal Control over Financial Reporting**

Our management is responsible for establishing and maintaining adequate internal control over financial reporting (as defined in Rule 13a-15(f) under the Securities Exchange Act of 1934, as amended). Our management assessed the effectiveness of our internal control over financial reporting as of December 31, 2006.

A material weakness is a significant deficiency, or combination of significant deficiencies, in internal control over financial reporting, such that there is reasonable possibility that a material misstatement of the Company's annual or interim financial statements will not be prevented or detected. Management performed an assessment of the effectiveness of the Company's internal control over financial reporting as of December 31, 2006, utilizing the criteria described in the "Internal Control — Integrated Framework" issued by the Committee of Sponsoring Organizations of the Treadway Commission ("COSO"). The objective of this assessment was to determine whether the Company's internal control over financial reporting was effective as of December 31, 2006. In its assessment of the effectiveness of internal control over financial reporting as of December 31, 2006, management determined that there were control deficiencies that constituted material weaknesses, as described below.

#### *Internal Control over Financial Reporting for Revenue*

Our management identified the following material weakness in the Company's internal control over financial reporting for revenue as of December 31, 2006:

Our management identified control deficiencies that resulted in material adjustments to revenue and deferred revenue accounts for the periods from 2000 to 2006. Management has evaluated the control deficiencies that resulted in these adjustments and has concluded that these control deficiencies in the aggregate constitute a material weakness in the internal controls over financial reporting for revenue as of December 31, 2006. Management believes that the Company did not staff a sufficient number of suitably experienced personnel and did not design or implement adequate controls to ensure that revenue and deferred revenue accounts were properly accounted for and reported over the periods from December 2000 to December 2006. More specifically, the control deficiencies that management concluded in the aggregate constitute a material weakness in the design and operating effectiveness of the internal control over financial reporting for revenue can be categorized as follows:

- (1) The Company lacked a control to adequately monitor the revenue recognition resulting from automated financial system calculations for its high volume of transactions. This resulted in the system's incorrect recognition of revenue across numerous reporting periods between 2000 and 2006.
- (2) The Company did not staff suitably experienced personnel to ensure compliance with revenue recognition rules. As such, incorrect interpretations of certain complex orders resulted in improper applications of existing accounting literature contained in SOP 97-2 and related Technical Practice Aids. This resulted in incorrect recognition of revenue across numerous reporting periods between 2000 and 2006.
- (3) The Company did not design and implement certain controls nor adequately staff revenue recognition personnel to ensure revenue recognition policies were sufficiently documented and communicated consistently to both domestic and international locations. This resulted in incorrect recognition of revenue across numerous reporting periods between 2000 and 2006.

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### *Internal Control over Financial Reporting, Financial Close and Reporting Process*

Our management identified the following material weakness in the Company's financial close and reporting process, as of December 31, 2006:

Our financial and accounting organization was not adequate to support our financial accounting and reporting needs given the growth of our business. Furthermore, we failed to effectively design and implement our financial accounting system to facilitate the needs of our financial close process across all reporting units. Specifically, we did not maintain a sufficient complement of personnel with an appropriate level of accounting knowledge and training in the application of GAAP, nor did we adequately use our financial accounting system commensurate with our financial reporting requirements to support the financial reporting and close process. Moreover, due to the lack of sufficient staffing during 2006 caused, in part, by unanticipated turnover, it was necessary to place undue reliance on external consultants to assist in the financial reporting and close process. The lack of a sufficient complement of personnel with an appropriate level of accounting knowledge and training coupled with an inadequate design and implementation of our financial accounting system across all reporting units resulted in significant manual processes for the existing personnel. This reduced the likelihood that such individuals could detect the need for a material adjustment to the Company's books and records or anticipate, identify, and resolve accounting issues in the normal course of performing their assigned functions. This material weakness resulted in not only the need to record various adjustments during 2006 and a significant delay in the issuance of these financial statements once the Special Committee's investigation was completed, but also resulted in a more than reasonable possibility that a material misstatement to the annual or interim financial statements would not have been prevented or detected.

### *Conclusion*

Because of the material weaknesses noted above management has concluded that internal control over financial reporting was not effective as of December 31, 2006, based on the criteria set forth in *Internal Control-Integrated Framework* issued by COSO.

Management's assessment of the effectiveness of the Company's internal control over financial reporting has been audited by Deloitte & Touche LLP, an independent registered public accounting firm, as stated in their report which is included herein.

### **Changes in Internal Control over Financial Reporting**

There was no change in internal control over financial reporting that occurred in the fourth quarter of 2006 that has materially affected or is reasonably likely to materially affect our internal control over financial reporting, except as described below:

- We undertook initial efforts in the fourth quarter of 2006 to identify the design for the control changes implemented in 2007. Specifically, during the fourth quarter the Company developed a number of automated queries that were applied against the financial system database to identify and account for those situations where revenue was not recognized historically within the correct reporting period. In addition, we increased revenue recognition training which we believe increased our awareness of the complexities of revenue recognition.
- During the fourth quarter, the reporting relationship of the internal audit department changed to report directly to the Audit Committee of the Board of Directors.

### *Plan for Remediation of Material Weaknesses*

We are undertaking further efforts to remediate the material weaknesses identified above. Each of the identified material weaknesses was caused, in part, by insufficient staffing of experienced, specialized accounting personnel. Therefore, our remediation plans for each material weakness include the hiring of additional personnel trained and experienced in the complex accounting areas of revenue recognition and revenue accounting as well as GAAP.

As of December 31, 2006, we have taken or plan to take the following steps to improve our internal control over financial reporting and to remediate the identified material weaknesses:

- We have engaged a number of qualified accounting personnel on a temporary basis to compensate for a lack of adequate permanent finance and accounting staff. With these additional resources, management has performed additional analysis and other post-closing procedures in an effort to ensure our consolidated financial statements are fairly stated as of and for the year ended December 31, 2006;
- We are actively recruiting to fill open positions in our accounting department;
- We plan to engage a professional service organization which specializes in the assessment and the enhancement of the effectiveness of internal controls over financial reporting;
- We have adjusted or plan to adjust the software used to allocate revenue to correct the identified system errors. Where management is unable, in the short term, to adjust the software, management will implement procedures whereby automated system queries are generated and analyzed to ensure these control deficiencies no longer recur; and

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- We will formally document and consistently communicate revenue recognition policies both domestically and internationally.

We believe that the actions described above and resulting improvement in controls will generally strengthen our disclosure controls and procedures, as well as our internal control over financial reporting, and will, over time, address the material weaknesses that we identified in our internal control over financial reporting as of December 31, 2006. However, because many of the remedial actions we have undertaken are very recent and because they relate, in part, to the hiring of additional personnel and many of the controls in our system of internal controls rely extensively on manual review and approval, the successful operation of these controls for, at least, several fiscal quarters may be required prior to management being able to conclude that the material weaknesses have been remediated.

### **REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

To the Board of Directors and Stockholders of  
Quest Software, Inc.

We have audited management's assessment, included in the accompanying Management's Report on Internal Control Over Financial Reporting, that Quest Software, Inc. (the "Company") did not maintain effective internal control over financial reporting as of December 31, 2006, because of the effect of the material weaknesses identified in management's assessment based on criteria established in *Internal Control — Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management's assessment and an opinion on the effectiveness of the Company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinions.

A company's internal control over financial reporting is a process designed by, or under the supervision of, the company's principal executive and principal financial officers, or persons performing similar functions, and effected by the company's board of directors, management, and other personnel to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of the inherent limitations of internal control over financial reporting, including the possibility of collusion or improper management override of controls, material misstatements due to error or fraud may not be prevented or detected on a timely basis. Also, projections of any evaluation of the effectiveness of the internal control over financial reporting to future periods are subject to the risk that the controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

A material weakness is a deficiency, or a combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the company's annual or interim financial statements will not be prevented or detected on a timely basis. The following material weaknesses have been identified and included in management's assessment:

#### (1) Internal Control over Financial Reporting for Revenue

The Company identified control deficiencies that resulted in significant adjustments to revenue and deferred revenue accounts for the periods from 2000 to 2006. The Company has evaluated the control deficiencies that resulted in these adjustments and has concluded that these control deficiencies in the aggregate constitute a material weakness in the internal controls over financial reporting for revenue as of December 31, 2006. The Company believes that they did not staff a sufficient number of suitably experienced personnel and did not design or operate adequate controls to ensure that revenue and deferred revenue accounts were properly accounted for and reported over the periods from December 2000 to December 2006.

#### (2) Internal Control over Financial Reporting, Financial Close and Reporting Process

The Company did not maintain a sufficient complement of personnel with an appropriate level of accounting knowledge and training in the application of GAAP, nor did the Company adequately use its financial accounting system commensurate with its financial reporting requirements to support the financial reporting and close process. The lack of a sufficient complement of personnel with an appropriate level of accounting knowledge and training coupled with an inadequate design and implementation of the Company's financial accounting system across all reporting units resulted in significant manual processes for the existing personnel. This reduced the likelihood that the Company could detect the need for a material adjustment to the Company's books and records or anticipate, identify, and resolve accounting issues in the normal course of performing their assigned functions. This material weakness resulted in not only the need for the Company to record various adjustments during 2006 and a significant delay in the issuance of these financial statements but also resulted in a more than reasonable possibility that a material misstatement to the annual or interim financial statements would not have been prevented or detected.

In our opinion, management's assessment that the Company did not maintain effective internal control over financial reporting as of December 31, 2006, is fairly stated, in all material respects, based on the criteria established in *Internal Control — Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. Also in our opinion, because of the effect of the material weaknesses described above on the achievement of the objectives of the control criteria, the Company has not maintained effective internal control over financial reporting as of December 31, 2006, based on the criteria established in *Internal Control — Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated financial statements as of and for the year ended December 31, 2006, of the Company and our report dated December 7, 2007 expressed an unqualified opinion on those financial statements and included an explanatory paragraph regarding the Company's adoption of two new accounting standards.

/s/ DELOITTE & TOUCHE LLP

Costa Mesa, California  
December 7, 2007

**Item 9B. Other Information.**

Not applicable.

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**PART III**

**Item 10. Directors, Executive Officers and Corporate Governance**

**Executive Officers**

Listed below is information regarding the individuals serving as our executive officers as of December 1, 2007:

Vincent C. Smith, 43 <i>Chairman of the Board and Chief Executive Officer</i>	Mr. Smith has served as our Chief Executive Officer since 1997 and a director since 1995. Mr. Smith became Chairman of the Board in 1998. From 1992 to 1994, Mr. Smith served as Vice President of Worldwide Sales and Marketing at Patrol Software North America, a company he founded. Following Patrol's acquisition by BMC Software in 1994, Mr. Smith managed BMC's sales operations as Director of Open Systems. From 1987 to 1992, Mr. Smith held a variety of sales management positions at Oracle Corporation.
Douglas F. Garn, 49 <i>President</i>	Mr. Garn has served as our President since February 2005. Mr. Garn previously served as our Vice President, Worldwide Sales from January 1998 to January 2002, and returned to this position in January 2003 after a medical leave of absence.
Scott J. Davidson, 42 <i>Senior Vice President, Chief Financial Officer</i>	Mr. Davidson has served as our Chief Financial Officer since October 2007. Mr. Davidson joined Quest as Treasurer in 2002, and he has served as a vice president since 2005. His responsibilities have included worldwide treasury and investment operations, SEC reporting, investor relations and risk management. Mr. Davidson has also been integrally involved within Quest's merger and acquisition activity, including related purchase accounting activities. From 1997 to 2001, Davidson was director of corporate treasury and investor relations at Citrix Systems, Inc., a global leader in application delivery infrastructure.

**Directors**

Listed below is information regarding the seven individuals serving as our directors as of December 1, 2007:

Vincent C. Smith, 43 <i>Chairman of the Board and Chief Executive Officer</i>	Information for Mr. Smith is included in the previous section titled "Executive Officers."
Jerry Murdock, Jr., 49 <i>Director since 1999</i>	Mr. Murdock is a General Partner of Insight Capital Partners, a venture capital firm, which he co-founded in 1995. From 1988 to 1995, Mr. Murdock was a director of Aspen Technology Group, a consulting firm that he founded. Mr. Murdock also serves on the board of directors of CallWave, Inc. and Divvx, Inc. Mr. Murdock is a member of the Boards of Trustees of The Santa Fe Institute and The Aspen Institute.
Raymond J. Lane, 60 <i>Director since 2000</i>	Mr. Lane is a Managing Partner of Kleiner Perkins Caufield & Byers, a venture capital firm focused on helping entrepreneurs with technological and market insight, organizational development, team building, selling and managing growth. Prior to joining Kleiner Perkins in July 2000, Mr. Lane was President and Chief Operating Officer and a Director of Oracle. Before joining Oracle in June 1992, Mr. Lane was a senior partner of Partner of Booz-Allen & Hamilton. Mr. Lane is a member of the Board of Trustees of Carnegie-Mellon University and also serves as Vice Chairman of Special Olympics International.
Augustine L. Nieto II, 49 <i>Director since 2002</i>	Mr. Nieto was a co-founder of Life Fitness, a leading manufacturer of cardiovascular and strength training fitness equipment for commercial and consumer use, and held a variety of executive positions with Life Fitness until the company was acquired by Brunswick Corporation in 1997. He is currently an Operating Advisor for North Castle Partners, a private equity firm based in Greenwich, Connecticut. Mr. Nieto is currently the chairman of Octane Fitness, a manufacturer of consumer exercise equipment. He is also a National Vice President of the Muscular Dystrophy Association, Co-Chairman of its ALS Division and Founder of its Augie's Quest campaign. In addition, Mr. Nieto serves as the Chairman of the ALS Therapy Development Institute, a leading non-profit biotechnology and drug research company.

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Kevin M. Klausmeyer, 49  
*Director since 2003*

Mr. Klausmeyer is Chief Financial Officer of The Planet, Inc., a leading provider of dedicated web hosting products and services. Before joining the Planet in August 2006, Mr. Klausmeyer served as Chief Financial Officer of RLX Technologies, Inc., a developer of management and provisioning software for utility computing environments which was acquired by Hewlett-Packard Company in October 2005. From December 1999 to February 2003, Mr. Klausmeyer was chief financial officer of PentaSafe Security Technologies, Inc., which was acquired by NetIQ Corporation in December 2002. As a software finance professional, Mr. Klausmeyer was a member of the AICPA's Software Revenue Recognition Taskforce from 1998 to 2005.

Paul A. Sallaberry, 51  
*Director since 2005*

Mr. Sallaberry previously held several executive level positions with Veritas Software, most recently as Executive Vice President, Worldwide Field Operations. Prior to that, Mr. Sallaberry served as Senior Vice President, Worldwide Sales of Veritas from July 1999 to December 1999, and Vice President, Worldwide Sales of Veritas from April 1997 to July 1999.

H. John Dirks, 63  
*Director since 2006*

Mr. Dirks has 40 years of auditing and accounting experience with PricewaterhouseCoopers LLP ("PwC"), having served as a National Office Partner from 1989 until his mandatory retirement in 2005. He served as a co-leader of the firm's National Accounting Services group and was an Audit Partner from 1979 through 1989, with an industry focus on technology clients. Mr. Dirks also represented PwC in a variety of accounting and auditing professional activities, including the Accounting Standards Executive committee of the American Institute of Certified Public Accountants, the Emerging Issues Task Force of the Financial Accounting Standards Board and as a member of the AICPA Task Forces regarding various accounting topics, including the AICPA Task Force on Software Revenue Recognition. Since his retirement from PwC, he has provided accounting consulting services to various organizations.

### ***Section 16(a) Beneficial Ownership Reporting Compliance***

Section 16(a) of the Securities Exchange Act of 1934, as amended, requires the Company's executive officers and directors, and persons who own more than ten percent of a registered class of the Company's equity securities, to file reports of securities ownership and changes in such ownership with the Securities and Exchange Commission. Executive officers, directors and greater than ten percent shareholders also are required by rules promulgated by the SEC to furnish the Company with copies of all Section 16(a) forms they file.

Based solely upon a review of the copies of such forms furnished to the Company or written representations that no Forms 4 or 5 were required, the Company believes that, during 2006, its officers, directors and greater than ten percent beneficial owners complied with all applicable Section 16(a) filing requirements, except that Mr. Smith filed one late report on Form 4 covering three transactions and Mr. Garn filed one late report on Form 4 covering the re-pricing of 3 stock option grants.

### ***Code of Ethics***

We have adopted a Code of Ethics that applies to all of our employees, including our principal executive officer, principal financial officer, principal accounting officer, and other persons performing similar functions. A copy of our Code of Ethics was filed as Exhibit 14 to our Annual Report on Form 10-K for the year ended December 31, 2003 and is also posted on the "Investor Relations" section of our website at [www.quest.com](http://www.quest.com). We intend to satisfy the disclosure requirements under Item 10 of Form 8-K regarding amendments to, or waivers from, the Code of Ethics by either providing such information on a Form 8-K filed with the Securities and Exchange Commission or by posting such information on the "Investor Relations" section of our website at [www.quest.com](http://www.quest.com). Information contained on our website is not part of this Report.

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### *Audit Committee*

We have a standing audit committee consisting of Messrs. Klausmeyer, Nieto and Dirks. Our board of directors has determined that Messrs. Klausmeyer and Dirks are audit committee financial experts and are both independent, as determined under the definition contained in NASDAQ's Marketplace Rules.

### **Item 11.      *Executive Compensation***

#### *Compensation Discussion & Analysis*

##### **Overview**

The following compensation discussion and analysis is intended to supplement and provide context to the disclosures contained in the compensation tables and narrative discussion that follows such tables. This discussion and analysis explains the material components of the compensation awarded or paid to, or earned by, each of our "named executive officers" during the last completed fiscal year, and how such compensation components advance and serve our overall compensation objectives and strategies.

##### **Executive Compensation Objectives and Philosophy**

The overall objectives of our compensation programs for our named executive officers are to:

- provide overall compensation that is sufficient to attract, motivate and retain executives of outstanding ability and potential;
- link executive compensation to the achievement of measurable corporate and individual goals and objectives;
- provide incentive to operate the company in a manner consistent with the company's short-term and long-term strategic performance goals and objectives; and
- align the interests of our executives with those of our shareholders with the ultimate objective of improving shareholder value.

We are engaged in the highly competitive software industry. The Compensation Committee of the Board of Directors (the "Committee") recognizes that our continued success depends upon the ability to attract and retain qualified executives through competitive compensation programs we offer to our named executive officers.

##### **Role of Compensation Committee and Outside Consultants**

Our Board of Directors has delegated to the Committee the power and authority to review, modify and approve our compensation strategy and policies. The Committee's charter is available on the Corporate Governance page of our Investor Relations web site located at [http://www.quest.com/investor\\_relations/](http://www.quest.com/investor_relations/). The Committee is currently comprised of three independent directors: Raymond J. Lane (Chairman), Paul A. Sallaberry and Augustine L. Nieto II. The Board of Directors has delegated to the Committee the responsibility for:

- reviewing, modifying and approving the compensation of our executive officers;
- establishing our executive compensation programs and periodically reviewing and modifying the operation of those programs;
- reviewing and approving corporate performance goals and objectives relevant to the compensation of our executive officers, based upon our business needs and consistent with the interests of our shareholders;
- administering our equity compensation plans and our executive compensation plans, programs and policies;
- monitoring corporate performance and its relationship to compensation of named executive officers; and
- making appropriate recommendations to the Board concerning matters of executive compensation.

The Committee meets regularly to discuss executive compensation matters and at least annually, the Committee performs a review of the total compensation packages of our named executive officers.

In determining an executive's total compensation packages, the Committee considers and reviews each of the components of compensation we offer our named executive officers to ensure consistency with our compensation philosophy and objectives. The Committee then determines whether the existing compensation programs are meeting our overall compensation objectives and philosophy and may implement adjustments to achieve a package of total compensation for each of our named executive officers. The Committee considers whether developments in compensation "best practices" should affect our compensation policies and objectives.

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The Committee considers input from the Chief Executive Officer in determining both the total amount of compensation for our named executive officers and the allocation between different types of compensation. Our Chief Executive Officer also discusses with the Committee our corporate performance goals during the applicable performance period and makes recommendations regarding the relative weights to assign to the different performance objectives when the Committee uses multiple objectives. However, our Chief Executive Officer is not present during the Committee's voting or final deliberations regarding his compensation.

The Committee has the authority to engage its own outside compensation consultants, at the company's expense, and to commission compensation studies or surveys to obtain advice regarding the amount and types of compensation we provide to our executive officers and how these compare to compensation practices generally in our industry. In August 2005, Frederic W. Cook & Co., Inc., at the request of the Committee, prepared a comparison (the "FW Cook Study") of the compensation of our executive officers against a peer group consisting of the following sixteen companies:

Altiris	Citrix Systems	Mercury	Serena Software
BEA Systems	Compuware	NetIQ	Sybase
BMC Software	FileNet	Progress Software	Tibco Software
Borland Software	Informatica	Red Hat	Verity

More recently, the Committee has relied on salary surveys from companies like Equilar, a leading executive compensation company, to compare the compensation programs for our executive officers with the compensation packages provided to executives with similar responsibilities at software companies that are similar in size to Quest.

### **Elements of Total Compensation**

To achieve the objectives of our compensation programs, we currently use the following principal forms of compensation for our named executive officers, each of which is discussed in detail below:

- cash compensation in the form of base salaries, cash bonus awards and sales commissions;
- equity compensation in the form of stock options, and recently, arrangements for awards of restricted stock units to our CEO and President;
- retirement and other benefits;
- perquisites; and
- change of control severance benefits.

### *Cash Compensation*

*Base Salary.* We pay our named executive officers a base salary to compensate them for the services they provide throughout the year. Although base salary has traditionally comprised a substantial portion of the overall compensation of our named executive officers, the Committee does not specifically target salary as a percentage of total compensation. To attract and retain qualified personnel, and because of the competitive industry in which we operate, we feel it is necessary to pay each of our named executive officers a base salary that is competitive with other software and technology companies with which we compete for personnel. In considering and determining the appropriate base salary for our named executive officers, the Committee reviews market data to compare salaries paid to executives holding similar positions at similar companies with the salaries we offer to our executive officers. The Committee may obtain this data from an independent external consultant or request our human resources staff to gather data from publicly available sources. Because we also rely heavily on other forms of compensation for our executive officers, most significantly being equity compensation, we believe that the base salaries paid to our executive officers in 2006 were, and for many years have been, at the low end of the market. In determining base salary, the Committee also takes into consideration the aggregate on-target compensation package that is being discussed with respect to each named executive officer. Base salaries are typically evaluated and adjusted by the Committee at least annually, usually near the beginning of each year. No changes were made in 2006 to the base salaries of any of our named executive officers from the prior year.

*Cash Bonus Awards.* We also offer incentive cash bonus opportunities to our named executive officers based on the achievement of specific corporate operating goals and objectives and also individual performance. The Committee believes that achievement of the established performance goals and objectives will result in increased shareholder value, thereby providing an incentive to our named executive officers in the performance of their duties that is aligned with the interests of our shareholders. By providing cash payments that are directly tied to the achievement of short-term strategic performance goals and objectives, the Committee has created an incentive for our executive officers to operate the company to achieve desired results.

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Near the beginning of each fiscal year, management prepares an operating plan and forecast detailing the anticipated level of revenues and other business activities for such fiscal year. The plan does not take into account the impact of any acquisitions during the year. This operating plan is presented to the Board of Directors and the Committee uses this plan for the target performance goals and objectives for the determination of the bonuses to be paid to our named executive officers. The performance metrics for 2006 for our executive officers (other than Anthony Foley, who served as our Senior Vice President, Worldwide Sales in 2006) were based on achievement of total corporate revenue and pro forma operating income targets. Sixty percent of the bonus was based on achievement of the pro forma operating income target while forty percent of the bonus was based on achievement of the corporate revenue target. These are the same performance measures that we used for executive bonuses in 2005, although in 2005 only forty percent of the bonus was tied to pro forma operating income while sixty percent of the bonus was tied to corporate revenue. For 2006, a 100 percent award would have been awarded with total revenue growth of 20.0 percent and maintenance of the same pro forma operating margin attainment (as a percentage of total revenues and excluding amortization of intangible items, stock-based compensation expenses and expenses associated with the stock option investigation) as was achieved by the Company in 2005. The cash bonuses ultimately awarded to our executive officers for 2006 (other than Mr. Foley) were determined in March 2006 based on preliminary, unaudited financial information which at the time did not include restatement adjustments, reflecting a 90.5% achievement to plan on a weighted basis, as the Company's actual pro forma operating margin performance in 2006 fell short of management's expectations. Actual results for both corporate revenues and pro forma operating income for 2006 were below the targeted amounts. Although the actual targeted amounts of corporate revenue and pro forma operating income are not material to an understanding of the discretionary cash bonus awards paid to our executive officers, it is important to note that these targets generally reflect growth in our business and increased financial and operating performance, and are designed to be challenging, but attainable. The performance metrics for Anthony Foley in 2006 were based upon our President's review of leadership, budget management and execution of Quest's sales strategy during the year. Because Mr. Foley also participated in a sales commission plan in 2006, his 2006 bonus was a smaller amount compared with most of our other executive officers. The Committee may also make discretionary cash bonus awards that are in excess of the bonus awards determined by the performance metrics based on high levels of individual performance.

*Sales Commissions.* In addition to cash bonus awards, we offer the opportunity to earn quarterly cash commissions to our executive officers who are in our sales organization. In 2006, Mr. Foley was the only executive officer in the sales organization. These commission payments are tied directly to actual sales of our products measured against assigned target sales quotas during the relevant period. The Committee believes that offering commission payments to executive officers in our sales organizations provides an additional financial incentive to meet or exceed internal sales targets. In 2006, Mr. Foley's on-target commissions for achieving his assigned sales quota were set at \$250,000. Mr. Foley actually received an aggregate of \$268,668 in commissions for 2006. The foregoing amounts are stated in U.S. dollars, although Mr. Foley's compensation arrangement is denominated and paid in British pounds. The amount reported as commissions for 2006 for Mr. Foley has been translated into U.S. dollars using the average exchange rate for 2006 (which was \$1.84295 per British pound).

### *Equity Compensation*

We provide our named executive officers with equity-based incentives pursuant to our 1999 Stock Incentive Plan to motivate them to achieve our long-term goals. These equity-based incentives also serve to align the interests of our executives with the interests of our shareholders. Our 1999 Stock Incentive Plan was established to provide all of our employees, including named executive officers, with an opportunity to share, along with our shareholders, in our long-term performance. The Committee believes that a primary goal of our equity compensation program should be to provide key employees who have significant responsibility for our management, growth and future success with an opportunity to obtain an ownership interest, or to otherwise increase their ownership interest, in Quest, as an incentive for them to remain as an employee of Quest. We also feel that awarding equity compensation will also provide incentive for our executives to work hard and strive to achieve our long-term strategic performance goals and objectives, by giving each a stake in the outcome.

*Stock Options* – Named executive officers are eligible to receive stock options at the discretion of the Committee. Option awards give the executives the right to purchase shares of our common stock in the future at a price equal to the fair market value at the date of grant. Historically, the amount of stock options granted to our named executive officers has varied widely and is determined at the discretion of the Committee, based on the recommendation of our Chief Executive Officer. All such grants are subject to the terms and conditions of our 1999 Stock Incentive Plan. We believe that the grant of stock options having an exercise price equal to the fair market value on the date of grant provides our executive officers with an

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incentive to build shareholder value, since the executive will only realize value in the stock options if there is stock price appreciation. Outstanding options held by executive officers typically vest over a period of five years and expire ten years from the date of grant. We believe the vesting period provides us with an executive retention tool, as well as providing an incentive to our named executive officers to increase long-term shareholder value. Our executive officers normally receive an annual option grant as an allocation of a company-wide granting action. The last company-wide grant that included named executive officers was completed in December 2005. We did not have a company-wide grant in 2006, and we did not grant any stock options to our executive officers in 2006, during the stock option investigation.

*Restricted Stock* – Historically, and in 2006, stock option grants were the primary form of equity-based incentives granted to our named executive officers. However, in February 2006, the Committee also reviewed and approved an arrangement with Anthony Foley, whereby Mr. Foley would agree to cancel certain stock options that had previously been granted to him and would receive a grant of 40,000 shares of restricted stock under the terms of our 1999 Stock Incentive Plan. This arrangement with Mr. Foley was never completed. Also, in 2007, the Committee determined to begin awarding grants of restricted stock units (RSUs) under the terms of our 1999 Stock Incentive Plan on a limited basis – see “*Changes to Compensation in 2007*” below.

We believe that the use of restricted stock to our long-term equity incentive program, both through direct restricted stock grants and grants of RSUs, will provide a number of benefits, including:

- decrease the dilutive effect of option grants on our outstanding shares;
- provide a more direct correlation between our recorded compensation expense for financial accounting purposes under SFAS 123R and the actual compensation received by our executive officers; and
- provide an additional compensation alternative for the Committee to consider in light of current tax considerations related to executive compensation arrangements.

We believe that the use of both stock options and RSUs will provide our executive officers with more competitive and balanced equity compensation arrangements. Also, while RSUs generally provide value even absent stock price appreciation, our executive officers can receive even greater value from the appreciation of our stock price, so RSUs create an incentive to maximize shareholder value. In addition, because RSUs are typically subject to vesting, this compensation element also provides the company with a retention benefit.

### *Retirement and Other Benefits*

We make available to each of our employees, including our named executive officers, a variety of employee benefit programs, including a 401(k) plan, medical, vision and dental benefits plans, short-term and long-term disability insurance, life insurance and certain other standard employee health and welfare benefit plans. Our named executive officers are eligible to participate in such plans to the same extent and on the same terms as all of our other employees. Our Board of Directors typically makes a discretionary matching contribution under our 401(k) plan to all participants once annually in February, based on our financial performance during the previous year. In 2006, we provided a discretionary matching contribution in the amount of up to \$2,500, which is similar to the amount of the matching contribution from previous years. We believe that we must offer a comprehensive and competitive employee benefits program to attract and retain our key executives.

### *Perquisites*

In addition to the compensation programs described above and the benefits programs that are generally available to all of our salaried employees, we also provide our named executive officers with certain additional perquisites. These benefits principally consist of periodic personal use of company aircraft, company automobiles or automobile allowances for certain named executive officers, and costs of attending our annual sales quota club trip (including related tax gross-up benefits). We believe these perquisites and other personal benefits are reasonable in nature and amount and consistent with the overall objectives of our compensation programs to enable us to attract, motivate and retain outstanding executives in our most critical positions. The most significant perquisite has historically been the periodic personal use of our company aircraft by our Chief Executive Officer. However, in the fourth quarter of 2006 we sold our company aircraft and have no present intention of purchasing a replacement. We, therefore, do not expect to continue to provide this benefit in the future.

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### Changes to Compensation in 2007

In 2007, the Committee adopted new compensation arrangements for Messrs. Smith and Garn, and also for Michael J. Lambert, who resigned in October 2007. Scott J. Davidson was appointed Senior Vice President and Chief Financial Officer following Mr. Lambert's resignation. The Committee believed the changes in our executive compensation practices were necessary to help attract, retain and motivate executives in order to achieve revenue growth, enhance profitability and maximize shareholder value in the highly competitive information technology software marketplace. In designing the new compensation packages, the Committee sought to align the interests of our executive officers with the interests of our shareholders through compensation tied to the achievement of short-term and long-term performance goals. The Committee also designed the executive compensation arrangements to provide economic incentives to outperform stated goals. As a result, the Committee determined that performance-based compensation should comprise a significant portion of Quest executive's compensation arrangements.

As part of the process to determine the nature and amount of the new compensation arrangements, the Committee used the FW Cook Study and additional compensation data obtained from Equilar, Inc. to determine actual compensation ranges for the executive officers in peer software companies. The Committee focused its comparative analysis on the following peer group of software companies: Adobe Systems, Autodesk, BEA Systems, BMC Software, Business Objects, Citrix Systems, Cognos, McAfee, Mercury (prior to its acquisition by HP) and Sybase (the "Peer Group"). In addition, the Committee considered the following factors:

- A belief that, for several years, our executive officers have been paid less than executive officers of software companies similar in size and characteristics to Quest;
- Information obtained from executive search firms regarding target compensation for similar executive officers within the software industry;
- Recognition that our executive officers performed well against goals during challenging circumstances during 2006; and
- The relative seniority, in terms of experience, of our executive officers in the software industry.

Taking into consideration all of the above factors, the Committee determined that on-target total compensation for each of our CEO and President should be at approximately the 75<sup>th</sup> percentile of the Peer Group if pre-determined performance objectives are reached at the target level.

### Base Salaries

Effective as of January 1, 2007, the Compensation Committee determined the annual base salaries of the executive officers as follows:

Vincent C. Smith, Chief Executive Officer	\$ 1,000,000
Douglas F. Garn, President	\$ 700,000
Michael J. Lambert, Senior Vice President and Chief Financial Officer	\$ 425,000 (1)

(1) Mr. Lambert resigned in October 2007.

Upon his appointment as Chief Financial Officer, Mr. Davidson's annual base salary was increased to \$375,000.

### Performance-Based Variable Compensation

*Executive Incentive Plan.* The Committee approved and adopted an Executive Incentive Plan (the "EIP"), subject to shareholder approval at the Company's next annual meeting of shareholders. The EIP is a variable cash incentive program designed to motivate participants to perform to the best of their abilities and achieve Quest's financial and other performance objectives.

Payments under the EIP will only be earned if and to the extent performance goals predetermined by the Compensation Committee are achieved. The performance period for 2007 runs from April 1, 2007 through December 31, 2007. The performance goals for 2007 require the achievement of certain performance criteria related to new product bookings and operating margin. For subsequent performance periods during the term of the EIP, the performance objectives may include one or more of the following: total revenues, license revenues, service revenues, new orders or bookings, operating income, operating margin, earnings per share, earnings before interest, taxes, depreciation and amortization and stock-based compensation, cash flow, net income, operating cash flow, return on assets, return on total shareholder equity, return on

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sales, assets, capital or investments, total shareholder return, cost reduction goals, budget comparisons, implementation or completion of projects or processes strategic or critical to Quest's operations, measures of customer satisfaction, or the completion of corporate transactions intended to enhance Quest's revenue or profitability or expand its business into new or adjacent markets, or any combination of, or a specified increase in, any of the foregoing.

The Committee will administer the EIP. The Committee will determine the basis on which to measure the performance criteria. Certain performance objectives may be measured in accordance with generally accepted accounting principles applied by the Company on a consistent basis, and others may be measured on a "pro forma" basis, excluding from the calculation of such objectives non-cash, non-recurring, extraordinary and certain other items, provided that such adjustments are in conformity with those reported by the Company on a non-GAAP basis. In addition, such performance objectives may be based upon the performance of any of the Company's business groups or division thereof or any subsidiary. Performance goals may differ from participant to participant, from performance period to performance period and from award to award. The EIP is intended to permit the payment of bonuses that qualify as performance-based compensation under section 162(m) of the Internal Revenue Code of 1986, as amended and members of the Committee must qualify as "outside directors" under Section 162(m). Subject to the terms of the EIP, the Committee has all discretion and authority necessary or appropriate to control and manage the operation and administration of the EIP. The Committee or the Board generally may amend or terminate the EIP at any time and for any reason.

The target cash bonus awards for the executive officers under the EIP for 2007 are as follows:

Vincent C. Smith, Chief Executive Officer	\$ 600,000
Douglas F. Garn, President	\$ 300,000
Michael J. Lambert, Senior Vice President and Chief Financial Officer	\$ 75,000 (1)

- (1) Mr. Lambert resigned in October 2007 and is not eligible to earn a bonus under the EIP for 2007.

Under the terms of the EIP, the maximum cash award any executive officer may earn is 125% of such executive officer's target cash bonus award, and the amount of the ultimate award may be reduced if actual achievement of the performance criteria is determined to be below the specified objectives. The Committee retains discretion to reduce or eliminate (but not increase) the cash bonus awards that would otherwise be payable under the EIP.

*Discretionary Target Cash Bonus Awards.* The Committee also determined discretionary variable cash bonus targets for the executive officers, which are designed to provide incentives for the executives to perform to the best of their abilities and achieve certain individual operational, strategic and regional objectives and initiatives or complete certain projects. The executives will become entitled to earn some or all of their respective discretionary bonus targets, to be determined at the discretion of the Committee, including the opportunity to earn up to 125% of their target bonus amounts based on superior performance relative to designated objectives. The 2007 discretionary bonus targets for the executive officers are as follows:

Vincent C. Smith, Chief Executive Officer	\$ 400,000
Douglas F. Garn, President	\$ 200,000
Scott J. Davidson, Senior Vice President and Chief Financial Officer	\$ 72,500 (1)
Michael J. Lambert, Senior Vice President and Chief Financial Officer	\$ 150,000 (2)

- (1) Mr. Davidson's 2007 bonus target includes the prorated amount of the \$100,000 annual bonus target associated with his new role as Chief Financial Officer.
- (2) Mr. Lambert resigned in October 2007 and is not eligible to earn a discretionary cash bonus for 2007.

*Restricted Stock Units.* The Committee also determined to grant 120,000 and 60,000 RSU's to Messrs. Smith and Garn, respectively, pursuant to our 1999 Stock Incentive Plan, as amended (the "1999 Plan"), subject to shareholder approval of the EIP described above. The Committee also determined to grant 25,000 RSU's to Mr. Davidson in connection with his appointment as Chief Financial Officer. The RSU's are designed to promote a longer-term interest in our performance and success through the design of performance objectives that are intended to result in increased value for our shareholders. The executive officers must achieve the specific performance objectives and remain employed with Quest through the vesting period in order to realize any value from the RSU's. The RSU awards to Messrs. Garn and Smith are intended to qualify as performance-based compensation under section 162(m) of the Internal Revenue Code of 1986, as amended.

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The RSU's to be granted to Messrs. Smith and Garn will initially vest upon the Committee's certification of our achievement of the same performance objectives adopted under the EIP for the executive officer incentive cash bonus awards for the performance period from April 1, 2007 through December 31, 2007, and the number of shares of the our Common Stock deliverable under the RSU's will be determined then on the basis of a formula, which provides for a reduction in the number of shares deliverable if our achievement of the performance objectives is below the specified objectives determined by the Committee. The RSU's to be granted to Mr. Davidson will not be granted until the Committee shall have established performance objectives for the EIP for the year ending December 31, 2008 and such RSU's will initially vest upon the Committee's certification of our achievement of the performance objectives established for the EIP for the period ending December 31, 2008.

The maximum number of shares of our Common Stock which Messrs. Smith, Garn and Davidson will receive under the RSU's is 120,000 shares, 60,000 shares and 25,000 shares, respectively. The RSU's for the number of shares so determined will thereafter vest in three equal increments, subject to continued employment with Quest, on each of the first three anniversary dates of the grant date. Vesting of the RSU's will be accelerated in the event of a Change of Control of the Company, in the manner set forth in the applicable provisions of the 1999 Plan. The executives will have the right to defer delivery of such shares subject to compliance with Section 409A of the Internal Revenue Code of 1986, as amended.

### **Equity Compensation Practices**

#### ***Market Timing of Equity Awards***

The Committee does not engage in any "market timing" of equity awards made to our named executive officers or other award recipients. There is no established practice of timing the grant of our equity awards in advance of the release of favorable financial results or adjusting the award date in connection with the release of unfavorable financial developments affecting our business. Under our current practice, equity awards for all officers are made by the Committee and equity awards for other eligible individuals are made either by the Committee or by our Chief Executive Officer under authority delegated by the Committee for grants meeting certain predetermined criteria, including limitations on the size of awards. Generally, all stock option grants, whether made by the Committee or by the Chief Executive Officer under delegated authority will have an exercise price per share equal to the closing price of our common stock as reported by on the Nasdaq Global Select Market on the date of grant.

#### ***Option Amendments***

During 2006 we conducted a voluntary review of our past equity award practices and determined that the measurement date for accounting purposes of most stock options granted between July 1998 and May 2002, including grants made to executive officers, differed from the measurement dates previously used in accounting for those awards. We entered into option amendment agreements with Messrs. Smith and Garn and M. Brinkley Morse, former Senior Vice President, Corporate Development, in December 2006 and Mr. Foley in April 2007 that increased the per share exercise prices previously in effect for the amended options. In each instance, the exercise price per share of the option was increased to the closing price per share of our common stock on the adjusted measurement date determined for the affected option in accordance with applicable accounting principles. The Committee believed that such amendments were appropriate and also necessary to avoid any potential adverse taxation of those options under Section 409A of the Internal Revenue Code, including certain federal and state penalty taxes that could potentially have been imposed on the affected executive officers. Please see Item 7, "*Management's Discussion and Analysis of Financial Condition and Results of Operations.*"

### **Change in Control and Severance Payments**

We have entered into agreements with certain of our executive officers that provide for payments or other benefits upon a change of control or involuntary termination. For a discussion of these agreements, please see "*Potential Payments upon Termination or Change in Control*" below.

### **Deductibility of Executive Compensation**

As part of its function, the Committee reviews and considers the deductibility of executive compensation under Section 162(m) of the Internal Revenue Code (the "Code") which limits the annual deduction we can claim for federal income tax purposes of no more than \$1 million of compensation paid to certain named executive officers (as determined in accordance with Section 162(m)) in a taxable year. Compensation above \$1 million may be deducted if it is "performance-based compensation" within the meaning of the Code. In certain situations, the Committee may approve compensation arrangements that do not meet these requirements to ensure competitive levels of total compensation for our named executive officers.

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### Summary Compensation Table

The following table sets forth for the year ended December 31, 2006 all compensation awarded or paid to, or earned by, our chief executive officer, chief financial officer and each of our other executive officers for services rendered to Quest in all capacities. These officers are referred to herein as the Named Executive Officers.

Name and Principal Position	Year	Salary (\$)	Bonus (\$)	Option Awards(\$)(1)	Non-Equity Incentive Plan Compensation(\$)	All Other Compensation(\$)(2)	Total(\$)
Vincent C. Smith, Chairman and Chief Executive Officer	2006	\$ 150,000	\$ 180,919	\$ 2,862,429	—	\$ 292,428(3)	\$ 3,485,776
Douglas F. Garn, President	2006	400,000	180,919	2,275,251	—	16,288(4)	2,872,458
Michael J. Lambert, Senior Vice President, Chief Financial Officer (5)	2006	350,000	90,459	876,539	—	14,538(6)	1,331,536
M. Brinkley Morse, Senior Vice President, Corporate Development (7)	2006	345,064	—	2,381,747	—	—	2,726,811
Anthony Foley, Senior Vice President, Sales (8)	2006	309,616	95,000	502,000	268,668	29,925(9)	1,205,209

- (1) No stock options were granted to any of our Named Executive Officers in 2006. The amounts shown do not reflect compensation actually received by the Named Executive Officer. Instead, the amounts shown are the compensation costs recognized in our financial statements for 2006 related to stock options granted to each Named Executive Officer in years prior to 2006, to the extent we recognized compensation cost in 2006 for such awards in accordance with the provisions of SFAS 123R, excluding estimated forfeitures. For a discussion of the valuation assumptions used in the SFAS 123R calculations, please see Note 1 of our Notes to Consolidated Financial Statements included in this Report on Form 10-K.
- (2) The amounts disclosed are valued based on the aggregate incremental cost to Quest for providing the applicable perquisite or personal benefit.
- (3) The amount of compensation disclosed includes expenses in the amount of: (a) \$12,038 related to the allocable cost of our annual sales quota club trip, including \$4,628 in related tax gross-up benefits; (b) \$23,852 for the cost of two company-provided cars and related expenses; (c) \$252,940 for personal use of company-owned aircraft; (d) \$96 for the cost of a health club membership; (e) \$60 for the cost of a credit card mileage plus membership; (f) \$942 in credit card late fees; and (g) \$2,500 related to the company matching contribution under our 401(k) plan. For purposes of the aircraft-related compensation disclosures, we have valued Mr. Smith's personal use of company aircraft based on the cost of fuel, maintenance reserves for engines and smaller variable costs, such as trip-related hangar and parking costs, landing fees, crew expenses and on-board catering. The Company's aircraft was sold in November 2006.
- (4) The amount of compensation disclosed includes expenses in the amount of: (a) \$12,038 related to the allocable cost of our annual sales quota club trip, including \$4,628 in related tax gross-up benefits; (b) \$250 for the cost of a physical exam; (c) \$1,500 for the cost of theatre tickets purchased for personal use; and (c) \$2,500 related to the company matching contribution under our 401(k) plan.
- (5) Mr. Lambert resigned in October 2007.
- (6) The amount of compensation disclosed includes expenses in the amount of: (a) \$12,038 related to the allocable cost of our annual sales quota club trip, including \$4,628 in related tax gross-up benefits; and (b) \$2,500 related to the company matching contribution under our 401(k) plan.

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- (7) Mr. Morse resigned in November 2006.
- (8) Mr. Foley's compensation is denominated in British pounds. However, the amounts disclosed in this Report have been translated into U.S. dollars using the average exchange rate for the relevant year (which was \$1.84295 per British pound). Mr. Foley is the only Named Executive Officer paid in total or in part in a currency other than the U.S. dollar.
- (9) The amount of compensation disclosed includes expenses in the amount of: (a) \$26,539 for an automobile allowance; and (b) \$3,386 for contributions to a personal pension plan.

### *Grants of Plan-Based Awards Table*

The following table sets forth summary information regarding all grants of plan-based awards made to our Named Executive Officers during the year ended December 31, 2006.

#### GRANTS OF PLAN-BASED AWARDS TABLE

Name	Grant Date	Estimated Future Payouts Under Non-Equity Incentive Plan Awards			All Other Option Awards: Number of Securities Underlying Options(#)	Exercise or Base Price of Option Awards (\$ / Sh)	Grant Date Fair Value of Awards
		Threshold(\$)	Target(\$)	Maximum(\$)			
Vincent C. Smith	12/29/2006	—	—	—	300,000	\$ 26.51	\$ —
	12/29/2006	—	—	—	485,000	\$ 24.40	\$ —
Douglas F. Garn	12/28/2006	—	—	—	80,000	\$ 55.25	\$ —
	12/28/2006	—	—	—	300,000	\$ 26.51	\$ —
M. Brinkley Morse	12/28/2006	—	—	—	72,900	\$ 24.40	\$ 235,539
	12/29/2006	—	—	—	100,000	\$ 26.51	\$ —
	12/29/2006	—	—	—	300,000	\$ 24.40	\$ —
Anthony Foley	—	— (2)	\$ 250,000(2)	\$ 268,668(2)	—	—	—

- (1) As previously disclosed, our board of directors established a special committee of independent directors to review our historical stock option granting practices and related accounting. The special committee's findings included a determination that accounting measurement dates for most of the stock option grants to employees from July 1998 to May 2002 differed from the recorded grant dates. Messrs. Smith, Garn and Morse, who each received one or more such grants, each agreed on the date identified above as the "grant date" to an amendment that increased the per share exercise prices previously in effect for certain options; the original option terms were not modified. For reporting purposes, these amendments are deemed to be a cancellation of the lower-priced option and the grant of a replacement option at the higher exercise price per share. The amendments did not result in any additional compensation cost for accounting purposes under SFAS 123R. Accordingly, the grant date fair value reported for each of the amended options reflects the portion (if any) of the original grant date fair value of those options that had not yet been amortized as of December 29, 2006. That remaining portion will be amortized as compensation cost over the balance of the vesting period. For options that were fully vested at the time of amendment, the grant date fair value under SFAS 123R was zero. For further information on the stock option amendments, including amendments to increase the exercise price of certain option grants to Mr. Foley that were made in 2007, see "*Compensation Discussion & Analysis — Option Amendments.*"
- (2) In 2006, Mr. Foley was entitled to receive sales commission payments based on the percentage of our actual sales in 2006. Mr. Foley would have been entitled to receive a payment in the amount of \$250,000 if actual sales in 2006 were equal to Mr. Foley's quota. The amount disclosed as the maximum future payout was actually earned by and paid to Mr. Foley.

As of the end of 2006, none of the Named Executive Officers held any performance-based equity or non-equity incentive awards. For a discussion of the performance-based equity and non-equity incentive awards granted to certain of our Named Executive Officers in May 2007, please see our *Compensation Discussion & Analysis – 2007 Compensation Plan Changes*.

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*Outstanding Equity Awards at Fiscal Year-End Table*

The following table shows certain information regarding outstanding equity awards held by the Named Executive Officers as of December 31, 2006.

**OUTSTANDING EQUITY AWARDS AT FISCAL YEAR-END TABLE**

Name	Option Awards			
	Number of Securities Underlying Unexercised Options(#) Exercisable	Number of Securities Underlying Unexercised Options(#) Unexercisable	Option Exercise Price(\$)	Option Expiration Date
Vincent C. Smith	300,000 (1)	0	\$ 26.51 (3)	4/4/2011
	300,000 (1)	0	\$ 24.40 (3)	10/1/2011
	185,000 (1)	0	\$ 24.40 (3)	10/1/2011
	640,000 (2)	160,000	\$ 8.30	8/7/2012
	450,000 (2)	300,000	\$ 11.56	9/10/2013
Michael J. Lambert	160,000 (2)	240,000	\$ 16.03	11/29/2014
	20,000 (2)	80,000	\$ 14.59	12/8/2015
Douglas F. Garn	80,000 (1)	0	\$ 55.25 (3)	4/14/2010
	300,000 (1)	0	\$ 26.51 (3)	4/4/2011
	52,900 (2)	20,000	\$ 24.40 (3)	10/1/2011
	330,000 (2)	220,000	\$ 11.56	9/10/2013
	20,000 (2)	30,000	\$ 11.18	8/5/2014
M. Brinkley Morse (4)	65,000 (2)	260,000	\$ 14.59	12/8/2015
	250,000 (1)	0	\$ 15.13	3/28/2011
	100,000 (1)	0	\$ 26.51 (3)	4/4/2011
	300,000 (1)	0	\$ 24.40 (3)	10/1/2011
	160,000 (1)	0	\$ 8.30	8/7/2012
Anthony Foley	90,000 (1)	0	\$ 11.56	9/10/2013
	225,000 (1)	0	\$ 25.00	4/14/2010
	20,000 (1)	0	\$ 15.13	3/28/2011
	23,000 (1)	0	\$ 10.74	10/1/2011
	34,000 (1)	0	\$ 11.91	4/29/2012
	11,000 (2)	6,000	\$ 8.40	8/6/2012
25,000 (2)	50,000	\$ 11.56	9/10/2013	
	8,000 (2)	48,000	\$ 11.18	8/5/2014

(1) Fully vested and immediately exercisable.

(2) The option vests and becomes exercisable for the total number of option shares over a period of 5 years, with 20% vesting on the date that is 12-months from the date of grant and an additional 10% vesting at the end of each 6-month period thereafter. The following schedule sets forth the grant date for each option with such a vesting schedule (identified in terms of the expiration date reported for that option in the above table) and the total number of shares for which that option was originally granted:

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Name	Grant Date	Expiration Date	Shares Granted
Vincent C. Smith	9/10/2003	9/10/2013	750,000
	8/7/2002	8/7/2012	800,000
Michael J. Lambert	11/29/2004	11/29/2014	400,000
	12/8/2005	12/8/2015	100,000
Douglas F. Garn	10/1/2001	10/1/2011	100,000
	12/8/2005	12/8/2015	325,000
Anthony Foley	8/5/2004	8/5/2014	50,000
	9/10/2003	9/10/2013	550,000
	9/10/2003	9/10/2013	125,000
	8/5/2004	8/5/2014	80,000
	8/6/2002	8/6/2012	30,000

- (3) The option was amended in December 2006 to increase the per share exercise price. For further information on these stock option amendments see “*Compensation Discussion & Analysis — Option Amendments.*”
- (4) In December 2006, we entered into a tolling arrangement with Mr. Morse with respect to the post-termination period during which Mr. Morse may exercise vested stock options which he held as of the date of his resignation. Under this arrangement, the Company and Mr. Morse agreed that Mr. Morse would not exercise any of his vested stock options without the consent of the Chairmen of the Special Committee and Compensation Committee of the Board of Directors.

### **Potential Payments upon Termination or Change in Control**

We have entered into agreements with certain of our Named Executive Officers that provide certain benefits upon the termination of their employment or under certain other circumstances. Those agreements are summarized as follows:

*Option Acceleration Agreements* – In April 2001, we granted options to Messrs. Smith, Garn and Morse to purchase 300,000, 300,000 and 100,000 shares of our common stock, respectively. These option grants included a provision for accelerated vesting such that, in the event of a change in control of Quest, each option would shall become exercisable in monthly increments over the eighteen-month period following such change in control or the expiration of the option term, if earlier, or sooner in the event of an involuntary termination during such eighteen-month period. Because each of these options is now fully vested, the acceleration provision described above no longer provides any additional benefit upon termination or change in control.

*Foley Agreement* – Mr. Foley is entitled to twelve-months notice prior to any termination of his employment. In addition, those options that have previously been granted to Mr. Foley and that would otherwise vest during such twelve-month period would immediately vest and become immediately exercisable in the event of any such termination.

*Other Programs* – Our 1999 Stock Incentive Plan, pursuant to which our Named Executive Officers have been granted all of their stock options, provides that in the event of a change in ownership or control of Quest (by way of merger, sale of assets or otherwise), each outstanding option under the discretionary option grant program will immediately become exercisable for all the shares represented by such option, except to the extent (i) such option is assumed or otherwise continued in full force and effect by the successor corporation; or (ii) such option is replaced with a cash incentive program by the successor corporation which preserves the economic value existing at the time of any such change in ownership or control and provides for subsequent payout in accordance with the same vesting schedule applicable to those option shares. These acceleration provisions do not discriminate in scope, terms or operation in favor of our Named Executive Officers and are available generally to all of our employees who have been granted options.

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### *Calculation of Potential Payments upon Termination or Change in Control*

In accordance with the rules of the SEC, the following table presents our estimate of the benefits payable to Mr. Foley assuming that his employment was terminated on December 29, 2006, the last business day of 2006:

Name	Trigger	Base Salary	Other Compensation	Value of Option Acceleration	Total Value
Anthony Foley (1)	Termination of Employment	\$ 309,616	\$ 29,925(2)	\$ 170,270(3)	\$ 509,811

- (1) Mr. Foley's compensation is denominated in British pounds. For purposes of calculating the value of potential payments in the event of a termination of Mr. Foley's employment, we have translated the amounts that would be owed to Mr. Foley into U.S. dollars using the average exchange rate for 2006 (which was \$1.84295 per British pound), since the average exchange rate for the relevant twelve month period can not be determined at this time.
- (2) Represents the cost of an automobile allowance for twelve months plus pension plan contributions.
- (3) A total of 47,000 options would vest and become immediately exercisable. The amounts shown are based on the intrinsic value of such options as of December 29, 2006. This amount was calculated by multiplying (a) the difference between the fair market value of a share of our common stock on December 29, 2006 (\$14.65) and the applicable exercise price for each option by (b) the assumed number of option shares vesting on December 29, 2006.

### *Compensation of Directors*

The following table sets forth the compensation paid to our non-employee directors for service during the year ended December 31, 2006:

#### DIRECTOR COMPENSATION TABLE

Name	Fees Earned or Paid in Cash\$(1)	Total(\$)
Raymond J. Lane	\$ 140,000	\$ 140,000
Jerry Murdock, Jr.	\$ 90,000	\$ 90,000
Augustine L. Nieto II	\$ 152,500	\$ 152,500
Kevin M. Klausmeyer	\$ 214,250 (2)	\$ 214,250
Paul A. Sallaberry	\$ 135,000	\$ 135,000
H. John Dirks	\$ 229,161 (3)	\$ 229,161

- (1) These amounts include fifty percent of the special cash payments described below, which a portion is attributable to services provided by such non-employee director in 2006.
- (2) Includes \$59,250 in compensation for service on the special committee established to investigate our historical stock option grant practices and related accounting.
- (3) Includes \$51,750 in compensation for service on the special committee established to investigate our historical stock option grant practices and related accounting. Mr. Dirks joined our board in June 2006. Also includes \$50,000 paid to Mr. Dirks in lieu of an option to purchase 50,000 shares of our common stock that otherwise would have been granted to Mr. Dirks upon his appointment to our board of directors pursuant to the terms of the automatic option grant program for outside directors under our 1999 Stock Incentive Plan.

Non-employee directors receive an annual retainer of \$30,000 for serving on the board of directors, and are reimbursed for reasonable expenses incurred by them in attending board and committee meetings. In addition, members of the regular committees of our board of directors receive the annual fees described below:

	Audit Committee	Compensation Committee	Nominating and Corporate Governance Committee
Chairman	\$ 20,000	\$ 10,000	\$ 7,500
Member	\$ 10,000	\$ 5,000	\$ 5,000

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In connection with our stock option related investigation that began in 2006, our board of directors created a special committee of the board consisting of Messrs. Klausmeyer and Dirks. For more information on our stock option investigation, see Note 2, “*Restatement of Previously Issued Financial Statements*” to the accompanying audited consolidated financial statements and the section entitled “*Restatement*” in Management’s Discussion and Analysis of Financial Condition and Results of Operations contained in this Report. As compensation for serving on this special committee, the board of directors determined that Messrs. Klausmeyer and Dirks would each receive \$1,500 in cash per day during service as a member of the Special Committee, payable in fifty percent increments for each half day or portion thereof that they were occupied with matters relating to the special committee. In 2006, Messrs. Klausmeyer and Dirks received cash payments totaling \$59,250 and \$51,750, respectively, as compensation for service on the special committee.

In May 2007, our board of directors authorized the monthly cash payment of \$25,000 to each of Messrs. Nieto and Dirks as compensation for additional board committee services. Such payments will continue to be made by Quest until the related services are completed or discontinued.

On the date of each annual meeting of our shareholders, non-employee directors who have served on the board since the date of the prior year’s annual meeting of shareholders are each entitled to receive an automatic grant of options to purchase 15,000 shares of Quest common stock pursuant to the provisions of the automatic option grant program under our 1999 Stock Incentive Plan. We did not hold an annual meeting of shareholders in 2006 due to our stock option related investigation and financial restatement. As a result, our non-employee directors did not receive an automatic grant of options in 2006. We have not yet held an annual meeting of shareholders in 2007. Because our non-employee directors have not received these automatic option grants in either 2006 or 2007, and as additional compensation for their valuable services provided us, in August 2007, our board of directors approved payment of the following special cash payments to each of our non-employee directors:

### SPECIAL CASH PAYMENTS

<u>Director</u>	<u>Amount</u>
Raymond J. Lane	\$ 200,000
Jerry Murdock	\$ 100,000
Augustine L. Nieto II	\$ 200,000
Kevin M. Klausmeyer	\$ 200,000
Paul A. Sallaberry	\$ 200,000
H. John Dirks	\$ 200,000

### *Compensation Committee Interlocks and Insider Participation*

Our Compensation Committee currently consists of Messrs. Lane, Nieto and Sallaberry. No interlocking relationship exists between any of our executive officers or any member of our compensation committee and any member of any other company’s board of directors or compensation committee. For additional information concerning transactions involving other members of the Board, including certain members of the Compensation Committee, see “Related Party Transactions.”

### *Compensation Committee Report*

*The information contained in the following report of Quest Software’s Compensation Committee is not considered to be “soliciting material,” “filed” or incorporated by reference in any past or future filing by Quest Software under the Securities Exchange Act of 1934 or the Securities Act of 1933 unless and only to the extent that Quest Software specifically incorporates it by reference.*

The Compensation Committee has reviewed and discussed with management the Compensation Discussion and Analysis (“CD&A”) contained in this Annual Report. Based on this review and discussion, the Compensation Committee has recommended to the Board that the CD&A be included in this Annual Report on Form 10-K for the fiscal year ended December 31, 2006.

*Raymond J. Lane (Chairman)*  
*Augustine L. Nieto II*  
*Paul A. Sallaberry*

### **Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters**

#### *Security Ownership of Certain Beneficial Owners and Management*

The following table sets forth certain information as of November 15, 2007 with respect to the beneficial ownership of Quest Common Stock by (i) each person Quest believes beneficially holds more than 5% of the outstanding shares of

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Common Stock; (ii) each director; (iii) each Named Executive Officer and (iv) all directors and executive officers as a group. Unless otherwise indicated, all persons named as beneficial owners of Common Stock have sole voting power and sole investment power with respect to the shares indicated as beneficially owned. Beneficial ownership also includes shares of Quest Common Stock issuable upon exercise of stock options that are exercisable or will become exercisable within 60 days of November 15, 2007, as reflected in the table below. Unless otherwise indicated, the principal address of each of the shareholders below is c/o Quest Software, Inc., 5 Polaris Way, Aliso Viejo, California 92656.

<u>Name of Beneficial Owner</u>	<u>Number of Shares Beneficially Owned</u>	<u>Options Exercisable Within 60 Days</u>	<u>Percent of Shares Outstanding</u>
FMR Corp. 82 Devonshire Street Boston, MA 02109	14,541,635 (1)	0	14.2 %
Kingdon Capital Management, LLC 152 West 57th Street, 50th Floor New York, NY 10019	5,223,323 (2)	0	5.1 %
<b>Executive Officers and Directors:</b>			
Vincent C. Smith	30,950,531 (3)	2,185,000	32.1 %
Douglas F. Garn	0	1,052,900	*
Michael J. Lambert	0	230,000	*
M. Brinkley Morse	0	900,000	*
Anthony Foley	0	393,000	*
Jerry Murdock, Jr.	135,701 (4)	75,000	*
Raymond J. Lane	447,234	114,309	*
Augustine L. Nieto II	0	80,000	*
Kevin M. Klausmeyer	3,400	65,000	*
Paul A. Sallaberry	4,213	50,000	*
H. John Dirks	0	0	*
All executive officers and directors as a group (11 persons)	31,541,079 (5)	5,145,209	34.2 %

\* Less than 1%

- (1) According to a Schedule 13G/A filed with the Securities and Exchange Commission by the beneficial owner of these shares on February 14, 2007.
- (2) According to a Schedule 13G filed with the Securities and Exchange Commission by the beneficial owner of these shares on August 13, 2007.
- (3) Includes an aggregate of 152,400 shares held in the names of Mr. Smith's minor children and 1,040 shares held by Mr. Smith as custodian for his minor children. Includes an aggregate of 29,892,300 shares held through limited liability companies. Includes 47,060 shares held by the Vincent C. Smith Charitable Remainder Trust, of which Mr. Smith is the trustee. Includes 30,750,531 shares pledged as collateral for Mr. Smith's margin account. Excludes 8,194 shares that were intended to be transferred to an entity controlled by Mr. Smith as part of a distribution of 757,717 shares made by the Insight Funds in June 2007, which transfer has not been completed.
- (4) Includes 9,638 shares owned by certain venture capital funds associated with Insight Venture Partners (the "Insight Funds"). Mr. Murdock is a member of the Board of Managers of Insight Holdings Group, LLC, the managing member of the general partner of each of the Insight Funds. Mr. Murdock disclaims beneficial ownership of these securities, except to the extent of his pecuniary interest therein, which may not be readily determinable. Excludes 8,194 shares that were intended to be transferred to an entity controlled by Mr. Smith as part of a distribution of 757,717 shares made by the Insight Funds in June 2007, which transfer has not been completed.
- (5) Includes the shares of Quest Common Stock referred to in footnotes 3 and 4 above.

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### **Equity Compensation Plan Information**

The following table gives information about our Common Stock that may be issued upon the exercise of options under all of our existing equity compensation plans as of December 31, 2006.

<b>Plan Category</b>	<b>Equity Compensation Plan Information</b>		
	<b>Number of securities to be issued upon exercise of outstanding options, warrants and rights (1)</b> (a)	<b>Weighted-average exercise price of outstanding options, warrants and rights</b> (b)	<b>Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a))</b> (c)
Equity compensation plans approved by security holders	14,418,165	\$ 15.66	4,583,914
Equity compensation plans not approved by security holders	6,374,506 (2)	\$ 12.80	453,783
<b>Totals</b>	<b>20,792,671</b>	<b>\$ 14.78</b>	<b>5,037,697</b>

- (1) Excludes options to purchase 416,078 shares of Common Stock with a weighted-average exercise price of \$2.54 that were assumed by Quest in connection with our acquisitions of Foglight Software, OnWire Technologies, Aelita Software Corporation, Imceda Software and Vintela. In connection with these acquisitions, Quest only assumed options outstanding at the time of the acquisition but did not assume the entire option plan; therefore, no further options may be granted under these acquired-company option plans.
- (2) Issued under our 2001 Stock Incentive Plan. See the description of the 2001 Stock Incentive Plan below.

### **2001 Stock Incentive Plan**

As of December 31, 2006, we had 6,828,289 shares of Common Stock reserved for issuance under the 2001 Stock Incentive Plan (the "2001 Plan") for employees. The 2001 Plan provides for the granting of non-qualified stock options to employees at the fair market value of our Common Stock at the grant date. Officers and directors of Quest are not eligible to participate in the 2001 Plan unless and until the 2001 Plan is approved by our shareholders. Options granted under the 2001 Plan have ten-year terms and generally vest 20% after the first year and in 10% increments every six months thereafter. The 2001 Plan is not required to be and has not been approved by our shareholders.

### **Item 13. Certain Relationships and Related Transactions, and Director Independence**

#### **Policies and Procedures for Approval of Related Party Transactions**

The charter of our audit committee requires that our audit committee review and approve all related party transactions. In determining whether to approve or ratify such a related party transaction, the audit committee will take into account, among other factors it deems appropriate, whether the transaction is on terms no less favorable than terms generally available to an unaffiliated third-party under the same or similar circumstances and the extent of the related person's interest in the transaction. The audit committee will generally approve only those related party transactions that are in the best interests of our company and our shareholders.

#### **Acquisition of ScriptLogic Corporation**

In August 2007 we acquired ScriptLogic Corporation ("ScriptLogic"), a privately held company that provides systems lifecycle management solutions for Windows-based networks, in a transaction valued at approximately \$88.8 million. In connection with the acquisition, Quest also offered key members of the management team of ScriptLogic an opportunity to participate in a post-closing incentive bonus plan in an aggregate amount of up to \$8.0 million payable over a four-year period (the "Incentive Plan"). A portion of the payments under the Incentive Plan will be based on the satisfaction of financial performance objectives and a portion of the payments will be based solely on continued employment.

Certain venture capital funds associated with Insight Venture Partners (the "Insight Funds") previously holding shares of ScriptLogic's preferred stock became entitled to receive (in respect of those shares of preferred stock) cash in an aggregate amount of up to approximately \$37.7 million (subject to claims against an indemnity escrow fund). Jerry Murdock, a director

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of Quest, is a Managing Director and the co-founder of Insight Venture Partners and an investor in the Insight Funds. Each of Vincent C. Smith, Quest's Chairman of the Board and CEO, and Raymond J. Lane and Paul A. Sallaberry, both directors of Quest, are passive limited partners in the Insight Funds, and have an indirect interest in a portion of the proceeds from the transaction by virtue of their respective ownership interests therein. We believe that the financial interests of Messrs. Smith, Lane and Sallaberry in the transaction are not material.

The acquisition of ScriptLogic was reviewed and approved by our board of directors, as well as by the audit committee of our board of directors. Mr. Murdock did not participate in the meetings of the board of directors and the audit committee at which the transaction was considered and ultimately approved. Prior to approving the transaction, our board of directors received, from an internationally recognized investment bank, an opinion that as of the date of such opinion, and subject to the assumptions and qualifications set forth therein, the consideration to be paid by Quest in the acquisition of ScriptLogic is fair, from a financial point of view, to Quest.

### *Certain Employee Relationships*

On May 30, 2006, we hired Jim Garn as our Sr. Director, Sales Operations (Processes and Systems). Jim Garn is the brother of our President, Douglas F. Garn. During 2006, Jim Garn received cash compensation totaling \$91,792, and also received a matching contribution under our 401(k) plan in the amount of \$2,500. On June 16, 2006, Jim Garn was granted options to purchase 10,000 shares of Quest common stock pursuant to our 2001 Stock Incentive Plan, with an exercise price of \$13.48. These options had a grant date fair value calculated in accordance with SFAS 123R of \$79,075. For a discussion of the valuation assumptions used in the SFAS 123R calculations, please see Note 1 of our Notes to Consolidated Financial Statements included in this Report on Form 10-K. Jim Garn's compensation arrangement includes a current base salary of \$185,000 and a discretionary target bonus of \$25,000.

In September 2007, Chris Garn, the brother of Douglas F. Garn, was hired by Vizioncore, Inc. as a Senior Account Executive, Pacific Southwest. We own 75% of the outstanding shares of Vizioncore. Jim Garn's compensation arrangement includes a current base salary of \$110,000 and on target commissions of \$110,000.

### *Other Relationships*

We have entered into indemnification agreements with our executive officers and our directors containing provisions that may require us, among other things, to indemnify them against certain liabilities that may arise by reason of their status or service as officers or directors, other than liabilities arising from willful misconduct of a culpable nature, and to advance expenses incurred as a result of any proceeding against them as to which they could be indemnified.

We believe that all of the transactions set forth above were made on terms no less favorable to us than could have been otherwise obtained from unaffiliated third parties.

### *Director Independence*

The Nasdaq Stock Market ("*NASDAQ*") requires that a majority of the members of our board of directors be independent, as such term is defined under NASDAQ's Marketplace Rules. Currently, five of the seven members of our board of directors are independent directors and all standing committees of the board of directors are composed entirely of independent directors, in each case under the definition of independence contained in NASDAQ's Marketplace Rules, which includes a series of objective tests. As further required by NASDAQ rules, our board of directors has determined, with respect to each of our independent directors, that no relationship exists which, in the opinion of the board of directors, would interfere with the exercise of independent judgment in carrying out the responsibilities of a director. Our board of directors has affirmatively determined that the following directors are independent (as such term is defined under NASDAQ's Marketplace Rules): Raymond J. Lane, Augustine L. Nieto II, Kevin M. Klausmeyer, Paul A. Sallaberry, and H. John Dirks.

### **Item 14. *Principal Accounting Fees and Services***

The following table presents the fees billed to Quest for professional audit services rendered by Deloitte & Touche LLP, the member firms of Deloitte Touche Tohmatsu, and their respective affiliates (collectively, "Deloitte"), for the audit of our annual financial statements for the years ended December 31, 2006 and 2005, and fees billed for other services rendered by Deloitte during those periods.

	<u>2006</u>	<u>2005</u>
Audit Fees (1)	\$ 1,107,000	\$ 1,529,000
Audit-Related Fees (2)	\$ 200,000	\$ —
Tax Fees (3)	\$ 236,000	\$ 499,000
All Other Fees	\$ —	\$ —
Total	<u>\$ 1,543,000</u>	<u>\$ 2,028,000</u>

- (1) Audit Fees related to professional services rendered for the audit of our annual financial statements, reviews of our quarterly financial statements, international statutory audits and other fees related to our SEC filings and other accounting consultations. The 2005 audit fees have been increased by \$188,000 from the amount reported in the proxy statement information of our 2005 Form 10-K/A for audit fees related to fiscal year 2005 that were billed after the proxy was filed. This category also includes \$380,000 and \$733,000 in fees in 2006 and 2005, respectively, for the audit of management's assessment of the effectiveness of internal control over financial reporting under Section 404 of the Sarbanes-Oxley Act of 2002.

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- (2) **Audit-Related Fees** consist of fees for assurance and related services that are reasonably related to the performance of the audit or review of our financial statements. The audit-related fees in 2006 were primarily related to audits of our restatement work. This category also includes \$182,000 in fees billed during 2006 for the audit of our restatement as described in Note 2, “*Restatement of Previously Issued Financial Statements*” to the accompanying audited consolidated financial statements and the section entitled “*Restatement*” in Management’s Discussion and Analysis of Financial Condition and Results of Operations contained in Item 7 of this Report.
- (3) **Tax Fees** included fees for tax compliance of approximately \$147,000 for 2006 and \$314,000 for 2005, relating to U.S. federal tax returns, tax returns in overseas countries in which we do business and various state and local tax returns. Tax fees also included fees for tax advisory services of approximately \$89,000 for 2006 and \$185,000 for 2005, including tax examination assistance, expatriate tax services, assistance related to mergers and acquisitions, tax research and tax planning services in the countries in which we do business.

The Audit Committee of the Board of Directors has considered whether the provision by Deloitte of the non-audit services listed above is compatible with maintaining Deloitte’s independence.

### ***Pre-Approval Policy***

The Audit Committee’s policy is to pre-approve all audit and permissible non-audit services provided by the independent registered public accounting firm. These services may include audit services, audit-related services, tax services and other services. Pre-approval is generally provided for up to one year and any pre-approval is detailed as to the particular service or category of services, and may be subject to a specific budget. The independent registered public accounting firm and management are required to periodically report to the Audit Committee regarding the extent of services provided by the independent registered public accounting firm in accordance with this pre-approval policy, and the related amounts of fees for services performed. The Audit Committee may also pre-approve particular services on a case-by-case basis.

### ***Corporate Governance***

Our Board of Directors and management are committed to good corporate governance to ensure that we are managed for the long-term benefit of our shareholders. We have in place a variety of policies and practices to promote good corporate governance. Consistent with our Corporate Governance Guidelines, a majority of our Board of Directors is independent in accordance with Nasdaq listing standards, and all members of our Audit Committee, our Compensation Committee, and our Nominating and Corporate Governance Committee also meet Nasdaq guidelines for independence. We have also established:

- Written charters for our Audit Committee, Compensation Committee, and Nominating and Corporate Governance Committee that address corporate governance practices in accordance with the Sarbanes-Oxley Act, current Nasdaq corporate governance guidelines, and other applicable rules and regulations;
- a Code of Business Conduct and Ethics applicable to our officers, directors and employees;
- a procedure for receipt and treatment of anonymous and confidential complaints or concerns regarding audit or accounting matters; and
- disclosure control policies and procedures.

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The Nominating and Corporate Governance Committee of our Board of Directors is responsible for establishing and reviewing the Corporate Governance Guidelines from time to time and reporting and making recommendations to the Board concerning corporate governance matters. Among the matters addressed by our Corporate Governance Guidelines are:

- *Director Independence* —Independent directors shall constitute at least a majority of our Board of Directors and all members of the Audit, Compensation, and Nominating and Corporate Governance Committees are required to be independent in accordance with NASDAQ criteria.
- *Executive Sessions of Independent Directors* —The non-employee directors regularly meet in executive sessions without management present.
- *Board Access to Independent Advisors* —Our Board of Directors as a whole, and each of its committees separately, have authority to retain such independent consultants, counselors or advisors to the Board or its committees as each shall deem necessary or appropriate.

Copies of our Corporate Governance Guidelines and Code of Business Conduct and Ethics can be found in the Investor Relations—Corporate Governance area of our website at [www.quest.com](http://www.quest.com).

### ***Audit Committee Financial Expert***

We have a standing audit committee consisting of Messrs. Klausmeyer, Nieto and Dirks. Our board of directors has determined that Mr. Klausmeyer and Mr. Dirks are audit committee financial experts.

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**PART IV**

**Item 15. Exhibits, Financial Statement Schedules**

The following documents are filed as part of this Form 10-K.

1. Financial Statements

	<u>Page</u>
<a href="#">Report of Independent Registered Public Accounting Firm</a>	F-1
<a href="#">Consolidated Balance Sheets as of December 31, 2006 and 2005 (As Restated)</a>	F-2
<a href="#">Consolidated Income Statements for the Years Ended December 31, 2006, 2005 (As Restated) and 2004 (As Restated)</a>	F-3
<a href="#">Consolidated Statements of Shareholders' Equity for the Years Ended December 31, 2006, 2005 (As Restated) and 2004 (As Restated)</a>	F-4
<a href="#">Consolidated Statements of Cash Flows for the Years Ended December 31, 2006, 2005 (As Restated) and 2004 (As Restated)</a>	F-5
<a href="#">Notes to Consolidated Financial Statements</a>	F-6

2. Financial Statement Schedule

The following financial statement schedule should be read in conjunction with the consolidated financial statements of Quest Software, Inc. filed as part of this Report:

- Schedule II — Valuation and Qualifying Accounts

Schedules other than that listed above have been omitted since they are either not required or not applicable or because the information required is included in the consolidated financial statements included elsewhere herein or the notes thereto.

3. Exhibits

<u>Exhibit Number</u>	<u>Exhibit Title</u>
3.1	Second Amended and Restated Articles of Incorporation. (1)
3.2	Certificate of Amendment of Articles of Incorporation of Quest Software, Inc. (2)
3.3	Bylaws of Quest Software, Inc. (3)
4.1	Form of Registrant's Specimen Common Stock Certificate. (1)
10.1++	Registrant's 1999 Stock Incentive Plan, as amended.
10.2	Form of Directors' and Officers' Indemnification Agreement. (1)
10.3++	Registrant's 2001 Stock Incentive Plan, as Amended.
10.9++	Form of Stock Option Agreement used under the Registrant's 1999 Stock Incentive Plan. (6)
10.10++	Form of Stock Option Agreement used under the Registrant's 2001 Stock Incentive Plan. (4)
14.1	Code of Ethics. (5)
21.1	Subsidiaries of the Company.
23.1	Consent of Deloitte & Touche LLP.
31.1	Certification of the Chief Executive Officer Pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934, as amended.
31.2	Certification of the Chief Financial Officer Pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934, as amended.
32.1	Certification of Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2	Certification of Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

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(1) Incorporated herein by reference to our Registration Statement on Form S-1 and all amendments thereto (File No. 333-80543).

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- (2) Incorporated herein by reference to our Quarterly Report on Form 10-Q for the period ended September 30, 2005.
- (3) Incorporated herein by reference to our Current Report on Form 8-K filed November 7, 2007.
- (4) Incorporated herein by reference to our Registration Statement on Form S-8 (File No. 333-82784) filed on February 14, 2002.
- (5) Incorporated herein by reference to our Annual Report on Form 10-K for the year ended December 31, 2003.
- (6) Incorporated herein by reference to our Quarterly Report on Form 10-Q for the period ended September 30, 2004.
- ++ Indicates a management contract or compensatory arrangement.



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**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

To the Board of Directors and Shareholders of  
Quest Software, Inc.

We have audited the accompanying consolidated balance sheets of Quest Software, Inc. and subsidiaries (the “Company”) as of December 31, 2006 and 2005, and the related consolidated statements of income, stockholders’ equity, and cash flows for each of the three years in the period ended December 31, 2006. These financial statements are the responsibility of the Company’s management. Our responsibility is to express an opinion on the financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the 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. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of Quest Software, Inc. and subsidiaries as of December 31, 2006 and 2005, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2006, in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note 1 to the consolidated financial statements, the Company adopted Statement of Financial Accounting Standards No. 123R, *Share-based Payment*, and FASB Staff Position No. AUG AIR-1, *Accounting for Planned Major Maintenance Activities*, in 2006.

As discussed in Note 2 to the consolidated financial statements, the accompanying 2005 and 2004 consolidated financial statements have been restated.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of the Company’s internal control over financial reporting as of December 31, 2006, based on the criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated December 7, 2007 expressed an unqualified opinion on management’s assessment of the effectiveness of the Company’s internal control over financial reporting and an adverse opinion on the effectiveness of the Company’s internal control over financial reporting because of material weaknesses.

/s/ Deloitte & Touche LLP  
Costa Mesa, California  
December 7, 2007

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**QUEST SOFTWARE, INC .**  
**CONSOLIDATED BALANCE SHEETS**  
**(In thousands)**

	<u>December 31,</u> <u>2006</u>	<u>December 31,</u> <u>2005</u>
		<u>As Restated (1)</u>
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 286,164	\$ 121,025
Short-term marketable securities	80,112	74,398
Accounts receivable, net of allowances of \$9,312 in 2006 and \$18,410 in 2005	132,983	107,327
Prepaid expenses and other current assets	14,899	15,253
Deferred income taxes	9,800	12,295
Total current assets	523,958	330,298
Property and equipment, net	75,817	83,044
Long-term marketable securities	23,884	47,538
Amortizing intangible assets, net	48,136	67,615
Goodwill	445,059	429,949
Deferred income taxes	33,679	26,675
Other assets	11,004	4,828
Total assets	<u>\$ 1,161,537</u>	<u>\$ 989,947</u>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
Current liabilities:		
Accounts payable	\$ 5,182	\$ 3,756
Accrued compensation	35,973	33,355
Other accrued expenses	35,949	33,340
Income taxes payable	27,832	19,531
Current portion of deferred revenue	177,372	136,371
Total current liabilities	282,308	226,353
Long-term liabilities:		
Long-term portion of deferred revenue	58,187	38,432
Other long-term liabilities	2,129	1,730
Total long-term liabilities	60,316	40,162
Commitments and contingencies (Note 13)		
Shareholders' equity:		
Preferred stock, no par value, 10,000 shares authorized; no shares issued or outstanding	—	—
Common stock, no par value, 200,000 shares authorized; 101,819 and 99,761 shares issued and outstanding at December 31, 2006 and 2005, respectively	815,437	794,863
Retained earnings (accumulated deficit)	4,293	(54,692)
Accumulated other comprehensive loss	(817)	(1,716)
Unearned compensation	—	(15,023)
Total shareholders' equity	818,913	723,432
Total liabilities and shareholders' equity	<u>\$ 1,161,537</u>	<u>\$ 989,947</u>

(1) See Note 2 of our Notes to Consolidated Financial Statements.

See accompanying Notes to Consolidated Financial Statements.

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**QUEST SOFTWARE, INC.**  
**CONSOLIDATED INCOME STATEMENTS**  
**(In thousands, except per share data)**

	Year Ended December 31,		
	2006	2005	2004
		As Restated (1)	As Restated (1)
<b>Revenues:</b>			
Licenses	\$ 290,247	\$ 256,131	\$ 224,647
Services	271,342	215,873	165,147
Total revenues	561,589	472,004	389,794
<b>Cost of revenues:</b>			
Licenses	5,570	5,005	3,962
Services	49,773	38,381	30,530
Amortization of purchased technology	15,932	11,476	8,902
Total cost of revenues	71,275	54,862	43,394
Gross profit	490,314	417,142	346,400
<b>Operating expenses:</b>			
Sales and marketing	247,500	203,851	172,138
Research and development	110,612	89,078	83,622
General and administrative	65,821	48,474	41,142
Amortization of other purchased intangible assets	6,758	7,179	5,212
In-process research and development	960	7,840	6,980
Litigation loss provision	—	—	16,000
Total operating expenses	431,651	356,422	325,094
Gain on sale of Vista Plus product suite	—	39	29,574
Gain on sale of corporate aircraft	3,987	—	—
Income from operations	62,650	60,759	50,880
Other income (expense), net	13,005	(1,046)	9,272
Income before income tax provision	75,655	59,713	60,152
Income tax provision	16,670	27,257	7,901
Net income	<u>\$ 58,985</u>	<u>\$ 32,456</u>	<u>\$ 52,251</u>
Net income per share:			
Basic	<u>\$ 0.58</u>	<u>\$ 0.33</u>	<u>\$ 0.55</u>
Diluted	<u>\$ 0.57</u>	<u>\$ 0.32</u>	<u>\$ 0.53</u>
<b>Weighted-average shares:</b>			
Basic	101,380	97,621	94,622
Diluted	104,103	101,030	97,841

(1) See Note 2 of our Notes to Consolidated Financial Statements.

See accompanying Notes to Consolidated Financial Statements.

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## QUEST SOFTWARE, INC.

 CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY  
 AND COMPREHENSIVE INCOME  
 (In thousands)

	Common Stock		Unearned Compensation	Retained Earnings/ (Accumulated Deficit)	Accumulated Other Comprehensive Income (Loss)	Note Receivable From Sale of Common Stock	Total Shareholders' Equity	Total Comprehensive Income
	Shares	Amount						
<b>BALANCE, January 1, 2004—As Previously Reported</b>	93,309	\$ 588,203	\$ —	\$ (47,073)	\$ 260	\$ (17,214)	\$ 524,176	
Cumulative adjustments	—	80,599	(48,178)	(92,326)	—	17,214	(42,691)	
<b>BALANCE, January 1, 2004—As Restated (1)</b>	93,309	668,802	(48,178)	(139,399)	260	—	481,485	
Exercise of stock options	2,254	16,704	—	—	—	—	16,704	
Net tax benefit related to stock- based compensation	—	51,258	—	—	—	—	51,258	
Common stock issued for employee stock purchase plan	548	4,797	—	—	—	—	4,797	
Compensation expense associated with stock option grants	—	—	21,592	—	—	—	21,592	
Stock options assumed with the acquisition of Aelita Software Corporation	—	13,372	(4,007)	—	—	—	9,365	
Forfeitures of stock options	—	(3,373)	3,373	—	—	—	—	
Unrealized loss on marketable securities, net of tax	—	—	—	—	(1,036)	—	(1,036)	\$ (1,036)
Net income (as restated)	—	—	—	52,251	—	—	52,251	52,251
Comprehensive income (as restated)	—	—	—	—	—	—	—	\$ 51,215
<b>BALANCE, December 31, 2004 — As Restated (1)</b>	96,111	751,560	(27,220)	(87,148)	(776)	—	636,416	
Exercise of stock options	2,707	13,295	—	—	—	—	13,295	
Net tax deficiency related to stock- based compensation	—	(944)	—	—	—	—	(944)	

Compensation expense associated with stock option grants	—	—	12,799	—	—	—	12,799	
Common stock issued for acquisitions	943	12,378	—	—	—	—	12,378	
Stock options assumed with the acquisitions of Imceda Software, Inc. and Vintela, Inc.	—	22,506	(4,534)	—	—	—	17,972	
Forfeitures of stock options	—	(3,932)	3,932	—	—	—	—	
Unrealized loss on	—	—	—	—	(940)	—	(940)	\$ (940)
Net income (as restated)	—	—	—	32,456	—	—	32,456	<u>32,456</u>
Comprehensive income (as restated)	—	—	—	—	—	—	—	\$ <u>31,516</u>
<b>BALANCE, December 31, 2005—As Restated (1)</b>	99,761	794,863	(15,023)	(54,692)	(1,716)	—	723,432	
Exercise of stock options	2,058	18,825	—	—	—	—	18,825	
Net tax deficiency related to stock-based compensation	—	(10,928)	—	—	—	—	(10,928)	
Compensation expense associated with stock option grants	—	27,700	—	—	—	—	27,700	
Elimination of unearned compensation in relation to the adoption of SFAS 123R	—	(15,023)	15,023	—	—	—	—	
Unrealized gain on marketable securities, net of tax	—	—	—	—	899	—	899	\$ 899
Net income	—	—	—	58,985	—	—	58,985	<u>58,985</u>
Comprehensive income	—	—	—	—	—	—	—	\$ <u>59,884</u>
<b>BALANCE, December 31, 2006</b>	<u>101,819</u>	<u>\$ 815,437</u>	<u>\$ —</u>	<u>\$ 4,293</u>	<u>\$ (817)</u>	<u>\$ —</u>	<u>\$ 818,913</u>	

(1) See Note 2 of our Notes to Consolidated Financial Statements.

See accompanying Notes to Consolidated Financial Statements.

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**QUEST SOFTWARE, INC.**
**CONSOLIDATED STATEMENTS OF CASH FLOWS**  
(In thousands)

	Year Ended December 31,		
	2006	2005 As Restated (1)	2004 As Restated (1)
<b>Cash flows from operating activities:</b>			
Net income	\$ 58,985	\$ 32,456	\$ 52,251
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	36,796	31,077	26,894
Compensation expense associated with stock option grants	27,700	12,799	21,592
Deferred income taxes	(21,926)	(3,677)	(10,439)
Gain on sale of Vista Plus product suite	—	(39)	(29,574)
Gain on sale of corporate aircraft	(3,987)	—	—
(Gain) loss on disposition of property and equipment	(411)	293	322
Excess tax benefit related to stock-based compensation	(6,180)	7,818	4,836
Provision for bad debts	(615)	265	240
In-process research and development	960	7,840	6,980
Litigation loss provision	—	—	16,000
Changes in operating assets and liabilities, net of effects of acquisitions:			
Accounts receivable	(17,740)	(16,277)	(34,014)
Prepaid expenses and other current assets	983	(5,667)	(1,472)
Other assets	(2,110)	(1,468)	3,870
Accounts payable	785	(1,045)	(829)
Accrued compensation	1,091	3,427	218
Other accrued expenses	1,100	2,059	(3,470)
Litigation settlement payment	—	(16,000)	—
Income taxes payable	12,685	5,404	1,956
Deferred revenue	60,521	43,987	40,656
Other liabilities	(260)	(1,342)	92
Net cash provided by operating activities	148,377	101,910	96,109
<b>Cash flows from investing activities:</b>			
Purchases of property and equipment	(16,639)	(41,109)	(31,873)
Proceeds from sale of corporate aircraft	15,600	—	—
Cash paid for acquisitions, net of cash acquired	(17,472)	(120,621)	(96,733)
Proceeds from sale of Vista Plus product suite	—	2,039	22,515
Purchases of cost-method investments	(3,803)	—	—
Purchases of marketable securities	(60,754)	—	(10,001)
Sales and maturities of marketable securities	79,379	56,272	40,446
Net cash used in investing activities	(3,689)	(103,419)	(75,646)
<b>Cash flows from financing activities:</b>			
Proceeds from repurchase agreement	—	10,008	67,581
Repayment of repurchase agreement	—	(22,896)	(55,492)
Repayment of notes payable	—	(51)	(769)
Repayment of capital lease obligations	(224)	(324)	(400)
Proceeds from the exercise of stock options	18,825	13,295	16,704
Proceeds from employee stock purchase plan	—	—	4,797
Excess tax benefit related to stock-based compensation	6,180	—	—
Net cash provided by financing activities	24,781	32	32,421
Effect of exchange rate changes on cash and cash equivalents	(4,330)	4,342	(2,194)
Net increase in cash and cash equivalents	165,139	2,865	50,690
Cash and cash equivalents, beginning of period	121,025	118,160	67,470
Cash and cash equivalents, end of period	<u>\$ 286,164</u>	<u>\$ 121,025</u>	<u>\$ 118,160</u>
<b>Supplemental disclosures of consolidated cash flow information:</b>			
Cash paid for interest	\$ 56	\$ 163	\$ 53
Cash paid for income taxes	<u>\$ 26,413</u>	<u>\$ 17,684</u>	<u>\$ 5,868</u>
<b>Supplemental schedule of non-cash investing and financing activities:</b>			
Unrealized gain (loss) on marketable securities	\$ 727	\$ (940)	\$ (1,036)
Unpaid purchases of property and equipment	<u>\$ 356</u>	<u>\$ —</u>	<u>\$ —</u>
Fair value of stock options and common stock issued in connection with acquisitions	<u>\$ —</u>	<u>\$ 34,884</u>	<u>\$ 13,372</u>

(1) See Note 2 of our Notes to Consolidated Financial Statements.

See accompanying Notes to Consolidated Financial Statements.

**QUEST SOFTWARE, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**1. Description of Business and Summary of Significant Accounting Policies**

*Nature of Operations*—Quest Software, Inc. (“Quest,” the “Company,” “we,” “us” or “our”), was incorporated in California in 1987 and is a leading developer and vendor of application management, Windows management and database management software products. We also provide consulting, training, and post-contract technical support services to our customers. We have wholly-owned research and development subsidiaries and sales subsidiaries for marketing, distribution, and support of our products and services in the United States and abroad.

*Basis of Consolidation*—The accompanying consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America and include our accounts and those of our majority owned subsidiaries. Intercompany transactions are eliminated and the portion of the net income or net loss of subsidiaries applicable to minority interests adjusts other income (expense), net.

*Use of Estimates*—The preparation of the consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

*Foreign Currency Translation*—In accordance with Statement of Financial Accounting Standards (“SFAS”) No. 52, “*Foreign Currency Translation*,” the United States Dollar is considered to be the functional currency for our foreign subsidiaries, as such subsidiaries act primarily as an extension of our parent company’s operations. The determination of functional currency is primarily based on the subsidiaries’ relative financial and operational dependence on the parent company. Assets and liabilities in these subsidiaries are re-measured at current exchange rates, except for property and equipment, deferred revenue, depreciation and investments, which are translated at historical exchange rates. Revenues and expenses are re-measured at weighted average exchange rates in effect during the year except for costs related to the above mentioned balance sheet items which are translated at historical rates. Foreign currency gains and losses are included in “other income (expense), net” in the consolidated income statements. There was a net foreign currency gain of \$4.4 million, a net loss of \$5.6 million and a net gain of \$3.4 million based on re-measurement for the years ended December 31, 2006, 2005 and 2004, respectively.

*Fair Value of Financial Instruments*—The carrying amounts of our financial instruments including cash and cash equivalents, marketable securities, accounts receivable, accounts payable and accrued liabilities approximate their respective fair values because of the relatively short period of time between origination of the instruments and their expected realization or because they are carried at fair value.

*Cash and Cash Equivalents*—We consider all highly liquid investments purchased with original maturities of three months or less to be cash equivalents.

*Concentration of Credit Risk*—Financial instruments that potentially subject us to credit risk include cash and cash equivalents, marketable securities and accounts receivable. We believe that credit risks related to our investment portfolio are moderated by limitations we place on our exposure to any one issuer and credit risks on accounts receivable are moderated by the diversity of our products, customers and geographic sales areas. We monitor extensions of credit and have not experienced significant credit losses in the past. We maintain an allowance both for bad debts and for sales returns and cancellations and such losses and returns have historically been within management’s expectations. No single customer accounted for 10% or more of our total revenues or accounts receivable for the years ended December 31, 2006, 2005 or 2004.

*Allowances for Doubtful Accounts and Returns*—We record allowances for doubtful accounts based upon a specific review of significant outstanding invoices and/or our historical write-off experience. For those invoices not specifically reviewed, provisions are provided at differing rates, based upon the age of the receivable, collection histories, and histories of write-offs. We also record a provision for estimated sales returns and allowances on product and service related sales in accordance with SFAS No. 48, “*Revenue Recognition When Right of Return Exists*.” These estimates are based on historical sales returns, the volume and size of our larger transactions and other known factors.

*Marketable Securities*—We have classified all debt securities with original maturities of greater than three months as available-for-sale. Available-for-sale securities are carried at fair value, with unrealized gains and losses reported as a separate component of shareholders’ equity net of applicable income taxes. Realized gains and losses and declines in value judged to be other-than-temporary on available-for-sale securities are included in other income. The cost basis for realized gains and losses on available-for-sale securities is determined on a specific identification basis. We have classified available-for-sale securities as current or long-term based primarily on the maturity date of the related securities.

**QUEST SOFTWARE, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

*Investments in Non-Consolidated Companies*—We have made investments in early stage private companies and a private equity fund for business and strategic purposes. We may make additional investments of this nature in the future. These investments total \$5.7 million and \$1.8 million at December 31, 2006 and 2005, respectively, and are accounted for under the cost method, as we do not have the ability to exercise significant influence over these companies' operations. We periodically monitor our investments for impairment and will record reductions in carrying values if and when necessary. The evaluation process is based on information that we request from these privately-held companies. This information is not subject to the same disclosure regulations as U.S. public companies and, as such, the basis for these evaluations is subject to the timing and the accuracy of the data received from these companies. As part of this evaluation process, our review includes but is not limited to a review of each company's cash position, recent financing activities, financing needs, earnings and revenue outlook, operational performance, management or ownership changes, and impacts from competitive pressures. If we determine that the carrying value of our investment in a company is at an amount below fair value, we write down the investment and record a loss in the consolidated income statements. Investments in non-consolidated companies are included in other assets on our consolidated balance sheet at December 31, 2006 and 2005.

*Long-Lived Assets*—We account for the impairment and disposition of long-lived assets in accordance with SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets." In accordance with SFAS No. 144, long-lived assets to be held and used are reviewed for events or changes in circumstances, which indicate that their carrying value may not be recoverable. We periodically review the carrying value of long-lived assets to determine whether or not impairment to such value has occurred.

*Property and Equipment*—Property and equipment are stated at cost less accumulated depreciation and amortization. Depreciation and amortization are provided using the straight-line method over the following estimated useful lives:

	<u>Years</u>
Building	30
Furniture and fixtures	7
Machinery and equipment	7
Computer equipment	3
Computer software	3

Leasehold improvements are amortized over the shorter of the estimated useful lives of the improvements or the term of the related lease. Repair and maintenance costs associated with property, equipment and leasehold improvements are expensed as incurred. Software licenses are recorded at cost and are amortized over the shorter of the estimated useful lives of the related products or the term of the license, generally three years.

*Goodwill and Amortizing Intangible Assets*—Goodwill arising from acquisitions (see Notes 5 and 6) is recorded as the excess of the purchase price over the fair value of assets acquired. Amortizing intangible assets are recorded at the estimated fair value of technology, customer lists, maintenance contracts, trademarks and non-compete agreements acquired and amortized using the straight-line method over estimated useful lives ranging from two to seven years. Accumulated amortization of amortizing intangible assets was \$88.8 million and \$66.1 million at December 31, 2006 and 2005, respectively. As described in Note 2 we recorded impairment charges, net of amortization adjustments, of \$0.6 million and \$0.8 million in 2005 and 2004, respectively, for certain amortizing intangible assets as part of our restatement. We also recorded impairment charges of \$2.3 million in 2006 for certain amortizing intangible assets. The net carrying amount of amortizing intangible assets was considered recoverable at December 31, 2006, as there were no further indications of impairment. We test goodwill for impairment at the reporting unit level on an annual basis in the fourth quarter or more frequently if we believe indicators of impairment exist. The carrying amount of goodwill was considered recoverable at December 31, 2006, based on the results from our goodwill impairment evaluation performed in the fourth quarter of 2006.

*Other Assets*—Other assets primarily include lease security deposits and those investments which are accounted for on the cost basis.

*Revenue Recognition*—We derive revenues from three primary sources: (1) perpetual software licenses, (2) annual maintenance and support services (referred to as post-contract technical support or "PCS") and (3) professional consulting and training services (referred to as "PSO").

**QUEST SOFTWARE, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

We recognize revenue in accordance with the American Institute of Certified Public Accountants (“AICPA”) Statement of Position ( “ SOP ” ) 97-2, “ *Software Revenue Recognition* ,” and related interpretations, SOP 98-9 “ *Modification of SOP 97-2, Software Revenue Recognition, With Respect to Certain Transactions*,” Securities and Exchange Commission (“SEC”) Staff Accounting Bulletin No. 104 (“SAB 104”), “ *Revenue Recognition* ,” and other related pronouncements.

We recognize revenue when all of the following criteria are satisfied:

- (1) Persuasive evidence of an arrangement exists – including a written contract signed by both the end customer and Quest.
- (2) Delivery has occurred – when all product and/or service that is essential to the functionality is delivered to the end customer.
- (3) The fee is fixed or determinable – when we have a signed contract that states the agreed upon fee for our product and/or service and specifies the related terms and conditions that govern that arrangement, and is free of material contingencies or significant uncertainty.
- (4) Collection is probable – assessed based on the probability of collection on a customer-by-customer basis based on payment history and our evaluation of the end customer’s financial position.

We license our products primarily through our direct sales force, our telesales force and, increasingly, indirect channels including value added resellers and distributors. For our direct sales, we utilize written contracts as the means to establish the terms and conditions upon which our products and services are sold to our end customers. For our indirect sales transactions, we accept orders from our resellers and distributors when they have existing orders from an end customer. We utilize written contracts coupled with purchase orders as the means to establish the terms and conditions of these indirect sales transactions.

Indirect sales through resellers, which are a growing proportion of our transaction volume, are generally handled via processes and policies that are similar to an end customer sale. Our policy until January 1, 2007 was to defer revenue recognition on indirect sales transactions of significant size until receipt of payment (assuming all other revenue recognition criteria had been satisfied) as collectability was not reasonably assured. Because of a change in circumstances involving improved cash collection histories with certain resellers we modified our revenue recognition practices to recognize revenue upon delivery of the software when all other revenue recognition criteria are satisfied. The modified practice, which now allows for the earlier recognition on most of our reseller transactions, has been implemented effective January 1, 2007.

Most of our software products are “off the shelf” products that do not require customization. We initially capture value for our products by selling a perpetual software license to end customers. The fee for the first year of PCS is included in, or bundled with, the perpetual software license at the time of initial sale. As such, the combination at initial sale of a perpetual software license and one year of PCS services represents a “multiple-element” arrangement for revenue recognition purposes.

We account for the perpetual software license component of these multiple-element arrangements using the residual method, which requires recognition of the perpetual software license revenue once all software products have been delivered to the end customer and the only undelivered element is PCS and/or PSO. The value of the undelivered elements is determined based on vendor specific objective evidence (“VSOE”) of fair value and is deferred. The residual value, after allocation of the fee to the undelivered elements based on VSOE of fair value, is then allocated to the perpetual software license for the software products being sold.

Our PCS VSOE of fair value is determined by reference to the prices our end customers pay for this support when it is sold separately; that is, when we enter into an arms length, annual renewal transaction with end customers where the only offering sold is PCS. These standalone PCS renewal transactions are typically for one year in duration and are priced as a targeted percentage of the initial, discounted purchase price. We bill these renewal transactions in advance of the services provided. We also offer end customers the right to purchase PCS for multiple annual periods beyond the first year. Revenue for our standalone sale of annual PCS renewals in years two, three and beyond is recognized ratably over the support term. Sales of PCS for multiple annual periods are treated similarly.

Our PSO VSOE of fair value is determined by reference to our established pricing and discounting practices for these services when sold separately. Our PSO are typically sold as time-and-materials based contracts that range from five to fifteen days in duration. Revenue from PSO is generally recognized as professional services are performed in accordance with the underlying service contracts.

**QUEST SOFTWARE, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

If we cannot objectively determine the fair value of any undelivered element (hardware, software, specific upgrade rights, etc.) in a bundled software and services arrangement, we defer revenue until all elements are delivered and services are performed, or until fair value can be objectively determined based on VSOE of fair value for any remaining undelivered elements.

In addition to perpetual software licenses, we sell a small amount of time-based software licenses (or term licenses) each year wherein customers pay a single fee for the right to use the software and receive PCS for a defined period of time. Approximately 2% of 2006 license revenue was generated by these time-based software licenses. All license and PCS revenues on these term licenses are deferred and recognized ratably over the license term.

There are numerous factors that can affect our assessment of whether the revenue recognition criteria are satisfied. For example:

- An arrangement with governing terms and conditions that extend payment terms beyond our customary and historical practices may indicate that collection is not probable. We assess whether fees are fixed or determinable at the time of sale and recognize revenue if all other requirements have been met. Our standard payment terms are 30 days but may vary based on the country in which the agreement is executed. We generally deem payments that are due within 6 months to be fixed and determinable based on collections history and thereby satisfy the required revenue recognition criterion.
- An arrangement with a contractual clause indicating the transaction is contingent on the end customer's "satisfaction with and acceptance of" the product may yield a conclusion that the fee is not yet fixed or determinable. Substantially all of our software license arrangements do not include acceptance provisions. Since such acceptance provisions are not contained in our software license arrangements as standard provisions and the incidence of returns in accordance with such acceptance provisions cannot be reasonably estimated, if a contract does include such a provision we recognize revenue upon the earlier of receipt of written customer acceptance or expiration of the acceptance period.
- We evaluate arrangements with governmental entities containing "fiscal funding" or "termination for convenience" provisions, when such provisions are required by law, to determine the probability of possible cancellation. We consider multiple factors, including the history with the customer in similar transactions, and the planning, budgeting and approval processes undertaken by the governmental entity. If we determine upon execution of these arrangements that the likelihood of cancellation is not likely, we then recognize revenue once all of the criteria described above have been met. If such a determination cannot be made, revenue is recognized upon the earlier of cash receipt or approval of the applicable funding provision by the governmental entity.

Our product return policy is reflected in our standard form license, PCS and/or service agreements for end customers as well as for resellers and distributors. These agreements do not typically or expressly provide for product returns and cancellations as a matter of right. Quest maintains an allowance for sales returns and cancellations to cover the circumstances where the company accepts returns or cancellations on a discretionary basis even though not contractually obligated to do so. This allowance is intended only as an estimate of customer payment obligations associated with enforceable contracts for the delivery of products or services, which based on our history, we do not expect to collect.

We analyze various factors including our historical experience, the credit-worthiness of our customers, accounts receivable aging data, contractual terms and conditions and our current analysis of the collectability of accounts receivable in helping us make judgments about the level of allowances to hold for sales returns and cancellations. Changes in judgments on any of these factors could materially impact the timing and amount of revenue and costs recognized.

*Uncollected Deferred Revenue*—Because of our revenue recognition policies, there are circumstances for which we are unable to recognize revenue relating to sales transactions that have been billed, but the related account receivable has not been collected. While the receivable represents an enforceable obligation, for balance sheet presentation purposes we have offset the deferred revenue against the related account receivable and no amounts appear in our consolidated balance sheets for such transactions. The aggregate amount of accounts receivable that have been offset by the related deferred revenue was \$47.6 million and \$38.9 million at December 31, 2006 and 2005, respectively.

*Software Development Costs*—Costs incurred in the research and development of new software products and enhancements to existing software products are expensed as incurred until technological feasibility has been established. After technological feasibility is established, any additional costs are capitalized in accordance with SFAS No. 86, "Accounting for the Costs of Computer Software to Be Sold, Leased or Otherwise Marketed" until the product is available for general release. Because our current process for developing software is essentially completed concurrently with the establishment of technological feasibility, no software development costs have been capitalized as of December 31, 2006 and 2005.

**QUEST SOFTWARE, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

*Advertising Expenses*—We expense all advertising costs as incurred, and such costs were \$3.9 million, \$3.3 million and \$2.9 million for the years ended December 31, 2006, 2005 and 2004, respectively.

*Income Taxes*—We account for income taxes under the provisions of SFAS No. 109, “*Accounting for Income Taxes*.” Deferred taxes on income result from temporary differences between the reporting of income for financial statements and tax reporting purposes. Measurement of the deferred items is based on enacted tax laws. In the event the future consequences of differences between financial reporting bases and tax bases of our assets and liabilities result in a deferred tax asset, SFAS No. 109 requires an evaluation of the probability of being able to realize the future benefits indicated by such asset. A valuation allowance related to a deferred tax asset is recorded when it is more likely than not that some portion or all of the deferred tax asset will not be realized.

*Stock-Based Compensation*—See also Note 2, “*Restatement of Previously Issued Financial Statements*,” for the discussion of the restatement related to our stock option grants.

Prior to January 1, 2006, we accounted for stock option grants in accordance with Accounting Principles Board (“APB”) Opinion No. 25, *Accounting for Stock Issued to Employees*, and related Interpretations, as permitted by SFAS No. 123, *Accounting for Stock-Based Compensation*. Accordingly, we recognized compensation expense for stock option grants where the exercise price was lower than the fair market value of our common stock on the originally stated grant date. In connection with the restatement of our previously issued financial statements, we have recognized additional stock-based compensation expense arising from corrections to accounting measurement dates. See Note 2 below. In accordance with SFAS 123 and SFAS 148, *Accounting for Stock-Based Compensation – Transition and Disclosure*, we provided pro forma net income or loss and net income or loss per share disclosures for each period prior to the adoption of SFAS No. 123R, *Share-Based Payment* (“SFAS 123R”), as if we had applied the fair value-based method in measuring compensation expense for our stock-based compensation plans.

Effective January 1, 2006, we adopted the fair value recognition provisions of SFAS 123R utilizing the modified prospective transition method. As required by SFAS 123R, we estimate forfeitures of employee stock options and recognize compensation cost only for those awards expected to vest. Forfeiture rates are determined based on historical experience. Estimated forfeitures are adjusted to actual forfeiture experience as needed. Under the modified prospective approach, compensation expense recognized during the year ended December 31, 2006 includes: (a) compensation expense for all stock-based awards granted prior to, but not yet vested, as of January 1, 2006, based on the grant date fair value estimated in accordance with the original provisions of SFAS 123, and (b) compensation expense for all stock-based awards granted on or after January 1, 2006, based on the grant date fair value estimated in accordance with the recognition provisions of SFAS 123R. In accordance with the modified prospective transition method, our audited consolidated financial statements for the year ended December 31, 2005 have not been restated to reflect, and do not include, the impact of SFAS 123R.

Prior to the adoption of SFAS 123R, we presented all tax benefits resulting from the exercise of stock options as operating cash flows in our consolidated statements of cash flows. SFAS 123R requires that the realized tax benefit related to the excess of the deductible amount over the compensation cost recognized (excess tax benefits) be classified in the statement of cash flow as a cash inflow from financing activities and a cash outflow from operating activities. Accordingly, we classified \$6.2 million of excess tax benefit related to stock-based compensation as financing cash inflows and operating cash outflows on our accompanying consolidated statements of cash flows for the year ended December 31, 2006. In addition, we previously presented unearned compensation as a separate component of shareholders’ equity. In accordance with the provisions of SFAS 123R, upon adoption, we also reclassified the balance in unearned compensation to common stock on our accompanying consolidated balance sheet.

SFAS 123R requires us to calculate the pool of excess tax benefits (the “APIC Pool”), available as of January 1, 2006, to absorb tax deficiencies recognized in subsequent periods, assuming we had applied the provisions of the standard in prior periods. We applied the provisions of SFAS 123R in calculating the APIC Pool, which was calculated using the long-haul method.

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**QUEST SOFTWARE, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The following table summarizes the total stock-based compensation expense, including the impact of related payroll taxes, by income statement line item that we recorded for the years ended December 31, 2006, 2005 and 2004 (in thousands, except per share data):

	Year Ended December 31,		
	2006	2005	2004
Cost of licenses	\$ 7	\$ 2	\$ 4
Cost of services	1,204	458	1,074
Sales and marketing	8,670	5,496	2,941
Research and development	9,435	2,857	5,887
General and administrative	7,700	3,581	4,685
Reduction of income from operations and income before income tax provision	27,016	12,394	14,591
Income tax effect using the effective tax rate for each year	5,953	5,658	1,917
Reduction of net income	<u>\$ 21,063</u>	<u>\$ 6,736</u>	<u>\$ 12,674</u>
Reduction of net income per share:			
Basic	<u>\$ 0.21</u>	<u>\$ 0.07</u>	<u>\$ 0.13</u>
Diluted	<u>\$ 0.20</u>	<u>\$ 0.07</u>	<u>\$ 0.13</u>

As of December 31, 2006, total unrecognized stock-based compensation cost related to unvested stock options was \$45.1 million, which is expected to be recognized over a weighted-average period of 3.1 years.

Pro Forma Information under SFAS 123 for Periods Prior to January 1, 2006

The following table illustrates the effect on operating results and per share information had we accounted for stock-based compensation in accordance with the fair value recognition provisions of SFAS 123 and after reflecting the change in the accounting measurement dates as discussed in Note 2 for the years ended December 31, 2005 and 2004 (in thousands, except per share data):

	Year Ended December 31,	
	2005	2004
Net income	\$ 32,456	\$ 52,251
Add: Stock-based compensation expense included in reported net income, net of related tax effects	6,963	18,763
Deduct: Total stock-based compensation determined under fair value based method for all awards, net of related tax effects	(21,662)	(48,535)
Pro forma net income	<u>\$ 17,757</u>	<u>\$ 22,479</u>
Net income per share:		
Basic	<u>\$ 0.33</u>	<u>\$ 0.55</u>
Basic - pro forma	<u>\$ 0.18</u>	<u>\$ 0.24</u>
Diluted	<u>\$ 0.32</u>	<u>\$ 0.53</u>
Diluted - pro forma	<u>\$ 0.18</u>	<u>\$ 0.23</u>

Determining Fair Value

*Valuation and Amortization Method.* We estimate the fair value of stock options granted using the Black-Scholes option valuation model utilizing a single option approach. The fair value of all options is generally amortized on a straight-line basis over the vesting period. We have reviewed our historical pattern of option exercises and have determined that meaningful differences in option activity existed among employees. Therefore, for all stock options granted after January 1, 2006, we have categorized these awards into two separate groups of employees. The employees within each group have similar historical exercise behavior for valuation purposes.

Determining the fair value of stock-based awards at the grant date requires judgment, including estimating the expected term, expected volatility, risk-free interest rate and dividend yield. We may use different assumptions under the Black-Scholes option valuation model in the future, which could materially affect our net income or loss and net income or loss per share.

*Expected Term.* The expected term of options granted represents the period of time such options are expected to be outstanding. We estimate the expected terms of options granted based on historical exercise patterns across two different groups of employees. We believe these estimates are reasonably representative of each group's likely future behavior.

*Expected Volatility.* We estimate the volatility of our common stock-based upon the implied volatility derived from the market prices of our traded options with similar terms. Our decision to use implied volatility was based upon the availability of actively traded options on our common stock and our assessment that implied volatility is more representative of future stock price trends than is historical volatility. Prior to the adoption of SFAS 123R, we used historical volatility under a "comparable companies" analysis approach, because our history as a public company was not sufficient to make volatility assumptions based solely on volatility of the Company's stock.

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**QUEST SOFTWARE, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

*Risk-Free Interest Rate.* We base the risk-free interest rate on the U.S. Treasury zero-coupon issues in effect at the time of option grant for equivalent remaining terms.

*Dividend Yield.* We do not expect to pay any dividends and, therefore, we use an expected dividend yield of zero.

We used the following assumptions to estimate the fair value of options granted during the years ended December 31, 2006, 2005 and 2004:

	Years Ended December 31,					
	2006		2005		2004	
	Range:	Weighted Average:	Weighted Average:		Weighted Average:	
Risk-free interest rate	4.5% to 5.2%	4.9%	4.2%	3.8%		
Expected term (in years)	6.3 to 7.8	6.6	6.7	6.5		
Expected volatility	54% to 55%	55%	53%	51%		
Expected dividend yield	None	None	None	None		

*Net Income Per Share*—We compute net income per share in accordance with SFAS No. 128, “*Earnings per Share*.” Basic earnings per share is computed by dividing net income available to common shareholders by the weighted-average number of common shares outstanding for the period. Diluted earnings per share reflects the potential dilution of securities by including other common stock equivalents, including stock options, in the weighted-average number of common shares outstanding for a period, if dilutive.

The table below sets forth the reconciliation of the denominator of the earnings per share calculation (in thousands):

	Years Ended December 31,		
	2006	2005	2004
Shares used in computing basic net income per share	101,380	97,621	94,622
Dilutive effect of stock options (1)	2,723	3,409	3,219
Shares used in computing diluted net income per share	<u>104,103</u>	<u>101,030</u>	<u>97,841</u>

(1) Options to purchase 12,274, 9,675 and 9,293 shares of common stock were outstanding during 2006, 2005 and 2004, respectively, but were not included in the computation of diluted net income per share as inclusion would have been anti-dilutive.

*Risks and Uncertainties*—We are subject to risks and uncertainties in the normal course of business, including customer acceptance of our products, rapid technological changes, delays in introducing and market acceptance of new products, competition, e-business developments, international expansion, ability to attract and retain qualified personnel, ability to protect our intellectual property, and other matters inherent in the software industry.

*Taxes Collected from Customers and Remitted to Governmental Authorities*—We present taxes collected from customers and remitted to governmental authorities in accordance with Emerging Issues Task Force Issue No. 06-3, on a net basis.

**Recently Issued Accounting Pronouncements**

In February 2007, the Financial Accounting Standards Board (“FASB”) issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities – Including an Amendment of FASB Statement No. 115* (“SFAS 159”), which permits entities to choose to measure many financial instruments and certain other items at fair value, on an instrument-by-instrument basis. The fair value measurement election is irrevocable and requires that unrealized gains and losses are reported in earnings. SFAS 159 is effective for fiscal years beginning after November 15, 2007. We have not determined whether we will elect to measure items subject to SFAS 159 at fair value and, as a result, have not assessed the potential effect if any of implementing this standard.

**QUEST SOFTWARE, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

In September 2006, the FASB issued FASB Staff Position (“FSP”) No. AUG AIR-1, Accounting for Planned Major Maintenance Activities. FSP No. AUG AIR-1 disallowed the use of the accrual method when accounting for planned major maintenance activities, such as the aircraft engine overhaul planned on our corporate aircraft sold in November 2006, thereby requiring the use of one of the other three approved methods under the AICPA Industry Audit Guide, *Audits of Airlines*. FSP No. AUG AIR-1 requires retrospective application for all financial statements presented and must be applied to financial statements filed with the Securities Exchange Commission (“SEC”) for fiscal years beginning after December 15, 2006, with early adoption permitted as of the beginning of a fiscal year. Effective fiscal year 2006, we adopted the direct expensing method which requires us to expense engine overhauls, as well as other major maintenance activity, as they are incurred. The adoption of the FSP is considered a change in accounting principle adopted by the FASB with retroactive application as described in SFAS No. 154, *Accounting Changes and Error Corrections*. As a result of early adoption, we reversed all engine overhaul accruals expensed in each of the appropriate periods from 2002 to the first quarter of 2006 and recorded engine overhaul expenses in the periods charges were incurred. Charges related to planned major maintenance on our corporate aircraft were incurred in the third quarter of 2006 and the corporate aircraft was subsequently sold in the fourth quarter of 2006. The effect of adopting FSP No. AUG AIR-1 on our consolidated balance sheet at December 31, 2005 was a decrease of \$1.0 million in other accrued expenses, an increase of \$0.4 million in the deferred tax liability and an increase of \$0.6 million in our retained earnings. The effects of adopting FSP No. AUG AIR-1 are included in the tables in Note 2.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements* (“SFAS 157”), which defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements. SFAS 157 is effective for fiscal years beginning after November 15, 2008, and interim periods within those fiscal years. We are currently assessing the potential effect if any of implementing this standard.

In September 2006, the SEC issued Staff Accounting Bulletin No. 108 (“SAB 108”), *Considering the Effects of Prior Year Misstatements When Quantifying Misstatements in Current Year Financial Statements*. SAB 108 provides interpretive guidance on how registrants should quantify financial statement misstatements. There was diversity in practice, with the two commonly used methods to quantify misstatements being the “rollover” method (which focuses primarily on the income statement impact of misstatements) and the “iron curtain” method (which focuses on the balance sheet impact). SAB 108 requires registrants to use a dual approach whereby both of these methods are considered in quantifying and evaluating the materiality of financial statement misstatements. We applied the provisions of SAB 108 during the fourth quarter of 2006 and such application did not have a material impact on our consolidated results of operations or financial position.

In July 2006, the FASB issued Interpretation No. 48 (“FIN 48”), *Accounting for Uncertainty in Income Taxes*. This Interpretation clarifies the accounting for uncertainty in income taxes recognized in an enterprise’s financial statements in accordance with SFAS No. 109, *Accounting for Income Taxes*. FIN 48 defines a recognition threshold and measurement attribute for financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return, and also provides guidance on de-recognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. FIN 48 is effective for fiscal years beginning after December 15, 2006 and as a result, is effective for us in the first quarter of 2007. We are currently assessing the potential effect if any of implementing this standard.

## **2. Restatement of Previously Issued Financial Statements**

Subsequent to the issuance of the Company’s 2005 consolidated financial statements, the Company’s management determined that incorrect measurement dates were used for financial accounting purposes for certain stock option grants made in prior periods and that other stock option and non-stock option related errors in its historical financial statements require correction, as described in more detail below. As a result, the consolidated financial statements as of December 31, 2005 and for the years ended December 31, 2005 and 2004 have been restated from the amounts previously reported to correct these errors. The after tax effect to net income of all adjustments amounted to \$(1.3) million, \$9.6 million and \$(4.9) million for the years ended December 31, 2006, 2005 and 2004, respectively.

On May 26, 2006, our Board formed a Special Committee of independent directors to conduct an investigation of our historical stock option grant practices and related accounting. For a detailed description of the background and scope of the investigation and information related to our historical stock option granting practices, see the section entitled “*Restatement*” in Management’s Discussion and Analysis of Financial Condition and Results of Operations contained in this Report.

### ***Findings of the Investigation and Measurement Date Determinations***

The Special Committee performed a detailed review of all stock option grants awarded from August 13, 1999 (the date of the Company’s initial public offering) through June 30, 2003 and all annual grants from July 1, 2003 through December 2005, covering grants to purchase 30,739,235 shares of Common Stock made in 7,287 awards on 39 granting dates. The

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**QUEST SOFTWARE, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Special Committee also performed limited testing on a sample of stock option grants made prior to the initial public offering covering grants to purchase 10,632,744 shares of Common Stock made in 762 awards on 38 granting dates. The Special Committee also performed limited testing on a sampling of new hire and merit stock option grants awarded after June 30, 2003 covering grants to purchase 5,082,350 shares of Common Stock representing 61% of all new hire and merit options granted during this period.

We classified option grants subject to the investigation into three time periods: (1) June 1998 through August 1999 (the "Pre-IPO Period"); (2) September 1999 through April 30, 2002; and (3) May 1, 2002 through December 2005. Because annual, broad-based grants were made in a process substantially similar to new hire and merit grants, we did not separately classify option grants by the nature of their granting process. Based on the facts obtained as a result of the Special Committee investigation, we identified grants for which we used an incorrect measurement date for financial accounting purposes, as defined under Generally Accepted Accounting Principles in the United States, or GAAP. To determine the correct accounting measurement dates for these grants we followed the guidance in Accounting Principles Board ("APB") No. 25, which deems the "measurement date" to be the first date on which all of the following are known with finality: (1) the identity of the individual employee who is entitled to receive the option grant; (2) the number of options that the individual employee is entitled to receive; and (3) the option's exercise price.

The Special Committee performed a grant date by grant date analysis of approximately 38 option grant dates during the Pre-IPO Period, 36 option grants between the IPO and June 30, 2003 and all 3 annual grants from July 1, 2003 through December 2005 for compliance with APB No. 25. Where we determined that we did not complete the required granting actions by the original grant date, we used judgment to determine corrected accounting measurement dates for all awards included within the granting action on each grant date consistent with what the evidence suggested was our practice or process. If the revised measurement date was not the same date we used previously, we made accounting adjustments as required, which resulted in stock-based compensation and related tax effects when an option had intrinsic value on the revised measurement date.

A total of 3,382 awards covering 22,553,293 shares of Common Stock required measurement date changes, of which options to purchase 3,604,950 shares of Common Stock were granted to employees who were executive officers of the Company at the time of their respective grant dates. None of our non-employee directors received stock options grants requiring measurement date corrections.

The following table summarizes certain information with respect to option awards requiring accounting measurement date changes:

<u>Time Period</u>	<u>Number of Granting Dates</u>	<u>Number of Awards</u>	<u>Number of Shares</u>
Pre-IPO Period	35	757	10,519,744
Initial Public Offering through April 30, 2002	21	2,567	11,255,299
After April 30, 2002	11	58	778,250
Total	<u>67</u>	<u>3,382</u>	<u>22,553,293</u>

A summary of incremental pre-tax stock-based compensation expense related to options awarded in each time period covering the period from June 1998 through December 31, 2005 ("restatement period") (in thousands), is as follows:

<u>Time Period</u>	<u>Pre-Tax Stock-based Compensation Expense, Net of Forfeitures</u>
Pre-IPO Period	\$ 23,288
Initial Public Offering through April 30, 2002	113,306
After April 30, 2002	319
Cumulative effect for options vested through December 31, 2005	<u>\$ 136,913</u>

#### ***Pre-IPO Period Grants***

During the course of the investigation, information and documentation relating to stock option grants made prior to the Company's initial public offering was evaluated. The Special Committee determined that accounting measurement dates for most of the stock option grants during the period from June 23, 1998 through August 11, 1999 were incorrectly determined. These instances involved an aggregate of 757 stock option grants awarded to employees covering 10,519,744 shares of Common Stock. Specifically, the Special Committee discovered evidence that required details of 588 awards covering

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**QUEST SOFTWARE, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

9,373,344 shares covered by all grants between June 1998 and June 9, 1999 did not have the required level of finality or were not supported by sufficient documentation until June 9, 1999, the date on which the Company's 1999 Stock Incentive Plan was adopted by the Company and approved by its shareholders.

For the stock option grants awarded between June 10, 1999 through August 11, 1999, the Company was unable to locate evidence of completion of required granting actions (specifically, approval of the stock option grants by the Company's Board of Directors or Compensation Committee). These instances involved an aggregate of 169 stock option grants to employees to purchase an aggregate of 1,146,400 shares of the Company's Common Stock. None of these stock options were granted to executive officers or senior officers who participated in the stock option granting processes associated with these grants. The Company has been honoring these stock options awards and settling them with stock and intends to continue doing so. Measurement date determinations for these option grants were made on the basis of all available relevant information and reflect the Company's reasonable conclusion as to the most likely option granting actions that occurred and related facts and circumstances. Specifically, we used evidence of the dates on which the Notices of Grant were executed on behalf of the Company as the best evidence of the granting actions actually completed, and used those dates as the revised measurement dates for financial reporting purposes.

Corrections to the measurement dates for option grants during the Pre-IPO Period resulted in the recording of additional pre-tax stock-based compensation of \$23.3 million.

***Post IPO Grants - September 1999 through April 2002***

In the fourth quarter of 1999, the Company initiated a practice of processing option grants to newly-hired employees and merit or promotion grants to existing employees on a monthly basis, starting with the grants dated September 1999, and to determine a single grant date for stock options granted within each of those particular months. The Special Committee found evidence demonstrating that stock option grants made in any given month were routinely made as of the trading date associated with the lowest closing sale price reported by Nasdaq for our Common Stock from September 1999 through April 2002, with only a few grants during such period made on other dates. The Special Committee also found evidence that the option grant dating practice expanded to quarterly, rather than monthly, grant date determinations.

For stock option grants during this time period, the Special Committee determined that:

- administrative approvals for required granting actions were generally documented by unanimous written consents of the Board or the Compensation Committee, and were dated "as of" the date corresponding to the trading date in a given month or quarter on which the Company's last sale price was determined to be the lowest in that period;
- all of such unanimous written consents were prepared after the selected grant dates and were executed by members of the Board or Compensation Committee at a later time, in some cases as much as up to three months after the selected grant date; and
- in certain cases, the lists reflecting stock option grants processed by the Company's stock plan administrator were different than the lists provided to and approved by either the Board or Compensation Committee, as the case may be.

For each of the 21 discretionary grants affected by the Special Committee's findings during this period, the Special Committee determined an accounting measurement date based on information and documentation evidencing the date as of which the related action by unanimous written consent ("UWC") had been signed by all of the directors or, in the case of Compensation Committee action, members of the Compensation Committee. However, in many cases, the Company was unable to locate definitive and complete documentation evidencing the date on which the last required approval of a UWC was signed by certain directors and received by the Company. For these stock option grants, the Company's measurement date determinations were made on the basis of all available relevant information and reflect the Company's reasonable conclusion as to the most likely option granting actions that occurred based on related facts and circumstances. For grants where there was insufficient evidence to determine when all required written consents were actually obtained, but there was evidence of the dates of receipt of individual written consents (such as contemporaneous electronic messages to or from individuals involved in the granting activities or facsimile header dates on signed unanimous written consent forms), we used this information as evidence of when the Compensation Committee approval was obtained, and used that date as the revised measurement date for financial reporting purposes. In other cases where we could not locate evidence of the date or dates on which required granting approvals were obtained, we used evidence of the dates on which the Notices of Grant were executed on behalf of the Company as the best evidence of the granting actions actually completed, and used those dates as the revised measurement dates for financial reporting purposes. We believe that these grants were communicated to employees in a

**QUEST SOFTWARE, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

timely manner. In some cases, we awarded option grants that were different in amount than that approved by the required granting actions or to employees whose awards were not included in lists approved by the Board of Directors or Compensation Committee. In each of these circumstances, we evaluated the existing information related to each individual grant and we established a new measurement date when we determined that the terms of the award were fixed with finality, which was generally the date on which the related Notice of Grant was signed on behalf of the Company.

Section 16 Insiders received stock options covering an aggregate of 2,904,950 shares of Common Stock in these grant events, which collectively resulted in \$24.0 million of additional compensation expense over the restatement period. See the discussion under the heading "Remedial Actions" below with respect to actions taken by the Company with respect to option awards to Section 16 Insiders. Employees other than Section 16 Insiders received options to purchase an aggregate of 8,350,349 shares in these grant events. Corrections to the measurement dates for all of the misdated grants during the period from September 1999 through April 2002 resulted in the recording of additional stock-based compensation expense of \$113.3 million.

***Post IPO Grants - May 1, 2002 through December 2005***

The Special Committee performed a detailed review of all stock option grants awarded between May 1, 2002 and June 30, 2003 and all annual grants awarded between May 1, 2002 and December 2005. Measurement date exceptions were noted for 45 grants covering options to purchase 294,750 shares, for which an additional stock-based compensation expense of approximately \$278,000 has been recorded in the restated financial statements included in this Report. Based on the significant improvements in the Company's stock option granting practices during this period, the Special Committee determined to conduct limited sampling and testing of new hire and merit stock option grants awarded after June 30, 2003. The Special Committee sampled 88 new hire and merit grants, covering 5,082,350 shares of Common Stock (61% of all shares covered by new hire and merit option grants). The remaining new hire and merit stock option grants occurring during the period from July 1, 2003 through December 31, 2005 were not individually reviewed and did not appear to have any unusual pricing or other characteristics indicating a need for full individual review. Sampling and other analysis indicated that these remaining grants consisted of new hire and merit grants to non-officer employees. Various tests were performed to determine whether these remaining grants had any unique pricing or other characteristics. None were identified, although measurement date exceptions were noted for 13 grants covering options to purchase 483,500 shares, for which an additional stock-based compensation expense of approximately \$41,000 has been recorded in the restated financial statements included in this Report. Given the immaterial number of shares and limited income statement impact, along with the absence of unique pricing or other characteristics, additional review procedures were not deemed necessary for these remaining grants occurring after June 30, 2003 and were therefore not applied.

***Other Stock Option Related Adjustments***

In addition to adjustments to our reported stock-based compensation expenses resulting from corrections to accounting measurement dates, the restatement also reflects stock-option related adjustments arising from a variety of other issues discovered during our investigation:

- We recorded compensation expense as a result of modifications to stock options made or deemed to have been made to certain employees in connection with their termination of employment or extended leaves of absence. Typically such modifications related to, or resulted in, extensions of the time periods following cessation of service within which these employees could exercise vested stock options. We have recorded incremental pre-tax stock-based compensation expense associated with such modifications in the aggregate amount of \$2.0 million.
- We identified certain stock option grants awarded to non-executive employees which were repriced or otherwise modified in circumstances which required variable accounting treatment. We also identified an option grant awarded to a non-employee consultant deemed to have been granted in exchange for services. We have recorded incremental pre-tax stock-based compensation expense associated with these stock option awards in the aggregate amount of \$4.3 million.
- We determined that our accounting treatment for a restricted stock issuance in 2000 was incorrect. We issued 339,200 shares of common stock to an employee in connection with his initial employment with the Company as Vice President, Marketing, and accepted this employee's secured promissory note in the principal amount of \$15.8 million as payment of the purchase price for the shares. In June 2002, we determined that we should have treated the promissory note as a non-recourse obligation and, accordingly, treated the transaction as a stock option for financial reporting purposes. We also determined that we should not have accrued approximately \$1.4 million of interest income on the promissory note that we accrued from 2000 through

**QUEST SOFTWARE, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

March 31, 2002 but deemed the error to be immaterial to our results of operations. We have recorded an adjustment to our beginning retained earnings balance as of January 1, 2004 to reverse the interest income previously recorded on this promissory note.

- We incorrectly calculated the intrinsic value of unvested stock options assumed by the Company in connection with certain acquisition transactions. As a result, we have reduced the stock-based compensation expense resulting from the amounts of unearned compensation recorded in connection with those acquisitions in the aggregate amount of \$2.3 million.
- We determined that volatility assumptions used previously to estimate the fair value of our stock option grants required correction. As a result, we revised our fair value estimates based on corrected volatility assumptions for the period beginning January 1, 2001 and ending December 31, 2005.

All but \$0.7 million of the foregoing adjustments were recorded in periods preceding 2004. As a result, most of the impact of these adjustments is reflected in the adjustment of our opening accumulated deficit balance at January 1, 2004 in the consolidated financial statements included in this Report.

As a result of the errors in determining measurement dates, certain options were determined to have been granted at an exercise price below the fair market value of our stock on the actual grant date. The primary adverse tax consequences are: (1) that the re-measured options vesting after December 31, 2004 are potentially subject to option holder excise tax under Section 409A of the Internal Revenue Code (and, as applicable, similar excise taxes under state law) and (2) certain incentive stock options previously granted, could be deemed granted at below market value producing incremental payroll tax liabilities. As a result during the year ended December 31, 2006, the Company recorded approximately \$0.6 million in liabilities related to Section 409A and the anticipated settlement by the Company of payroll and excise taxes on behalf of the Company's employees for options that were exercised during 2006. Additionally, during the year ended December 31, 2006, the Company recorded a benefit related to the potential withholding tax liabilities on incentive stock options deemed granted at below market value. The benefit recorded was approximately \$1.9 million and is based on the running of the statute of limitations.

Regarding potential future liabilities associated with Section 409A, the Company has yet to determine whether it will either implement a plan to assist the affected employees for the amount of this tax, adjust the terms of the original option grant, or adjust the terms of the original option grant and pay the affected employees an amount to compensate such employees for this lost benefit. As such, no additional expense has been recorded in the consolidated financial statements in the adjustments discussed above in connection with potential future liabilities related to this matter.

***Remedial Actions***

The following remedial steps were directed or recommended by the Special Committee in December 2006:

- For stock options which required measurement date changes granted to officers of the Company ("Section 16 Insiders") who, at the time of grant, were required to file the reports required pursuant to Section 16 of the Securities Exchange Act of 1934 ("Executive Options"), the Special Committee required amendments to those Executive Options to increase the exercise price of any such stock options which remain outstanding to the market value of our Common Stock as reported by Nasdaq on the revised accounting measurement date. The Executive Options held by our Section 16 Insiders were amended as set forth in the table below, without the payment of any consideration by the Company:

<b>Officer</b>	<b>Original Grant Date</b>	<b>Options Outstanding</b>	<b>Original Exercise Price</b>	<b>Amended Exercise Price</b>
Vincent C. Smith	April 4, 2001	300,000	\$ 14.81	\$ 26.51
Vincent C. Smith	October 1, 2001	485,000	\$ 10.74	\$ 24.40
Douglas F. Garn	April 14, 2000	80,000	\$ 26.50	\$ 55.25
Douglas F. Garn	April 4, 2001	300,000	\$ 14.81	\$ 26.51
Douglas F. Garn	October 1, 2001	72,900	\$ 10.74	\$ 24.40
M. Brinkley Morse	April 4, 2001	100,000	\$ 14.81	\$ 26.51
M. Brinkley Morse	October 1, 2001	300,000	\$ 10.74	\$ 24.40
Kevin E. Brooks	October 1, 2001	5,000	\$ 10.74	\$ 24.40
Anthony Foley	April 29, 2002	34,000	\$ 11.91	\$ 12.96

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**QUEST SOFTWARE, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The increase to the exercise prices of such options held by Messrs. Smith, Garn, Morse, and Brooks also had the effect of eliminating potential tax consequences to them under Section 409A of the Internal Revenue Code and comparable provisions of applicable state tax law.

- The Special Committee also directed the Company to request repayment from Section 16 Insiders of an amount representing the estimated after-tax gain realized by such Section 16 Insiders from exercises of Executive Options, except for Anthony Foley, and Eyal Aronoff (whose requested payment is subject to a cap of \$200,000). As of the date of this report, the Company has received repayments totaling \$157,831. Mr. Smith and Mr. Morse have never exercised any stock options granted to them by the Company and had no such gain to repay.

Officer	Gain To Repay
Eyal Aronoff	\$ 200,000
Douglas F. Garn	\$ 64,000
David M. Doyle	\$ 59,056
Kevin E. Brooks	\$ 34,775

- The Special Committee also determined to adopt a variety of process and corporate governance changes, including changes adopted in connection with the proposed settlement of the Company's shareholder derivative litigation. The proposed corporate governance measures include, among other things, implementing certain policies, procedures and guidelines for stock option grants, adopting additional standards of director independence, adopting the "majority vote" standard for uncontested elections of directors, incorporating term limits for independent directors (16 years) and for audit committee members (10 consecutive years), and incorporating additional policies, procedures and guidelines. In addition, the Board approved certain amendments to the Company's 1999 Stock Incentive Plan and 2001 Stock Incentive Plan. The stock option plan amendments include a new requirement that the exercise price for all nonqualified stock options (i.e., stock options which do not qualify for "incentive stock option" treatment under applicable provisions of the Internal Revenue Code of 1986, as amended) must be not less than the market value of Quest's common stock on the grant date. Prior to this change, the exercise price for nonqualified stock options was required by the plans to be established by the applicable Plan Administrator. The Company's Board of Directors also approved related updates to the written charters of the Board's Audit Committee, Compensation Committee and Nominating & Corporate Governance Committee, and a related update to the Company's Corporate Governance Guidelines.

**Non-Stock Option Related Adjustments**

The Company has determined that additional errors in its historical financial statements require correction in this restatement. Many of these errors were identified by the Company or its auditors in connection with the restatement related procedures. Other adjustments include items identified in prior periods, but deemed them not to be material to the Company's results of operations, and are included in this restatement. A summary of the impact of these adjustments to pre-tax income for the twelve months ended December 31, 2005 and 2004 (in thousands), is as follows:

(Increase) Decrease in Pre-Tax Income Category	Year Ended December 31,	
	2005	2004
<b>Revenue Adjustments</b>		
Financial system programming error	\$ (134)	\$ (717)
Incorrect interpretation of complex orders	2,442	434
Inconsistent application of company policies	1,178	—
Other	688	(48)
Total Revenue Adjustments	4,174	(331)
<b>Expense Adjustments</b>		
Incorrect application of SFAS No. 144	566	795
Incorrect interpretation of complex orders	(239)	(65)
Incorrect application of company policies	(10)	(31)
Other	(115)	5
Total Expense Adjustments	202	704
<b>Other Income (Expense), Net Adjustments</b>		
Incorrect application of SFAS No. 52	(113)	(114)
Other	(24)	—
Total Other Income (Expense), Net Adjustments	(137)	(114)
Total All Adjustments	\$ 4,239	\$ 259

**QUEST SOFTWARE, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**Revenue Adjustments**

Based upon a review of more than 100,000 software license and services transactions over the restatement period, the Company identified several instances where previously reported revenues were required to be corrected and recognized across various and appropriate reporting periods. There were several categories of revenue adjustments, but most were attributable to the following three categories of errors:

First, a programming error made at the time of our financial system's initial implementation in 2000, resulted in a systematic miscalculation of the timing of revenue recognition across certain of the Company's orders that contained a post-contract technical support services (referred to as PCS) line item. The error was identified and corrected in 2005 however we failed to evaluate the impact of the programming error and its effect on previously reported revenues. This error caused a shift in the timing of revenue recognition for all affected orders across numerous quarters and years, resulting in periodic quarterly over- and understatements of revenue.

Second, incorrect interpretations of certain complex orders resulted in an overstatement of license and/or PCS revenue either early in the contract or around the time of initial customer purchase and an understatement of the corresponding revenue either later in the contract or over a ratable period designated in the contract.

Third, inconsistent application of the Company's revenue recognition policies in geographies outside North America resulted in an overstatement of license and PCS revenue at and around the time of initial customer purchase and an understatement of the corresponding revenue at the time of cash collection.

**Operating Expenses and Other Income (Expense), Net Adjustments**

The Company also identified several instances where previously reported operating expenses or other income (expense), net items were required to be corrected and recognized across various reporting periods.

The first item related to an incorrect application of SFAS No. 144, "*Accounting for the Impairment or Disposal of Long Lived Assets*," where we performed our impairment analysis of acquired technology at the acquisition level as opposed to a product-by-product level approach, which resulted in an understatement of intangibles amortization expense related to acquired assets in the period that the impairment occurred and a corresponding overstatement of the related expense over that asset's remaining estimated useful life.

The second item related to the incorrect revaluation of monetary assets and liabilities in foreign subsidiaries as required by SFAS No. 52, "*Foreign Currency Translation*," which resulted in the periodic misstatement (both over and under) of the other income (expense), net line item on the income statement with the corresponding offsetting impact to monetary asset and liability accounts on the balance sheet (primarily cash and accounts receivable).

In addition to the revenue, operating expenses and other income (expense), net items covered specifically above, there were several additional adjustments also included in these restatement items that were grouped into the "other" categories given their minimal individual impact. Many of these adjustments include certain errors that were not previously recorded because in each case, and in the aggregate, the underlying errors were not considered by management to be material to our consolidated financial statements.

All the items identified above generally affect the timing pattern of revenue, expense and income recognition. As such, they do not generally change the cumulative revenues, expenses, pre-tax operating income, liquidity or cash flow of the Company.

***Impact of Errors on Previously Issued Consolidated Financial Statements***

As a result of the findings of the Special Committee's investigation with respect to employee stock options and the other adjustments described in this footnote, our consolidated financial statements for the years ended December 31, 2005 and 2004 have been restated. We recorded additional stock-based compensation expense and other accounting adjustments, and related tax adjustments, affecting our previously-reported financial statements for 1999 through 2003, the effects of which are summarized in cumulative adjustments to our common stock (additional paid-in capital), unearned compensation, accumulated deficit and note receivable from sale of common stock accounts as of January 1, 2004, in the amounts of \$80.6 million, \$48.2 million, \$92.5 million and \$17.2 million, respectively.

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**QUEST SOFTWARE, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The financial information presented in this Report has been adjusted to reflect the incremental impact resulting from the restatement adjustments discussed above, as follows (in thousands):

**Summary of Impact of Restatement Adjustments**

Year Ended	(Increase) Decrease in Pre-Tax Income			Tax Effect of Adjustments		
	Stock Option Related Adjustments (1)	Other Adjustments (2)	Total Adjustments, Pre-Tax	Option Related Payroll Tax Adjustments (3)	Income Tax Effect of All Adjustments	Total Adjustments, Net of Tax
1999	\$ 10,060	\$ —	\$ 10,060	\$ —	\$ (2,782)	\$ 7,278
2000	21,731	1,579	23,310	6,221	(5,066)	24,465
2001	24,270	2,195	26,465	1,268	(8,370)	19,363
2002	30,679	(248)	30,431	2,103	(7,825)	24,709
2003	25,860	240	26,100	635	(10,048)	16,687
Cumulative effect on January 1, 2004 opening accumulated deficit	112,600	3,766	116,366	10,227	(34,091)	92,502(4)
2004	19,814	259	20,073	(7,433)	(17,563)	(4,923)
2005	9,869	4,239	14,108	(889)	(3,582)	9,637
<b>Total</b>	<b>\$ 142,283</b>	<b>\$ 8,264</b>	<b>\$ 150,547</b>	<b>\$ 1,905</b>	<b>\$ (55,236)</b>	<b>\$ 97,216</b>

- (1) Comprised of \$136.9 million of stock-based compensation expense adjustments arising from measurement date corrections and \$5.4 million of other stock option related adjustments.
- (2) Other non-stock option related adjustments to revenue, operating expenses, and other income (expense), net.
- (3) Relates to potential payroll tax liabilities for incentive stock options deemed to be granted at below market value and is included with the appropriate compensation expense.
- (4) The cumulative effect does not include the cumulative impact of the retrospective adoption of a change in accounting for planned major maintenance activities on our corporate aircraft of \$0.2 million.

The financial statement impact of the restatement on previously reported stock-based compensation expense, including income tax impact by year, is as follows (in thousands):

Year Ended December 31,	Stock-Based Compensation Expense as Previously Reported	Stock-Based Compensation Expense Adjustments	Stock-Based Compensation Expense as Restated	Income Tax Benefit Relating to Stock-Based Compensation Expense	Stock-Based Compensation Expense, Net of Income Tax
1999	\$ 432	\$ 10,060	\$ 10,492	\$ (2,829)	\$ 7,663
2000	3,439	21,315	24,754	(8,289)	16,465
2001	4,508	23,244	27,752	(8,877)	18,875
2002	1,455	30,679	32,134	(10,329)	21,805
2003	890	25,860	26,750	(8,575)	18,175
Cumulative through December 31, 2003	10,724	111,158	121,882	(38,899)	82,983
2004	1,779	19,814	21,593	(6,561)	15,032
2005	2,931	9,869	12,800	(4,157)	8,643
<b>Total</b>	<b>\$ 15,434</b>	<b>\$ 140,841</b>	<b>\$ 156,275</b>	<b>\$ (49,617)</b>	<b>\$ 106,658</b>

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**QUEST SOFTWARE, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The following tables present the impact of the Restatement on the Company's previously issued audited consolidated balance sheet as of December 31, 2005, consolidated income statements and statements of cash flows for the years ended December 31, 2005 and 2004:

**CONSOLIDATED BALANCE SHEETS**  
**(In thousands)**

	December 31, 2005			
	As Previously Reported	Adjustments		As Restated
<b>ASSETS</b>				
Current assets:				
Cash and cash equivalents	\$ 121,025	\$ —	\$ —	\$ 121,025
Short-term marketable securities	74,398	—	—	74,398
Accounts receivable, net of allowances of \$17,088 as previously reported and \$18,410 as restated	116,052	(8,725)(2)	—	107,327
Prepaid expenses and other current assets	15,202	51 (2)	—	15,253
Deferred income taxes	11,905	779 (3)	(389) (4)	12,295
Total current assets	338,582	(7,895)	(389)	330,298
Property and equipment, net	82,845	199 (2)	—	83,044
Long-term marketable securities	47,538	—	—	47,538
Amortizing intangible assets, net	68,975	(1,360)(2)	—	67,615
Goodwill	430,239	(290)(1)	—	429,949
Deferred income taxes	—	26,675 (3)	—	26,675
Other assets	4,828	—	—	4,828
Total assets	<u>\$ 973,007</u>	<u>\$ 17,329</u>	<u>\$ (389)</u>	<u>\$ 989,947</u>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>				
Current liabilities:				
Accounts payable	\$ 3,756	\$ —	\$ —	\$ 3,756
Accrued compensation	32,696	659 (2)	—	33,355
Other accrued expenses	34,351	(40)(2)	(971) (4)	33,340
Income taxes payable	19,554	(23)(3)	—	19,531
Current portion of deferred revenue	140,267	(3,896)(2)	—	136,371
Total current liabilities	230,624	(3,300)	(971)	226,353
Long-term liabilities:				
Long-term portion of deferred revenue	34,980	3,452 (2)	—	38,432
Deferred income taxes	10,576	(10,576)(3)	—	—
Other long-term liabilities	1,460	270 (2)	—	1,730
Total long-term liabilities	47,016	(6,854)	—	40,162
Commitments and contingencies (Notes 5 and 13)				
Shareholders' equity:				
Preferred stock, no par value, 10,000 shares authorized; no shares issued or outstanding	—	—	—	—
Common stock, no par value, 200,000 shares authorized; 99,761 shares issued and outstanding	676,285	118,578 (1)	—	794,863
Retained earnings (accumulated deficit)	41,942	(97,216)(1-3)	582 (4)	(54,692)
Accumulated other comprehensive loss	(1,716)	—	—	(1,716)
Unearned compensation	(3,930)	(11,093)(1)	—	(15,023)
Note receivable from sale of common stock	(17,214)	17,214 (1)	—	—
Total shareholders' equity	695,367	27,483	582	723,432
Total liabilities and shareholders' equity	<u>\$ 973,007</u>	<u>\$ 17,329</u>	<u>\$ (389)</u>	<u>\$ 989,947</u>

- (1) Stock option related adjustments.
- (2) Other non-stock option related adjustments.
- (3) Tax effect of all restatement adjustments.
- (4) Represents adjustments related to the retrospective adoption of a change in accounting for planned major maintenance activities on our corporate aircraft. See Note 1 above.

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**QUEST SOFTWARE, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**CONSOLIDATED INCOME STATEMENTS**  
**(In thousands, except per share data)**

	Year Ended December 31, 2005			
	As Previously Reported	Adjustments		As Restated
<b>Revenues:</b>				
Licenses	\$ 260,349	\$ (4,218)	\$ —	\$ 256,131
Services	216,033	(160)	—	215,873
Total revenues	476,382	(4,378)	—	472,004
<b>Cost of revenues:</b>				
Licenses (1)	5,004	1	—	5,005
Services (1)	38,128	253	—	38,381
Amortization of purchased technology	10,910	566	—	11,476
Total cost of revenues	54,042	820	—	54,862
Gross profit	422,340	(5,198)	—	417,142
<b>Operating expenses:</b>				
Sales and marketing (1)	200,335	3,516	—	203,851
Research and development (1)	87,876	1,202	—	89,078
General and administrative (1)	45,034	3,440	—	48,474
Amortization of other purchased intangible assets	7,179	—	—	7,179
In-process research and development	7,840	—	—	7,840
Litigation loss provision	—	—	—	—
Total operating expenses	348,264	8,158	—	356,422
Gain on sale of Vista Plus product suite (2)	—	—	39	39
Income from operations	74,076	(13,356)	39	60,759
Other income (expense), net	(1,634)	137	451(3)	(1,046)
Income before income tax provision	72,442	(13,219)	490	59,713
Income tax provision	30,644	(3,582)	195	27,257
Net income	\$ 41,798	\$ (9,637)	\$ 295	\$ 32,456
Basic net income per share	\$ 0.43	\$ (0.10)	\$ —	\$ 0.33
Diluted net income per share	\$ 0.41	\$ (0.09)	\$ —	\$ 0.32
<b>Weighted-average shares:</b>				
Basic	97,621	—	—	97,621
Diluted	100,770	260	—	101,030
<b>(1) Stock-based compensation and related payroll taxes:</b>				
Cost of licenses	\$ 1	\$ 1	\$ —	\$ 2
Cost of services	197	261	—	458
Sales and marketing	1,374	4,122	—	5,496
Research and development	1,655	1,202	—	2,857
General and administrative	187	3,394	—	3,581
Total stock-based compensation and related payroll taxes	\$ 3,414	\$ 8,980	\$ —	\$ 12,394

(2) The amount previously reported in 2005 was presented within other income (expense), net.

(3) Represents adjustments related to the retrospective adoption of a change in accounting for planned major maintenance activities on our corporate aircraft. See Note 1 above.

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**QUEST SOFTWARE, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

	Year Ended December 31, 2004			
	As Previously Reported	Adjustments		As Restated
<b>Revenues:</b>				
Licenses	\$ 225,032	\$ (385)	\$ —	\$ 224,647
Services	164,431	716	—	165,147
Total revenues	389,463	331	—	389,794
<b>Cost of revenues:</b>				
Licenses (1)	3,958	4	—	3,962
Services (1)	29,646	884	—	30,530
Amortization of purchased technology	8,107	795	—	8,902
Total cost of revenues	41,711	1,683	—	43,394
Gross profit	347,752	(1,352)		346,400
<b>Operating expenses:</b>				
Sales and marketing (1)	170,702	1,436	—	172,138
Research and development (1)	78,305	5,317	—	83,622
General and administrative (1)	36,493	4,649	—	41,142
Amortization of other purchased intangible assets	5,212	—	—	5,212
In-process research and development	6,980	—	—	6,980
Litigation loss provision	16,000	—	—	16,000
Total operating expenses	313,692	11,402	—	325,094
Gain on sale of Vista Plus product suite (2)	29,574	—	—	29,574
Income from operations	63,634	(12,754)	—	50,880
Other income (expense), net	8,976	114	182(3)	9,272
Income before income tax provision	72,610	(12,640)	182	60,152
Income tax provision	25,390	(17,563)	74(3)	7,901
Net income	\$ 47,220	\$ 4,923	\$ 108	\$ 52,251
Basic net income per share	\$ 0.50	\$ 0.05	\$ —	\$ 0.55
Diluted net income per share	\$ 0.48	\$ 0.05	\$ —	\$ 0.53
<b>Weighted-average shares:</b>				
Basic	94,622	—	—	94,622
Diluted	98,158	(317)	—	97,841
<b>(1) Stock-based compensation and related payroll taxes:</b>				
Cost of licenses	\$ —	\$ 4	\$ —	\$ 4
Cost of services	190	884	—	1,074
Sales and marketing	1,409	1,532	—	2,941
Research and development	570	5,317	—	5,887
General and administrative	41	4,644	—	4,685
Total stock-based compensation and related payroll taxes	\$ 2,210	\$ 12,381	\$ —	\$ 14,591

(2) The amount previously reported in 2005 was disclosed within other income (expense), net.

(3) Represents adjustments related to the retrospective adoption of a change in accounting for planned major maintenance activities on our corporate aircraft. See Note 1 above.

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**QUEST SOFTWARE, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**CONSOLIDATED STATEMENTS OF CASH FLOWS**  
**(In thousands)**

	Year Ended December 31, 2005			
	As Previously Reported	Adjustments		As Restated
<b>Cash flows from operating activities:</b>				
Net income	\$ 41,798	\$ (9,637)(1-3)	\$ 295 (4)	\$ 32,456
Adjustments to reconcile net income to net cash provided by operating activities:				
Depreciation and amortization	30,734	343 (2)	—	31,077
Compensation expense associated with stock option grants	2,930	9,869 (1)	—	12,799
Deferred income taxes	(1,251)	(2,621)(3)	195 (4)	(3,677)
Gain on sale of Vista Plus product suite	(39)	—	—	(39)
Loss on disposition of property and equipment	—	293 (5)	—	293
Tax benefit related to stock option exercises	7,810	8 (3)	—	7,818
Provision for bad debts	264	1 (2)	—	265
In-process research and development	7,840	—	—	7,840
Litigation loss provision	—	—	—	—
Changes in operating assets and liabilities, net of effects of acquisitions:				
Accounts receivable	(20,519)	4,242 (2)	—	(16,277)
Prepaid expenses and other current assets	(5,616)	(51)(2)	—	(5,667)
Other assets	(1,468)	—	—	(1,468)
Accounts payable	(1,045)	—	—	(1,045)
Accrued compensation	4,879	(1,452)(2)	—	3,427
Other accrued expenses	2,590	(41)(2)	(490)(4)	2,059
Litigation settlement payment	(16,000)	—	—	(16,000)
Income taxes payable	6,373	(969)(3)	—	5,404
Deferred revenue	43,976	11 (2)	—	43,987
Other liabilities	(1,343)	1 (2)	—	(1,342)
Net cash provided by operating activities	101,913	(3)	—	101,910
<b>Cash flows from investing activities:</b>				
Purchases of property and equipment	(41,109)	—	—	(41,109)
Cash paid for acquisitions, net of cash acquired	(120,621)	—	—	(120,621)
Proceeds from sale of Vista Plus product suite	2,039	—	—	2,039
Purchases of marketable securities	—	—	—	—
Sales and maturities of marketable securities	56,272	—	—	56,272
Net cash used in investing activities	(103,419)	—	—	(103,419)
<b>Cash flows from financing activities:</b>				
Proceeds from repurchase agreement	10,008	—	—	10,008
Repayment of repurchase agreement	(22,896)	—	—	(22,896)
Repayment of notes payable	(51)	—	—	(51)
Repayment of capital lease obligations	(324)	—	—	(324)
Proceeds from the exercise of stock options	13,295	—	—	13,295
Proceeds from employee stock purchase plan	—	—	—	—
Net cash provided by financing activities	32	—	—	32
Effect of exchange rate changes on cash and cash equivalents	4,342	—	—	4,342
Net increase in cash and cash equivalents	2,868	(3)	—	2,865
Cash and cash equivalents, beginning of period	118,157	3	—	118,160
Cash and cash equivalents, end of period	<u>\$ 121,025</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ 121,025</u>
Supplemental disclosures of consolidated cash flow information:				
Cash paid for interest	<u>\$ 163</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ 163</u>
Cash paid for income taxes	<u>\$ 17,684</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ 17,684</u>
Supplemental schedule of non-cash investing and financing activities:				
Unrealized loss on marketable securities	<u>\$ (940)</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ (940)</u>
Fair value of stock options and common stock issued in connection with acquisitions	<u>\$ —</u>	<u>\$ —</u>	<u>\$ 34,884 (6)</u>	<u>\$ 34,884</u>

(1) Stock option related adjustments.

(2) Other non-stock option related adjustments.

(3) Tax effect of all restatement adjustments.

(4) Represents adjustments related to the retrospective adoption of a change in accounting for planned major maintenance activities on our corporate aircraft. See Note 1 above.

- (5) The amount previously reported in 2005 was disclosed within depreciation and amortization.
- (6) Not previously disclosed.

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**QUEST SOFTWARE, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

	Year Ended December 31, 2004			
	As Previously Reported	Adjustments		As Restated
<b>Cash flows from operating activities:</b>				
Net income	\$ 47,220	\$ 4,923 (1-3)	\$ 108 (4)	\$ 52,251
Adjustments to reconcile net income to net cash provided by operating activities:				
Depreciation and amortization	26,420	474 (2)	—	26894
Compensation expense associated with stock option grants	1,778	19,814 (1)	—	21,592
Deferred income taxes	7,314	(17,827)(3)	74 (4)	(10,439)
Gain on sale of Vista Plus product suite	(29,574)	—	—	(29,574)
Loss on disposition of property and equipment	—	322 (5)	—	322
Tax benefit related to stock option exercises	3,909	927 (3)	—	4,836
Provision for bad debts	236	4 (2)	—	240
In-process research and development	6,980	—	—	6,980
Litigation loss provision	16,000	—	—	16,000
Changes in operating assets and liabilities, net of effects of acquisitions:				
Accounts receivable	(34,290)	276 (2)	—	(34,014)
Prepaid expenses and other current assets	(1,472)	—	—	(1,472)
Other assets	3,870	—	—	3,870
Accounts payable	(829)	—	—	(829)
Accrued compensation	7,747	(7,529)(2)	—	218
Other accrued expenses	(3,285)	(3)	(182)(4)	(3,470)
Income taxes payable	2,619	(663)(3)	—	1,956
Deferred revenue	41,371	(715)(2)	—	40,656
Other liabilities	92	—	—	92
Net cash provided by operating activities	96,106	3	—	96,109
<b>Cash flows from investing activities:</b>				
Purchases of property and equipment	(31,873)	—	—	(31,873)
Cash paid for acquisitions, net of cash acquired	(96,733)	—	—	(96,733)
Proceeds from sale of Vista Plus product suite	22,515	—	—	22,515
Purchases of marketable securities	(10,001)	—	—	(10,001)
Sales and maturities of marketable securities	40,446	—	—	40,446
Net cash used in investing activities	(75,646)	—	—	(75,646)
<b>Cash flows from financing activities:</b>				
Proceeds from repurchase agreement	67,581	—	—	67,581
Repayment of repurchase agreement	(55,492)	—	—	(55,492)
Repayment of notes payable	(769)	—	—	(769)
Repayment of capital lease obligations	(400)	—	—	(400)
Proceeds from the exercise of stock options	16,704	—	—	16,704
Proceeds from employee stock purchase plan	4,797	—	—	4,797
Net cash provided by financing activities	32,421	—	—	32,421
Effect of exchange rate changes on cash and cash equivalents	(2,194)	—	—	(2,194)
Net increase in cash and cash equivalents	50,687	3	—	50,690
Cash and cash equivalents, beginning of period	67,470	—	—	67,470
Cash and cash equivalents, end of period	\$ 118,157	\$ 3	\$ —	\$ 118,160
<b>Supplemental disclosures of consolidated cash flow information:</b>				
Cash paid for interest	\$ 53	\$ —	\$ —	\$ 53
Cash paid for income taxes	\$ 5,868	\$ —	\$ —	\$ 5,868
<b>Supplemental schedule of non-cash investing and financing activities:</b>				
Unrealized loss on marketable securities	\$ (1,036)	\$ —	\$ —	\$ (1,036)
Fair value of stock options issued in connection with an acquisition	\$ —	\$ —	\$ 13,372 (6)	\$ 13,372

- (1) Stock option related adjustments.
- (2) Other non-stock option related adjustments.
- (3) Tax effect of all restatement adjustments.
- (4) Represents adjustments related to the retrospective adoption of a change in accounting for planned major maintenance activities on our corporate aircraft. See Note 1 above.
- (5) The amount previously reported in 2004 was disclosed within depreciation and amortization.
- (6) Not previously disclosed.

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**QUEST SOFTWARE, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**3. Marketable Securities**

The following table summarizes our portfolio of marketable securities (in thousands):

<u>December 31, 2006</u>	<u>Amortized Cost</u>	<u>Net Unrealized Gains</u>	<u>Net Unrealized Losses</u>	<u>Estimated Fair Value</u>
Due in one year or less:				
U.S. government agencies	\$ 20,000	\$ —	\$ (102)	\$ 19,898
Other	60,214	—	—	60,214
Due in one to five years:				
U.S. government agencies	—	—	—	—
U.S. government agency mortgage-backed securities	24,687	—	(803)	23,884
Total	<u>\$ 104,901</u>	<u>\$ —</u>	<u>\$ (905)</u>	<u>\$ 103,996</u>
Reported As:				
Short-term marketable securities				\$ 80,112
Long-term marketable securities				23,884
Total				<u>\$ 103,996</u>

<u>December 31, 2005</u>	<u>Amortized Cost</u>	<u>Net Unrealized Gains</u>	<u>Net Unrealized Losses</u>	<u>Estimated Fair Value</u>
Due in one year or less:				
U.S. government agencies	\$ 74,999	\$ —	\$ (729)	\$ 74,270
Other	128	—	—	128
Due in one to five years:				
U.S. government agencies	20,000	—	(265)	19,735
U.S. government agency mortgage-backed securities	28,525	—	(722)	27,803
Total	<u>\$ 123,652</u>	<u>\$ —</u>	<u>\$ (1,716)</u>	<u>\$ 121,936</u>
Reported As:				
Short-term marketable securities				\$ 74,398
Long-term marketable securities				47,538
Total				<u>\$ 121,936</u>

The following table summarizes the fair value and gross unrealized losses for our portfolio of marketable securities, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, at December 31, 2006 (in thousands):

	<u>Less than 12 months</u>		<u>12 months or longer</u>		<u>Total</u>	
	<u>Estimated Fair Value</u>	<u>Gross Unrealized Losses</u>	<u>Estimated Fair Value</u>	<u>Gross Unrealized Losses</u>	<u>Estimated Fair Value</u>	<u>Gross Unrealized Losses</u>
U.S. government agencies	\$ —	\$ —	\$ 19,898	\$ (159)	\$ 19,898	\$ (159)
U.S. government agency mortgage-backed securities	—	—	23,884	(1,255)	23,884	(1,255)
Total	<u>\$ —</u>	<u>\$ —</u>	<u>\$ 43,782</u>	<u>\$ (1,414)</u>	<u>\$ 43,782</u>	<u>\$ (1,414)</u>

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**QUEST SOFTWARE, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Our investments in marketable securities consist primarily of investment-grade bonds and United States government and agency securities. Unrealized losses from these investments are primarily attributable to changes in interest rates. We do not believe any unrealized losses represent other-than-temporary impairments based on our evaluation of available evidence as of these dates. We have the intention and ability to hold such securities until the maturity dates.

Interest income, included in other income (expense), net in the accompanying consolidated income statements, was \$11.2 million, \$6.8 million and \$7.3 million for the years ended December 31, 2006, 2005 and 2004, respectively.

**4. Cost Method Investments**

We made minority equity investments, totaling \$3.8 million in three early stage private companies for business and strategic purposes during the twelve months ended December 31, 2006. These investments were accounted for under the cost method, as the equity securities do not have a readily determined market value and we do not have the ability to exercise significant influence. Our investments in non-consolidated companies are included in other assets in our consolidated balance sheet at December 31, 2006 and 2005 and were valued at \$5.7 million and \$1.8 million, respectively.

**5. Acquisitions and Disposition**

**2006 Acquisitions**

We completed two acquisitions, both of which have been fully consolidated, during the year ended December 31, 2006. The aggregate consideration paid for these transactions totaled \$17.6 million paid in cash, including \$0.6 million of transaction costs, and was allocated as follows: \$13.7 million to goodwill, \$3.6 million to amortizing intangible assets, \$1.0 million to In Process Research and Development ("IPR&D"), and \$0.7 million to assumed liabilities, net of tangible assets acquired. Actual results of operations of these acquisitions are included in our consolidated financial statements from the effective dates of the acquisitions.

The following represents the aggregate allocation of the purchase price for the two companies to amortizing intangible assets and IPR&D (table in thousands):

Acquired technology (weighted average useful life of 3 years)	\$ 3,120
Customer relationships (weighted average useful life of 4.8 years)	340
Non-compete agreements (weighted average useful life of 2.6 years)	90
Acquired IPR&D	960
Total amortizing intangible assets and IPR&D	<u>\$ 4,510</u>

The amount allocated to IPR&D was written off at the respective dates of acquisition because the IPR&D had no alternative uses and had not reached technological feasibility. The value assigned to IPR&D was determined utilizing the income approach by determining cash flow projections relating to identified IPR&D projects. The stage of completion of each in-process project was estimated to determine the discount rates to be applied to the valuation of the in-process technology. Based upon the level of completion and the risk associated with in-process technology, we applied discount rates that ranged from 28.4% to 33.0% to value the IPR&D projects acquired.

The pro forma effects of these acquisitions in 2006 would not have been material to our results of operations for fiscal 2006, 2005 or 2004 and therefore are not included in the pro forma table below.

**2005 Acquisitions**

***Vintela, Inc.***

In July 2005, we acquired Vintela, a leader in innovative platform integration solutions. The acquisition expands our product portfolio of Windows management solutions to allow existing Microsoft products, such as Active Directory, Windows Group Policy, Systems Management Server (SMS) 2003, and Microsoft Operations Manager (MOM) 2005, to integrate with systems outside the realm of Windows, including Unix, Linux, Java and Mac systems. The total purchase price for Vintela was \$76.5 million which consisted of \$57.5 million in cash paid to acquire the outstanding shares of Vintela, \$18.5 million for the fair value of Vintela options assumed and \$0.5 million for transaction costs. In allocating the purchase price based on estimated fair values, we allocated most of the purchase price to goodwill, amortizing intangible assets and IPR&D (expensed immediately upon completion of the acquisition). Actual results of operations of Vintela are included in our consolidated financial statements from July 8, 2005, the effective date of this acquisition.

In connection with this acquisition, \$6.8 million was allocated to IPR&D and expensed immediately upon completion of the acquisition (as a charge not deductible for tax purposes), because the technological feasibility of products under development had not been established and no future alternative uses existed. At December 31, 2006, all projects originally identified as IPR&D were 100% complete.

**QUEST SOFTWARE, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

***Imceda Software, Inc.***

In May 2005, we acquired Imceda, a leader in database administration products for SQL Server databases. The acquisition expands our product portfolio to include backup and recovery solutions and enables us to offer one of the most comprehensive product sets for the growing SQL Server database market. The total purchase price for Imceda was \$63.7 million which consisted of \$46.5 million in cash paid to acquire the outstanding shares of Imceda, 942,855 shares of Quest common stock valued at \$12.4 million, \$4.0 million for the fair value of Imceda options assumed and \$0.8 million for transaction costs. In allocating the purchase price based on estimated fair values, we allocated most of the purchase price to goodwill and amortizing intangible assets. Actual results of operations of Imceda are included in our consolidated financial statements from May 20, 2005, the effective date of this acquisition.

***Wingra Technologies, LLC***

In January 2005, we acquired Wingra, a provider of messaging integration and migration solutions. The purchase price for the transaction, consisting primarily of cash, totaled \$13.1 million, and was allocated primarily to goodwill, amortizing intangible assets and IPR&D (expensed immediately upon completion of the acquisition). Actual results of operations of Wingra are included in our consolidated financial statements from January 18, 2005, the effective date of this acquisition.

In connection with this acquisition, \$1.1 million was allocated to IPR&D and expensed immediately upon completion of the acquisition (as a charge not deductible for tax purposes), because the technological feasibility of products under development had not been established and no future alternative uses existed. At December 31, 2006, all projects identified as IPR&D were 100% complete.

***Other Acquisitions***

During December 2005, we acquired a 75% equity interest in Vizioncore, Inc. ("Vizioncore"), a privately-owned software company, for approximately \$4.1 million in cash and substantially all of the assets of another software company for \$2.0 million in cash, both fully consolidated for accounting purposes. The aggregate consideration paid for these transactions were allocated primarily to goodwill and amortizing intangible assets. We also recorded a minority interest representing the equity of Vizioncore we did not acquire, which is classified in other long-term liabilities on our consolidated balance sheet with a carrying amount of \$1.1 as of December 31, 2006. With our investment in Vizioncore we obtained a right to acquire the remaining 25% equity interest in the entity for a purchase price to be determined by a formula, and agreed to a put option under which we may be required, in certain circumstances, to acquire the remaining equity interests in this entity for consideration to be determined by a formula. As the formula approximates fair value as of December 31, 2006, no amount has been recorded related to this put option. As of December 31, 2006, our maximum contingent liability under this put option is not determinable. Actual results of operations of both our investment in Vizioncore and our other acquisition are included in our consolidated financial statements from the effective date of the investment and acquisition. The minority interest in Vizioncore's net income (loss) is reflected as an adjustment to other income (expense), net.

The pro forma effects of all acquisitions in 2005 would not have been material to our results of operations for fiscal 2005 or 2004 and therefore are not included in the pro forma table below.

**2004 Acquisitions and Disposition**

***Disposition of Vista Plus***

In September 2004, pursuant to an Asset Purchase Agreement with Open Text Corporation ("Open Text"), we sold our Vista Plus output management product line and related assets and certain customer support obligations to Open Text for approximately \$24.5 million in cash. The decision to sell this line of products was made because the products did not fit in with our primary product portfolio focus, which is to provide solutions for application, database and Windows management. The sale of Vista was considered a sale of assets because the product line was not a separate component of Quest with clearly distinguished operations and cash flows apart from the rest of the entity. The assets sold primarily consisted of intellectual property, a customer list, contracts, certain receivables and fixed assets. Open Text also assumed certain customer support obligations of the Vista Plus output management product line. The sale resulted in a pretax gain of \$29.6 million.

***Acquisition of Aelita Software Corporation***

In March 2004, we acquired Aelita Software Corporation ("Aelita"), a leading provider of systems management solutions for Microsoft Active Directory and Microsoft Exchange products. The acquisition expanded our product portfolio of solutions to simplify, automate and secure increasingly complex Microsoft infrastructures. The total purchase price for Aelita was \$117.3 million which consisted of \$102.0 million in cash paid to acquire the outstanding shares of Aelita, \$13.4 million for the fair value of Aelita options assumed and \$1.9 million for transaction costs. In allocating the purchase price based on estimated fair values, we allocated most of the purchase price to goodwill, amortizing intangible assets and IPR&D (expensed immediately upon completion of the acquisition). Actual results of operations of Aelita are included in our consolidated financial statements from March 17, 2004, the effective date of this acquisition.

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**QUEST SOFTWARE, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

*Other Acquisitions*

We completed other immaterial acquisitions during the year ended December 31, 2004, all of which have been fully consolidated. The aggregate purchase price for these transactions consisting primarily of cash totaled \$4.0 million, and was allocated primarily to goodwill and amortizing intangible assets. The pro forma effects of these acquisitions would not have been material to our results of operations for fiscal 2004 and therefore are not included in the pro forma table below. Actual results of operations of other acquisitions are included in our consolidated financial statements from the effective date of the acquisitions.

**Pro Forma Disclosures**

Actual results of operations of Aelita are included in our consolidated financial statements from March 17, 2004, the effective date of this acquisition. The unaudited financial information in the table below summarizes the combined results of operations of Quest and Aelita, on a pro forma basis, as though the companies had been combined as of the beginning of the period presented, and combines the historical results for Quest for the twelve months ended December 31, 2004 and Aelita's historical results for the period from January 1, 2004 to March 17, 2004. The pro forma financial information includes amortization of identified intangibles and unearned compensation charges of \$1.6 million and \$0.4 million, respectively, that we would have recognized had the Aelita acquisition closed on January 1, 2004. The pro forma data is presented for informational purposes only and we believe is not indicative of the results of future operations nor of the actual results that would have been achieved had the acquisition taken place at the beginning of the period presented (in thousands, except per share data):

	Twelve Months Ended December 31, 2004		
	As Reported	Adjustments	Pro Forma
Revenues	\$ 389,794	\$ 6,546	\$ 396,340
Net income	\$ 52,251	\$ (4,209)	\$ 48,042
Net income per share:			
Basic	\$ 0.55	\$ (0.04)	\$ 0.51
Diluted	\$ 0.53	\$ (0.04)	\$ 0.49

**6. Goodwill and Amortizing Intangible Assets**

Amortizing intangible assets as of December 31, 2006 and 2005, respectively, are comprised of the following (in thousands):

	2006			2005		
	Gross Carrying Amount	Accumulated Amortization	Net	Gross Carrying Amount	Accumulated Amortization	Net
Acquired technology	\$ 95,351	\$ (63,291)	\$ 32,060	\$ 92,569	\$ (47,358)	\$ 45,211
Customer relationships	21,411	(13,677)	7,734	21,071	(11,273)	9,798
Existing maintenance contracts	4,020	(1,981)	2,039	3,970	(1,201)	2,769
Non-compete agreements	10,215	(6,908)	3,307	10,175	(4,473)	5,702
Trademarks	5,970	(2,974)	2,996	5,970	(1,835)	4,135
	<u>\$ 136,967</u>	<u>\$ (88,831)</u>	<u>\$ 48,136</u>	<u>\$ 133,755</u>	<u>\$ (66,140)</u>	<u>\$ 67,615</u>

Amortization expense for amortizing intangible assets was \$22.7 million, \$18.7 million and \$14.1 million for the twelve months ended December 31, 2006, 2005 and 2004, respectively. Estimated annual amortization expense related to amortizing intangible assets reflected on our December 31, 2006 balance sheet is as follows (in thousands):

	Estimated Annual Amortization Expense
2007	\$ 18,053
2008	15,123
2009	8,797
2010	4,321
2011 and thereafter	1,842
	<u>\$ 48,136</u>

All intangible assets reflected on our December 31, 2006 balance sheet are expected to be fully amortized by the end of 2012.

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**QUEST SOFTWARE, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The changes in the carrying amount of goodwill by reportable operating segment for the year ended December 31, 2005 are as follows (in thousands):

	Licenses	Services	Total
Balance as of December 31, 2004	\$ 246,044	\$ 75,162	\$ 321,206
Acquisitions	90,467	22,617	113,084
Adjustments (1)	(3,335)	(1,006)	(4,341)
Balance as of December 31, 2005	333,176	96,773	429,949
Acquisitions	10,772	2,687	13,459
Adjustments (1)	1,270	381	1,651
Balance as of December 31, 2006	<u>\$ 345,218</u>	<u>\$ 99,841</u>	<u>\$ 445,059</u>

- (1) Tax related adjustments to the preliminary purchase price allocations for various acquisitions.

**7. Property and Equipment**

Net property and equipment consist of the following at December 31 (in thousands):

	2006	2005
Building	\$ 38,918	\$ 38,647
Furniture and fixtures	14,320	13,089
Machinery and equipment (1)	4,231	22,368
Computer equipment	36,464	33,061
Computer software	28,736	23,974
Leasehold improvements	10,414	5,774
Land	11,156	11,125
	144,239	148,038
Less accumulated depreciation and amortization	(68,422)	(64,994)
Property and equipment, net	<u>\$ 75,817</u>	<u>\$ 83,044</u>

- (1) In November 2006, we completed the sale of our corporate aircraft to a third party for \$15.6 million in cash, net of \$0.3 million in transaction fees. The sale resulted in a pretax gain of \$4.0 million.

Total depreciation and amortization expense related to property and equipment was \$13.9 million and \$12.1 million in 2006 and 2005, respectively.

**8. Related Party Transactions**

In August 2007 we acquired ScriptLogic Corporation (“ScriptLogic”). See Note 15 below. Certain venture capital funds associated with Insight Venture Partners (the “Insight Funds”) previously holding shares of ScriptLogic’s preferred stock became entitled to receive (in respect of those shares of preferred stock) cash in an aggregate amount of up to approximately \$37.7 million (subject to claims against an indemnity escrow fund).

On May 20, 2005, we acquired Imceda. See Note 4 above. Certain venture capital funds associated with Insight Venture Partners (the “Insight Funds”) previously holding shares of Imceda’s preferred stock became entitled to receive cash and (subject to claims against an indemnity escrow fund) shares of Quest common stock representing an aggregate value of approximately \$48.0 million in respect of those shares of preferred stock as a result of this acquisition.

Jerry Murdock, a director of Quest Software, is a Managing Director and the co-founder of Insight Venture Partners and an investor in the Insight Funds. Vincent C. Smith, Quest’s Chairman of the Board and CEO, and Raymond J. Lane and Paul A. Sallaberry, directors of Quest Software, are passive limited partners in one or more of the Insight Funds. As a result of their interests in the Insight Funds, Messrs. Murdock, Smith, Lane and Sallaberry have interests in the Imceda and ScriptLogic transactions. We believe that the financial interests of Messrs. Smith, Lane and Sallaberry in these transactions are not material to them.

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**QUEST SOFTWARE, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

On March 17, 2004, we acquired Aelita. See Note 5 above. Certain venture capital funds associated with Insight Venture Partners (the "Insight Funds") previously holding shares of Aelita's preferred stock became entitled to receive (subject to claims against an indemnity escrow fund) approximately \$47.6 million in cash in respect of those shares of preferred stock as a result of this acquisition.

In 2000, we received a note receivable with a face amount of \$15.8 million from one of our then executive officers for the purchase of 339,200 shares of our common stock at a purchase price of \$46.50 per share. The former officer granted Quest a security interest in the shares and also assigned, transferred, and pledged the shares to Quest in order to secure his obligations under the Note. The Company maintains physical possession of the certificates representing the shares purchased as collateral until payment of the principal and interest under the note is made. The former officer remained employed by Quest as of December 31, 2006. The maturity date of the note receivable is August 2007, when the principal amount and accrued interest become due and payable. The note receivable bears interest at 6.33% per annum. We intend to pursue collection. The note receivable was deemed to be a non-recourse obligation of the former officer for financial reporting purposes and as such we recorded the note as a reduction to shareholders' equity in accordance with Emerging Issues Task Force Issue No. 85-1, *Classifying Notes Received for Capital Stock*, and recorded a corresponding credit to common stock. As part of our restatement, discussed in Note 2, we reduced the carrying value of the note receivable for interest income incorrectly recorded in other income (expense), net of \$0.4 million and \$1.0 million in 2000 and 2001, respectively, and we reclassified the face amount of the note to common stock on our accompanying consolidated balance sheet.

We believe that all of the transactions set forth above were made on terms no less favorable to us than could have been otherwise obtained from unaffiliated third parties.

### 9. Obligation Under Repurchase Agreement

We entered into a repurchase agreement in March 2004, utilizing \$67.6 million of our investment securities as collateral. The cash proceeds of this transaction were used to provide funding for our acquisition of Aelita and our purchase of a new office facility. Our remaining obligation under this agreement of \$12.7 million was paid in full in February 2005. In July 2005 we entered into another repurchase agreement utilizing \$10.4 million of our investment securities as collateral. The cash proceeds of this transaction were used to provide funding for our acquisition of Vintela. Our remaining obligation under this agreement of \$10.1 million was paid in full in December 2005.

### 10. Income Taxes

The provision for income taxes consists of the following for the years ended December 31 (in thousands):

	2006	2005	2004
Current:			
Federal	\$ 26,299	\$ 22,203	\$ 5,226
State	2,954	6,003	787
Foreign	6,556	4,058	7,165
Deferred:			
Federal	(10,328)	2,047	(5,293)
State	(1,551)	(4,524)	(2,265)
Foreign	(7,260)	(2,530)	2,281
Total income tax provision	<u>\$ 16,670</u>	<u>\$ 27,257</u>	<u>\$ 7,901</u>

The reconciliation of the U.S. federal statutory rate to the effective income tax rate for the years ended December 31, 2006, 2005 and 2004, is as follows:

	2006	2005	2004
Tax provision at U.S. federal statutory rates	35.0%	35.0%	35.0%
State taxes	3.1	2.9	0.5
Foreign taxes and foreign losses with tax benefit	(15.7)	(3.0)	(17.0)
Repatriation of foreign earnings	—	4.9	—
Research and development credits	(2.2)	(1.3)	(1.5)
In-process research and development	—	4.0	4.1
Other	1.8	3.1	(8.0)
	<u>22.0%</u>	<u>45.6%</u>	<u>13.1%</u>

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**QUEST SOFTWARE, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Deferred income taxes reflect the net tax effect of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. Significant components of our deferred taxes as of December 31, 2006 and 2005 are as follows (in thousands):

	2006	2005
Deferred tax assets:		
Accounts receivable and sales returns reserves	\$ 4,635	\$ 3,061
Accrued liabilities	4,485	6,671
Foreign net operating loss carry-forwards	22,916	14,989
U.S. net operating loss carry-forwards	4,262	6,229
Stock compensation	22,654	30,707
Tax credits	17,486	15,978
Other	2,902	5,473
Total gross deferred assets	79,340	83,108
Deferred tax liabilities:		
Intangibles	(12,832)	(20,389)
State taxes	(3,954)	(3,076)
Fixed assets	965	(4,792)
Total gross deferred liabilities	(15,821)	(28,257)
Valuation allowance	(20,040)	(15,881)
Net deferred income taxes	43,479	38,970
Less current portion	(9,800)	(12,295)
Non-current portion	<u>\$ 33,679</u>	<u>\$ 26,675</u>

At December 31, 2006, our valuation allowance was approximately \$20.0 million on certain of our deferred tax assets. Based on the weight of available evidence, we believe that it is more likely than not that these deferred tax assets will not be realized. The change in valuation allowance primarily relates to an increase in foreign net operating losses.

At December 31, 2006, we have estimated net operating losses of approximately \$4.6 million related to subsidiaries acquired during 2005. Additionally, we have certain federal net operating losses of approximately \$5.3 million related to an acquired subsidiary that, as a result of federal consolidation rules, are not available to offset current or future income of our other U.S. entities. At December 31, 2006, we also had foreign net operating loss carry-forwards of approximately \$66.9 million, which begin to expire in 2007. Approximately \$18.9 million of the federal and foreign net operating loss carry-forwards were incurred by subsidiaries prior to the date of our acquisition of such subsidiaries. We established a valuation allowance of approximately \$3.8 million at the date of acquisitions related to these subsidiaries. Accordingly, the tax benefits associated with the realization of such net operating losses will be credited to goodwill if realized.

At December 31, 2006 we had state tax credit carry-forwards of \$8.8 million, which carry-forward indefinitely until utilized.

During the current year, we realized tax benefits of \$4.7 million from the exercise of stock options. That amount was allocated and credited to the following items:

Shareholders' equity	\$ 707
Goodwill	689
Deferred income tax asset	3,107
Income tax provision	242
Total	<u>\$ 4,745</u>

Income before income taxes consists of the following components (in thousands):

	2006	2005	2004
United States	\$ 48,078	\$ 38,514	\$ 22,501
Foreign	27,577	21,199	37,651
Total	<u>\$ 75,655</u>	<u>\$ 59,713</u>	<u>\$ 60,152</u>

**QUEST SOFTWARE, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

At December 31, 2006, we had not provided for U.S. income taxes or foreign withholding taxes on undistributed earnings from continuing operations of subsidiaries operating outside of the United States. Undistributed earnings of our foreign subsidiaries were approximately \$101.1 million as of the year ended December 31, 2006. Such undistributed earnings are considered permanently reinvested.

Our U.S. and foreign tax returns are subject to routine compliance reviews by the various tax authorities. Although we believe we have appropriate support for the positions taken on our tax returns, our income tax expense includes amounts intended to satisfy income tax assessments that could result from the examination of our tax returns. Determining the income tax expense for such contingencies requires a significant amount of judgment and estimation. We evaluate such tax contingencies in accordance with the requirements of SFAS No. 5, *Accounting for Contingencies*, and have accrued for income tax contingencies that meet both the probable and estimable criteria of SFAS No. 5. These estimates are updated over time as more definitive information becomes available from taxing authorities, completion of tax audits, expiration of statutes of limitation, or upon occurrence of other events. The amounts ultimately paid upon resolution of such contingencies could be materially different from the amounts previously included in our income tax expense and therefore could have a material impact on our consolidated results of operations. The tax contingency accrual is recorded as a component of our net income taxes payable/receivable balance.

In July 2006, the FASB issued Interpretation No. 48 (“FIN 48”), *Accounting for Uncertainty in Income Taxes*. This Interpretation clarifies the accounting for uncertainty in income taxes recognized in an enterprise’s financial statements in accordance with SFAS No. 109, *Accounting for Income Taxes*. FIN 48 defines a recognition threshold and measurement attribute for financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return, and also provides guidance on de-recognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. FIN 48 is effective for fiscal years beginning after December 15, 2006 and as a result, is effective for us in the first quarter of 2007. We are currently assessing the potential effect if any of implementing this standard.

**11. Employee Benefit Plans**

**Stock Option Plans**

We have authorized the issuance of an aggregate of 38.5 million shares of common stock to employees, directors and consultants under the Quest Software, Inc. 1999 Stock Incentive Plan, as amended (the “1999 Plan”) and the Quest Software, Inc. 2001 Stock Incentive Plan (the “2001 Plan” and, together with the 1999 Plan, the “Plans”). Non-qualified stock options granted under the Plans generally have a 10-year life and vest ratably over a four to five year period, generally at the rate of 20% one year after the grant date and 10% semi-annually thereafter. The exercise price of all options granted under the Plans is to be established by the Plan Administrator. The Plan Administrator for the Plans is the Compensation Committee of the Board of Directors, with certain authority delegated to a secondary committee pursuant to the terms of the Plans. As of December 31, 2006, 5.4 million shares were available for grant under the Plans.

A summary of the activity of employee stock options during the year ended December 31, 2006, and details regarding the options outstanding and exercisable at December 31, 2006, are provided below:

	Number of Shares (in thousands)	Weighted-Average Exercise Price (per share)	Weighted-Average Remaining Contractual Term (in years)	Aggregate Intrinsic Value (in thousands) (1)
Outstanding at December 31, 2005	25,773	\$ 13.47		
Granted (2)	564	\$ 14.67		
Exercised	(2,059)	\$ 9.15		
Canceled (2)	(2,730)	\$ 12.64		
Outstanding at December 31, 2006	<u>21,548</u>	\$ 15.05	6.38	\$ 47,927
Vested or expected to vest at December 31, 2006	<u>20,262</u>	\$ 15.14	6.26	\$ 46,345
Exercisable at December 31, 2006	<u>13,657</u>	\$ 16.22	5.51	\$ 34,014

- (1) These amounts represent the difference between the exercise price and \$14.65, the closing price of Quest Software, Inc. stock on December 29, 2006 as reported on the NASDAQ National Market, for all in-the-money options outstanding.
- (2) Excludes the cancellation of options to Section 16 Insiders of the Company that were re-priced (re-granted) as part of our restatement. None of the re-priced options resulted in an incremental stock-based compensation charge as the

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**QUEST SOFTWARE, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

amended exercise price was higher than the original exercise price on all re-granted options. See “*Remedial Actions*” in Note 2 for additional information.

The weighted-average fair value of options granted during the years ended December 31, 2006, 2005 and 2004 was \$8.64, \$8.21 and \$7.32, respectively. The total intrinsic value of options exercised was \$14.3 million, \$25.9 million and \$16.4 million for the years ended December 31, 2006, 2005 and 2004, respectively. The total fair value of options vested during the years ended December 31, 2006, 2005 and 2004 was \$34.0 million, \$64.0 million and \$58.6 million, respectively.

Because we announced our determination to restate our previously issued financial statements and have become delinquent in our periodic reporting obligations under the Securities Exchange Act of 1934, as amended, we determined that we could no longer rely upon the Registration Statements on Form S-8 previously filed with the U.S. Securities Exchange Commission to register the shares of our common stock issuable upon exercise of stock options granted under our various stock option plans. Accordingly, we took action to block exercises of all stock options based on our determination that doing so was necessary to prevent violations of applicable securities law and as a result employees separating from the Company were no longer able to exercise vested options that were in-the-money prior to expiration of the post-separation exercise period provided for by the various Company stock incentive plans. As a result, the Company’s Compensation Committee approved an arrangement whereby the post-separation exercise period would be suspended while the Company’s exercise block remained in effect. Once the exercise block is removed the affected employees would then have 30 days to exercise any vested options. As a result of this modification to extend the life of the affected options, in the fourth quarter of 2006 we recorded incremental stock-based compensation expense of \$1.5 million.

**Employee 401(k) Plan**

We sponsor the Quest Software, Inc. 401(k) Plan (“401(k) Plan”) covering substantially all of our employees. As allowed under Section 401(k) of the Internal Revenue Code, the 401(k) Plan provides tax-deferred salary deductions for eligible employees. Employees may contribute from 1% to 100% of their annual compensation to the 401(k) Plan, limited to a maximum annual amount as set periodically by the Internal Revenue Service. Participant contributions vest immediately, while discretionary matching contributions we make vest ratably over a three-year period. Our discretionary matching contributions to the 401(k) Plan totaled \$1.9 million, \$1.8 million and \$1.5 million for the years ended December 31, 2006, 2005 and 2004, respectively.

**12. Other Income (Expense), Net**

Other income (expense), net consists of the following for the years ended December 31 (in thousands):

	2006	2005	2004
Interest income	\$ 11,162	\$ 6,806	\$ 7,339
Interest expense	(94)	(327)	(648)
Foreign currency gain (loss), net	4,387	(5,577)	3,356
Other expense, net (1)	(2,450)	(1,948)	(775)
Total other income (expense), net	<u>\$ 13,005</u>	<u>\$ (1,046)</u>	<u>\$ 9,272</u>

- (1) Other expense, net includes several other components, of which the majority relates to costs incurred with operating and maintaining our corporate aircraft which was sold in the fourth quarter of 2006. During 2006, we also included adjustments for the minority interest in Vizioncore’s net income (loss), which were not material during the year ended December 31, 2006.

**13. Commitments and Contingencies**

We lease office facilities and certain equipment under various operating leases. A majority of these leases are non-cancelable and obligate us to pay costs of maintenance, utilities, and applicable taxes. The leases on most of the office facilities contain escalation clauses and renewal options. Rental expense is recorded on a straight-line basis over the life of the lease. Total rent expense was \$14.8 million, \$15.1 million and \$15.3 million for the years ended December 31, 2006, 2005 and 2004, respectively.

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**QUEST SOFTWARE, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Minimum lease commitments under non-cancelable operating leases as of December 31, 2006 are as follows (in thousands):

<u>Year ending December 31:</u>	
2007	\$ 12,281
2008	8,389
2009	5,144
2010	3,092
2011	901
Thereafter	2,189
	<u>\$ 31,996</u>

*Securities Litigation.* From June 2006 through August 2006 a number of purported Quest Software shareholders filed putative shareholder derivative actions against the Company, the members of our Board of Directors, and certain current or former officers, alleging, among other things, that the defendants improperly dated certain Quest Software employee stock option grants. Two of these cases, *Eng v. Smith, et al.* (Case No. 06-cv-751 DOC(RNBx)) and *Freedman v. Smith, et al.* (Case No. 06-cv-763 DOC(RNBx)) have been consolidated in the United States District Court for the Central District of California. The plaintiffs filed a consolidated amended complaint in November 2006 and a further amended consolidated complaint in September 2007. In addition, two putative shareholder derivative actions, *Patterson v. Aronoff, et al.* (Case No. 06CC00115) and *Hodge v. Aronoff, et al.* (Case No. 06CC06787), were filed in the California Superior Court for the County of Orange. The state court derivative actions were consolidated in July 2006.

In August 2007, an additional putative shareholder derivative action was filed against the Company (as nominal defendant), the members of our Board of Directors and certain current or former officers, alleging generally that the individual defendants violated United States securities laws by improper stock option grant practices and related accounting and disclosures. This case, *City of Livonia Employees' Retirement System v. Smith, et al.* (Case No. SACV07-901 DOC (ANx)) was also filed in the United States District Court for the Central District of California.

The putative state and federal derivative actions identified above are collectively referred to as the "Options Derivative Actions". The plaintiffs in the Options Derivative Actions contend, among other things, that the defendants' conduct violated United States and California securities laws, breached defendants' fiduciary duties, wasted corporate assets, unjustly enriched the defendants, and caused errors in our financial statements. The plaintiffs seek, among other things, unspecified damages and disgorgement of profits from the alleged conduct, to be paid to the Company.

In November 2007, we entered into a Stipulation of Settlement with the plaintiffs in the Options Derivative Actions, pursuant to which the Options Derivative Actions shall be settled and dismissed with prejudice, subject to approval of the U.S. District Court for the Central District of California, as to the Company and all of its current and former officers and directors. As part of the settlement, the company agreed to adopt certain remedial measures and corporate governance changes, in addition to the actions taken by the Special Committee of the Company's Board arising from the stock option investigation, and the plaintiffs will be entitled to payment of an amount representing their attorneys' fees, which is expected to be provided by the Company's directors' and officers' liability insurance carrier.

In October 2006 a purported shareholder class action was filed in the United States District Court for the Central District of California against Quest Software and certain of its current or former officers and directors, entitled *Middlesex Retirement System v. Quest Software, Inc., et al.* (Case No. CV06-6863 DOC (RNBx)) (the "Options Class Action"). The essence of the plaintiff's allegations in the Options Class Action is that the Company improperly backdated stock options, resulting in false or misleading disclosures concerning, among other things, Quest Software's financial condition. Plaintiffs also allege that the individual defendants sold Quest Software stock while in possession of material nonpublic information, and that the defendants' conduct caused damages to the putative plaintiff class. The plaintiff asserts claims under Sections 10(b), 20(a) and 20A of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated thereunder. In January 2007, the Court appointed Middlesex Retirement System as lead class plaintiff and entered a stipulated order establishing a pleading schedule for the plaintiff's first amended complaint and the defendants' response thereto. The first amended class action complaint was filed with the Court in March 2007. In October 2007, the Court issued its order on the Company's motion to dismiss the amended class action complaint. The Court dismissed the plaintiff's claims under Section 10(b) with respect to Michael Lambert, the Company's former Chief Financial Officer, and the plaintiff's claims under Section 20(a) with respect to the Company and to Doug Garn, the Company's President, which claims have been dismissed without prejudice. The Court also held in abeyance the plaintiff's claims under Section 20A pending plaintiff's filing of an amended complaint, which must be filed by December 1, 2007. Otherwise, the Court denied the Company's motion to dismiss as it related to the Company and other individual defendants. The Company and the individual defendants have filed a motion with the U.S. District Court requesting certification of the Court's order for interlocutory appellate review. The Company intends to defend the Options Class Action vigorously.

**QUEST SOFTWARE, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

*SEC Investigation and United States Attorney's Office Information Request.* In June 2006 the Company received an informal request for information from the staff of the Los Angeles regional office of the Securities and Exchange Commission regarding its option granting practices. In January 2007 the SEC issued a formal order of investigation and a subpoena for the production of documents. The Company is cooperating with the SEC, but does not know when the inquiry and investigation will be resolved or what, if any, actions the SEC may require it to take as part of that resolution. Quest Software has also been informally contacted by the U.S. Attorney's Office for the Central District of California ("U.S. Attorney's Office") and has been asked to produce on a voluntary basis documents many of which it previously provided to the SEC. The Company is fully cooperating with both the SEC and the U.S. Attorney's Office. Any action by the SEC, the U.S. Attorney's Office or other governmental agency could result in civil or criminal sanctions against the Company and/or certain of its current or former officers, directors and/or employees.

*Initial Public Offering Securities Litigation.* In November 2001, the Company, three of its current and former officers ("Individual Defendants") and the underwriters in the Company's initial public offering ("IPO") were named as defendants in a consolidated shareholder lawsuit in the United State District Court for the Southern District of New York. This case is one of a number of actions coordinated for pretrial purposes as In re Initial Public Offering Securities Litigation, 21 MC 92. Plaintiffs in the coordinated proceeding have brought claims under the federal securities laws against approximately 300 companies, underwriters, and individuals, alleging generally that defendant underwriters engaged in improper and undisclosed activities concerning the allocation of shares in the companies' IPOs from late 1998 through 2000. The amended complaint in the Company's case seeks unspecified damages on behalf of a purported class of purchasers of its common stock between August 13, 1999 and December 6, 2000. Pursuant to a tolling agreement, the Court dismissed the Individual Defendants without prejudice. In February 2003, the Court denied the Company's motion to dismiss the claims against it. The issuer defendants and plaintiffs negotiated a stipulation of settlement for the claims against the issuer defendants, including the Company, which was submitted to the Court for approval in June 2004 and preliminarily approved in August 2005. In December 2006, the Court of Appeals for the Second Circuit overturned the certification of classes in the six test cases that were selected by the underwriter defendants and plaintiffs in the coordinated proceeding. Because class certification was a condition of the settlement, it became unlikely that the settlement would receive final court approval. On June 25, 2007, the Court entered an order terminating the proposed settlement based upon a stipulation among the parties to the settlement.

On August 14, 2007, the plaintiffs filed a second amended class action complaint against the Company. The amended complaint contains a number of changes, including changes to the definition of the purported class of investors, and the elimination of the Individual Defendants as defendants. On September 27, 2007, the plaintiffs filed a motion for class certification against the Company. The Company filed a motion to dismiss the claims against it on November 14, 2007. It is uncertain whether the parties will be able to negotiate a revised or future settlement that complies with the standards set forth in the Second Circuit's decision. The Company believes that it has meritorious defenses to the plaintiffs' claims and intends to defend the action vigorously.

*Intellectual Property Litigation.* In December 2006, Diagnostic Systems Corporation ("DSC") filed a complaint for patent infringement against Quest Software, Inc. and five other software companies. The complaint was filed in the United States District Court for the Central District of California, as Case No. SACV06-1211 CJC(ANx). DSC is a subsidiary of Acacia Research Corporation, and asserts that it is the owner by assignment of all rights and interests in U.S. patent nos. 5,701,400 and 5,537,590, and that certain of Quest's software products infringe these two patents. DSC seeks injunctive relief and damages. Quest filed an answer denying infringement on the two patents asserted and asserting various affirmative defenses to DSC's claims. Discovery in this matter is only recently beginning. If any of our products were found to infringe such patents, the patent holder could seek an injunction to enjoin our use of the infringing product. If we were required to settle such a claim, it could have a material impact on our business, results of operations, financial condition or cash flows.

*General.* The Company and its subsidiaries are also involved in other legal proceedings, claims and litigation arising in the ordinary course of business.

In the normal course of our business, we enter into certain types of agreements that require us to indemnify or guarantee the obligations of other parties. These commitments include (i) intellectual property indemnities to licensees of our software products, (ii) indemnities to certain lessors under office space leases for certain claims arising from our use or occupancy of the related premises, or for the obligations of our subsidiaries under leasing arrangements, (iii) indemnities to customers, vendors and service providers for claims based on negligence or willful misconduct of our employees and agents, (iv) indemnities to our directors and officers to the maximum extent permitted under applicable law, and (v) letters of credit and similar obligations as a form of credit support for our international subsidiaries and certain resellers. The terms and duration of these commitments varies and, in some cases, may be indefinite, and certain of these commitments do not limit the maximum amount of future payments we could become obligated to make there under; accordingly, our actual aggregate maximum exposure related to these types of commitments cannot be reasonably estimated. Historically, we have not been obligated to make significant payments for obligations of this nature, and no liabilities have been recorded for these obligations in our financial statements included in this report, as the estimated fair value of these obligations as of December 31, 2006 was considered nominal.

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**QUEST SOFTWARE, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**14. Geographic and Segment Information**

Operating segments are defined as components of an enterprise about which separate financial information is available that is evaluated regularly by our chief operating decision maker, or decision-making group, in assessing performance and deciding how to allocate resources.

Our reportable operating segments are Licenses and Services. The Licenses segment develops and markets licenses to use our software products. The Services segment provides after-sale support for software products and fee-based training and consulting services related to our software products.

We do not separately allocate operating expenses to these segments, nor do we allocate specific assets to these segments. Therefore, segment information reported includes only revenues, cost of revenues, and gross profit.

Reportable segment data for the three years in the period ended December 31, 2006, is as follows (in thousands):

	<u>Licenses</u>	<u>Services</u>	<u>Total</u>
<b>Year ended December 31, 2006:</b>			
Revenues	\$ 290,247	\$ 271,342	\$ 561,589
Cost of revenues	<u>21,502</u>	<u>49,773</u>	<u>71,275</u>
Gross profit	<u>\$ 268,745</u>	<u>\$ 221,569</u>	<u>\$ 490,314</u>
<b>Year ended December 31, 2005:</b>			
Revenues	\$ 256,131	\$ 215,873	\$ 472,004
Cost of revenues	<u>16,481</u>	<u>38,381</u>	<u>54,862</u>
Gross profit	<u>\$ 239,650</u>	<u>\$ 177,492</u>	<u>\$ 417,142</u>
<b>Year ended December 31, 2004:</b>			
Revenues	\$ 224,647	\$ 165,147	\$ 389,794
Cost of revenues	<u>12,864</u>	<u>30,530</u>	<u>43,394</u>
Gross profit	<u>\$ 211,783</u>	<u>\$ 134,617</u>	<u>\$ 346,400</u>

Revenues are attributed to geographic areas based on the location of the entity to which the products or services were delivered. Revenues and long-lived assets concerning principal geographic areas in which we operate are as follows (in thousands):

	<u>United States</u>	<u>United Kingdom</u>	<u>Other International (2)</u>	<u>Total</u>
<b>Year ended December 31, 2006:</b>				
Revenues	\$ 344,932	\$ 70,007	\$ 146,650	\$ 561,589
Long-lived assets (1)	96,189	5,777	8,738	110,704
<b>Year ended December 31, 2005:</b>				
Revenues	\$ 297,211	\$ 61,259	\$ 113,534	\$ 472,004
Long-lived assets (1)	125,660	2,607	7,142	135,409
<b>Year ended December 31, 2004:</b>				
Revenues	\$ 254,141	\$ 52,452	\$ 83,201	\$ 389,794
Long-lived assets (1)	212,574	1,825	5,194	219,593

(1) Excludes amortizing intangible assets, net, goodwill and deferred income taxes.

(2) No single location within Other International accounts for greater than 10% of total revenues.

**QUEST SOFTWARE, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**15. Subsequent Event**

In August 2007 we acquired ScriptLogic Corporation (“ScriptLogic”), a privately held company that provides systems lifecycle management solutions for Windows-based networks, for purchase consideration of approximately \$88.8 million. In connection with the acquisition, Quest also offered key members of the management team of ScriptLogic an opportunity to participate in a post-closing incentive bonus plan in an aggregate amount of up to \$8.0 million payable over a four-year period (the “Incentive Plan”). A portion of the payments under the Incentive Plan will be based on the satisfaction of financial performance objectives along with continued employment and a portion of the payments will be based solely on continued employment. All bonus payments will be recorded as compensation expense in the periods such bonuses are earned. Of the cash amount paid at closing, \$12.0 million was deposited in an escrow account to secure certain indemnification obligations of the selling shareholders. The acquisition will be accounted for as a purchase and the purchase price is expected to be allocated primarily to goodwill and other intangible assets. See Note 8 above.

QUEST SOFTWARE, INC.  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

FINANCIAL STATEMENT SCHEDULE

SCHEDULE II—VALUATION AND QUALIFYING ACCOUNTS

<u>Description</u>	<u>Balance at Beginning of Period</u>	<u>Acquired Balances</u>	<u>Charges, Costs and Expenses</u>	<u>Additions/ Deductions</u>	<u>Balance at End of Period</u>
<b>Year ended December 31, 2006:</b>					
Allowance for bad debt	\$ 1,657	\$ 10	\$ 614	\$ (1,691)	\$ 590
Allowance for sales returns and cancellations	\$ 11,226	\$ 82	\$ (865)	\$ (1,944)	\$ 8,499
<b>Year ended December 31, 2005:</b>					
Allowance for bad debt	\$ 1,576	\$ —	\$ (265)	\$ 346	\$ 1,657
Allowance for sales returns and cancellations	\$ 12,753	\$ 249	\$ 2,433	\$ (4,209)	\$ 11,226
<b>Year ended December 31, 2004:</b>					
Allowance for bad debt	\$ 1,098	\$ —	\$ (239)	\$ 717	\$ 1,576
Allowance for sales returns and cancellations	\$ 8,242	\$ 820	\$ 8,165	\$ (4,474)	\$ 12,753

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**EXHIBIT INDEX**

<b>Exhibit Number</b>	<b>Exhibit Title</b>
3.1	Second Amended and Restated Articles of Incorporation. (1)
3.2	Certificate of Amendment of Articles of Incorporation of Quest Software, Inc. (2)
3.3	Bylaws of Quest Software, Inc. (3)
4.1	Form of Registrant's Specimen Common Stock Certificate. (1)
10.1++	Registrant's 1999 Stock Incentive Plan, as amended.
10.2	Form of Directors' and Officers' Indemnification Agreement. (1)
10.3++	Registrant's 2001 Stock Incentive Plan, as Amended.
10.9++	Form of Stock Option Agreement used under the Registrant's 1999 Stock Incentive Plan. (6)
10.10++	Form of Stock Option Agreement used under the Registrant's 2001 Stock Incentive Plan. (4)
14.1	Code of Ethics. (5)
21.1	Subsidiaries of the Company.
23.1	Consent of Deloitte & Touche LLP.
31.1	Certification of the Chief Executive Officer Pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934, as amended.
31.2	Certification of the Chief Financial Officer Pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934, as amended.
32.1	Certification of Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2	Certification of Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

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(1) Incorporated herein by reference to our Registration Statement on Form S-1 and all amendments thereto (File No. 333-80543).

(2) Incorporated herein by reference to our Quarterly Report on Form 10-Q for the period ended September 30, 2005.

(3) Incorporated herein by reference to our Current Report on Form 8-K filed November 7, 2007.

(4) Incorporated herein by reference to our Registration Statement on Form S-8 (File No. 333-82784) filed on February 14, 2002.

(5) Incorporated herein by reference to our Annual Report on Form 10-K for the year ended December 31, 2003.

(6) Incorporated herein by reference to our Quarterly Report on Form 10-Q for the period ended September 30, 2004.

++ Indicates a management contract or compensatory arrangement.

## QUEST SOFTWARE, INC.

1999 STOCK INCENTIVE PLAN  
(as amended on November 1, 2007)ARTICLE ONE  
GENERAL PROVISIONS**I. PURPOSE OF THE PLAN**

This 1999 Stock Incentive Plan is intended to promote the interests of Quest Software, Inc., a California corporation, by providing eligible persons with the opportunity to acquire a proprietary interest, or otherwise increase their proprietary interest, in the Corporation as an incentive for them to remain in the service of the Corporation.

Capitalized terms shall have the meanings assigned to such terms in the attached Appendix.

**II. STRUCTURE OF THE PLAN**

A. The Plan shall be divided into four separate equity programs:

(i) the Discretionary Option Grant Program under which eligible persons may, at the discretion of the Plan Administrator, be granted options to purchase shares of Common Stock,

(ii) the Stock Issuance Program under which eligible persons may, at the discretion of the Plan Administrator, be issued shares of Common Stock directly, either through the immediate purchase of such shares or as a bonus for services rendered the Corporation (or any Parent or Subsidiary),

(iii) the Automatic Option Grant Program under which eligible non-employee Board members shall automatically receive options at periodic intervals to purchase shares of Common Stock; and

(iv) the Director Fee Option Grant Program under which non-employee Board members may elect to have all or any portion of their annual retainer fee otherwise payable in cash applied to a special option grant.

B. The provisions of Articles One and Six shall apply to all equity programs under the Plan and shall govern the interests of all persons under the Plan.

**III. ADMINISTRATION OF THE PLAN**

A. The following provisions shall govern the administration of the Plan:

(i) The Board shall have the authority to administer the Discretionary Option Grant and Stock Issuance Programs with respect to Section 16 Insiders but may delegate such authority in whole or in part to the Primary Committee.

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(ii) Administration of the Discretionary Option Grant and Stock Issuance Programs with respect to all other persons eligible to participate in those programs may, at the Board's discretion, be vested in the Primary Committee or a Secondary Committee, or the Board may retain the power to administer those programs with respect to all such persons.

(iii) Administration of the Automatic Option Grant Program shall be self-executing in accordance with the terms of that program.

**B.** Each Plan Administrator shall, within the scope of its administrative jurisdiction under the Plan, have full power and authority subject to the provisions of the Plan:

(i) to establish such rules as it may deem appropriate for proper administration of the Plan, to make all factual determinations, to construe and interpret the provisions of the Plan and the awards thereunder and to resolve any and all ambiguities thereunder;

(ii) to determine, with respect to awards made under the Discretionary Option Grant and Stock Issuance Programs, which eligible persons are to receive such awards, the time or times when such awards are to be made, the number of shares to be covered by each such award, the vesting schedule (if any) applicable to the award, the status of a granted option as either an Incentive Option or a Non-Statutory Option and the maximum term for which the option is to remain outstanding;

(iii) to amend, modify or cancel any outstanding award with the consent of the holder or accelerate the vesting of such award; and

(iv) to take such other discretionary actions as permitted pursuant to the terms of the applicable program.

Decisions of each Plan Administrator within the scope of its administrative functions under the Plan shall be final and binding on all parties.

**C.** Members of the Primary Committee or any Secondary Committee shall serve for such period of time as the Board may determine and may be removed by the Board at any time. The Board may also at any time terminate the functions of any Secondary Committee and reassume all powers and authority previously delegated to such committee.

**D.** Service on the Primary Committee or the Secondary Committee shall constitute service as a Board member, and members of each such committee shall accordingly be entitled to full indemnification and reimbursement as Board members for their service on such committee. No member of the Primary Committee or the Secondary Committee shall be liable for any act or omission made in good faith with respect to the Plan or any options or stock issuances under the Plan.

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#### **IV. ELIGIBILITY**

**A.** The persons eligible to participate in the Discretionary Option Grant and Stock Issuance Programs are as follows:

- (i) Employees,
- (ii) non-employee members of the Board or the board of directors of any Parent or Subsidiary, and
- (iii) consultants and other independent advisors who provide services to the Corporation (or any Parent or Subsidiary).

**B.** Only non-employee Board members shall be eligible to participate in the Automatic Option Grant and Director Fee Option Grant Programs.

#### **V. STOCK SUBJECT TO THE PLAN**

**A.** The stock issuable under the Plan shall be shares of authorized but unissued or reacquired Common Stock, including shares repurchased by the Corporation on the open market. The maximum number of shares of Common Stock reserved for issuance over the term of the Plan shall not exceed 28,500,000 shares.

**B.** No one person participating in the Plan may receive options, separately exercisable stock appreciation rights and direct stock issuances for more than One Million (1,000,000) shares of Common Stock in the aggregate per calendar year, beginning with the 1999 calendar year.

**C.** Shares of Common Stock subject to outstanding options (including options incorporated into this Plan from the Predecessor Plan) shall be available for subsequent issuance under the Plan to the extent those options expire, terminate or are cancelled for any reason prior to exercise in full. Unvested shares issued under the Plan and subsequently repurchased by the Corporation, at the original exercise or issue price paid per share, pursuant to the Corporation's repurchase rights under the Plan shall be added back to the number of shares of Common Stock reserved for issuance under the Plan and shall accordingly be available for reissuance through one or more subsequent options or direct stock issuances under the Plan. However, should the exercise price of an option under the Plan be paid with shares of Common Stock or should shares of Common Stock otherwise issuable under the Plan be withheld by the Corporation in satisfaction of the withholding taxes incurred in connection with the exercise of an option or the vesting of a stock issuance under the Plan, then the number of shares of Common Stock available for issuance under the Plan shall be reduced by the gross number of shares for which the option is exercised or which vest under the stock issuance, and not by the net number of shares of Common Stock issued to the holder of such option or stock issuance. Shares of Common Stock underlying one or more stock appreciation rights exercised under the Plan shall not be available for subsequent issuance.

**D.** If any change is made to the Common Stock by reason of any stock split, stock dividend, recapitalization, combination of shares, exchange of shares or other change affecting

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the outstanding Common Stock as a class without the Corporation's receipt of consideration, appropriate adjustments shall be made to (i) the maximum number and/or class of securities issuable under the Plan, (ii) the number and/or class of securities by which the share reserve is to increase each calendar year pursuant to the automatic share increase provisions of the Plan, (iii) the number and/or class of securities for which any one person may be granted options, separately exercisable stock appreciation rights and direct stock issuances under the Plan per calendar year, (iv) the number and/or class of securities for which grants are subsequently to be made under the Automatic Option Grant Program to new and continuing non-employee Board members, (v) the number and/or class of securities and the exercise price per share in effect under each outstanding option under the Plan and (vi) the number and/or class of securities and price per share in effect under each outstanding option incorporated into this Plan from the Predecessor Plan. Such adjustments to the outstanding options are to be effected in a manner which shall preclude the enlargement or dilution of rights and benefits under such options. The adjustments determined by the Plan Administrator shall be final, binding and conclusive.

**ARTICLE TWO**  
**DISCRETIONARY OPTION GRANT PROGRAM**

**I. OPTION TERMS**

Each option shall be evidenced by one or more documents in the form approved by the Plan Administrator; *provided, however*, that each such document shall comply with the terms specified below. Each document evidencing an Incentive Option shall, in addition, be subject to the provisions of the Plan applicable to such options.

**A. Exercise Price.**

1. The exercise price per share shall be fixed by the Plan Administrator at the time of the option grant, provided that the exercise price per share shall not be less than one hundred percent (100%) of the Fair Market Value per share of Common Stock on the option grant date.

2. The exercise price shall become immediately due upon exercise of the option and shall, subject to the provisions of Section II of Article Six and the documents evidencing the option, be payable in cash or check made payable to the Corporation. Should the Common Stock be registered under Section 12 of the 1934 Act at the time the option is exercised, then the exercise price may also be paid as follows:

(i) shares of Common Stock held for the requisite period necessary to avoid a charge to the Corporation's earnings for financial reporting purposes and valued at Fair Market Value on the Exercise Date, or

(ii) to the extent the option is exercised for vested shares, through a special sale and remittance procedure pursuant to which the Optionee shall concurrently provide irrevocable instructions to (a) a Corporation-approved brokerage firm to effect the immediate sale of the purchased shares and remit to the Corporation, out of the sale proceeds available on the settlement date, sufficient funds to cover the aggregate exercise price payable for the purchased shares plus all applicable Federal, state and local income and employment taxes

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required to be withheld by the Corporation by reason of such exercise and (b) the Corporation to deliver the certificates for the purchased shares directly to such brokerage firm in order to complete the sale.

Except to the extent such sale and remittance procedure is utilized, payment of the exercise price for the purchased shares must be made on the Exercise Date.

**B. Exercise and Term of Options.** Each option shall be exercisable at such time or times, during such period and for such number of shares as shall be determined by the Plan Administrator and set forth in the documents evidencing the option. However, no option shall have a term in excess of ten (10) years measured from the option grant date.

**C. Cessation of Service.**

1. The following provisions shall govern the exercise of any options outstanding at the time of the Optionee's cessation of Service or death:

(i) Any option outstanding at the time of the Optionee's cessation of Service for any reason shall remain exercisable for such period of time thereafter as shall be determined by the Plan Administrator and set forth in the documents evidencing the option, but no such option shall be exercisable after the expiration of the option term.

(ii) Any option exercisable in whole or in part by the Optionee at the time of death may be subsequently exercised by his or her Beneficiary.

(iii) During the applicable post-Service exercise period, the option may not be exercised in the aggregate for more than the number of vested shares for which the option is exercisable on the date of the Optionee's cessation of Service. Upon the expiration of the applicable exercise period or (if earlier) upon the expiration of the option term, the option shall terminate and cease to be outstanding for any vested shares for which the option has not been exercised. However, the option shall, immediately upon the Optionee's cessation of Service, terminate and cease to be outstanding to the extent the option is not otherwise at that time exercisable for vested shares.

(iv) Should the Optionee's Service be terminated for Misconduct or should the Optionee engage in Misconduct while his or her options are outstanding, then all such options shall terminate immediately and cease to be outstanding.

2. The Plan Administrator shall have complete discretion, exercisable either at the time an option is granted or at any time while the option remains outstanding:

(i) to extend the period of time for which the option is to remain exercisable following the Optionee's cessation of Service to such period of time as the Plan Administrator shall deem appropriate, but in no event beyond the expiration of the option term, and/or

(ii) to permit the option to be exercised, during the applicable post-Service exercise period, for one or more additional installments in which the Optionee would have vested had the Optionee continued in Service.

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**D. Stockholder Rights.** The holder of an option shall have no stockholder rights with respect to the shares subject to the option until such person shall have exercised the option, paid the exercise price and become a holder of record of the purchased shares.

**E. Repurchase Rights.** The Plan Administrator shall have the discretion to grant options which are exercisable for unvested shares of Common Stock. Should the Optionee cease Service while holding such unvested shares, the Corporation shall have the right to repurchase, at the exercise price paid per share, any or all of those unvested shares. The terms upon which such repurchase right shall be exercisable (including the period and procedure for exercise and the appropriate vesting schedule for the purchased shares) shall be established by the Plan Administrator and set forth in the document evidencing such repurchase right.

**F. Vesting Period of Certain Grants.** Options granted under the Plan to the Chief Executive Officer of the Company or Chairman of the Board of Directors shall be subject to a minimum vesting period and shall vest as follows: not more than twenty percent (20%) of any shares of Common Stock subject to an option shall vest after the first year following the date of grant and not more than ten percent (10%) after every six-month period thereafter, provided, however, the Compensation Committee shall have the authority, in its sole discretion, to reduce the minimum vesting period provided in this Article Two, Section I(F). Notwithstanding the foregoing, at such time as the Chairman is Independent, the minimum vesting period required by this Article Two, Section I(F) shall not apply to options granted to such Chairman.

**G. Limited Transferability of Options.** During the lifetime of the Optionee, Incentive Options shall be exercisable only by the Optionee and shall not be assignable or transferable other than to a Beneficiary following the Optionee's death.

## II. INCENTIVE OPTIONS

The terms specified below shall be applicable to all Incentive Options. Except as modified by the provisions of this Section II, all the provisions of Articles One, Two and Six shall be applicable to Incentive Options. Options which are specifically designated as Non-Statutory Options when issued under the Plan shall *not* be subject to the terms of this Section II.

**A. Eligibility.** Incentive Options may only be granted to Employees.

**B. Exercise Price.** The exercise price per share shall not be less than one hundred percent (100%) of the Fair Market Value per share of Common Stock on the option grant date.

**C. Dollar Limitation.** The aggregate Fair Market Value of the shares of Common Stock (determined as of the respective date or dates of grant) for which one or more options granted to any Employee under the Plan (or any other option plan of the Corporation or any Parent or Subsidiary) may for the first time become exercisable as Incentive Options during any one calendar year shall not exceed the sum of One Hundred Thousand Dollars (\$100,000). To the extent the Employee holds two (2) or more such options which become exercisable for the first time in the same calendar year, the foregoing limitation on the exercisability of such options as Incentive Options shall be applied on the basis of the order in which such options are granted.

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**D. 10% Stockholder.** If any Employee to whom an Incentive Option is granted is a 10% Stockholder, then the exercise price per share shall not be less than one hundred ten percent (110%) of the Fair Market Value per share of Common Stock on the option grant date, and the option term shall not exceed five (5) years measured from the option grant date.

### **III. CHANGE IN CONTROL/HOSTILE TAKE-OVER**

**A.** Each option outstanding at the time of a Change in Control but not otherwise fully-vested shall automatically accelerate so that each such option shall, immediately prior to the effective date of the Change in Control, become exercisable for all of the shares of Common Stock at the time subject to that option and may be exercised for any or all of those shares as fully-vested shares of Common Stock. However, an outstanding option shall not so accelerate if and to the extent: (i) such option is, in connection with the Change in Control, assumed or otherwise continued in full force and effect by the successor corporation (or parent thereof) pursuant to the terms of the Change in Control, (ii) such option is replaced with a cash incentive program of the successor corporation which preserves the spread existing at the time of the Change in Control on the shares of Common Stock for which the option is not otherwise at that time exercisable and provides for subsequent payout in accordance with the same vesting schedule applicable to those option shares or (iii) the acceleration of such option is subject to other limitations imposed by the Plan Administrator at the time of the option grant. Each option outstanding at the time of the Change in Control shall terminate as provided in Section III.C. of this Article Two.

**B.** All outstanding repurchase rights shall also terminate automatically, and the shares of Common Stock subject to those terminated rights shall immediately vest in full, in the event of any Change in Control, except to the extent: (i) those repurchase rights are assigned to the successor corporation (or parent thereof) or otherwise continue in full force and effect pursuant to the terms of the Change in Control or (ii) such accelerated vesting is precluded by other limitations imposed by the Plan Administrator at the time the repurchase right is issued.

**C.** Immediately following the consummation of the Change in Control, all outstanding options shall terminate and cease to be outstanding, except to the extent assumed by the successor corporation (or parent thereof) or otherwise expressly continued in full force and effect pursuant to the terms of the Change in Control.

**D.** Each option which is assumed in connection with a Change in Control shall be appropriately adjusted, immediately after such Change in Control, to apply to the number and class of securities which would have been issuable to the Optionee in consummation of such Change in Control had the option been exercised immediately prior to such Change in Control. Appropriate adjustments to reflect such Change in Control shall also be made to (i) the exercise price payable per share under each outstanding option, *provided* the aggregate exercise price payable for such securities shall remain the same, (ii) the maximum number and/or class of securities available for issuance over the remaining term of the Plan and (iii) the maximum number and/or class of securities for which any one person may be granted options, separately exercisable stock appreciation rights and direct stock issuances under the Plan per calendar year.

**E.** The Plan Administrator may at any time provide that one or more options will

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automatically accelerate in connection with a Change in Control, whether or not those options are assumed or otherwise continued in full force and effect pursuant to the terms of the Change in Control. Any such option shall accordingly become exercisable, immediately prior to the effective date of such Change in Control, for all of the shares of Common Stock at the time subject to that option and may be exercised for any or all of those shares as fully-vested shares of Common Stock. In addition, the Plan Administrator may at any time provide that one or more of the Corporation's repurchase rights shall not be assignable in connection with such Change in Control and shall terminate upon the consummation of such Change in Control.

**F.** The Plan Administrator may at any time provide that one or more options will automatically accelerate upon an Involuntary Termination of the Optionee's Service within a designated period (not to exceed eighteen (18) months) following the effective date of any Change in Control in which those options do not otherwise accelerate. Any options so accelerated shall remain exercisable for fully-vested shares until the *earlier* of (i) the expiration of the option term or (ii) the expiration of the one (1) year period measured from the effective date of the Involuntary Termination. In addition, the Plan Administrator may at any time provide that one or more of the Corporation's repurchase rights shall immediately terminate upon such Involuntary Termination.

**G.** The Plan Administrator may at any time provide that one or more options will automatically accelerate in connection with a Hostile Take-Over. Any such option shall become exercisable, immediately prior to the effective date of such Hostile Take-Over, for all of the shares of Common Stock at the time subject to that option and may be exercised for any or all of those shares as fully-vested shares of Common Stock. In addition, the Plan Administrator may at any time provide that one or more of the Corporation's repurchase rights shall terminate automatically upon the consummation of such Hostile Take-Over. Alternatively, the Plan Administrator may condition such automatic acceleration and termination upon an Involuntary Termination of the Optionee's Service within a designated period (not to exceed eighteen (18) months) following the effective date of such Hostile Take-Over. Each option so accelerated shall remain exercisable for fully-vested shares until the expiration or sooner termination of the option term.

**H.** The portion of any Incentive Option accelerated in connection with a Change in Control or Hostile Take Over shall remain exercisable as an Incentive Option only to the extent the applicable One Hundred Thousand Dollar (\$100,000) limitation is not exceeded. To the extent such dollar limitation is exceeded, the accelerated portion of such option shall be exercisable as a Non-Statutory Option under the Federal tax laws.

#### **IV. STOCK APPRECIATION RIGHTS**

The Plan Administrator may, subject to such conditions as it may determine, grant to selected Optionees stock appreciation rights which will allow the holders of those rights to elect between the exercise of the underlying option for shares of Common Stock and the surrender of that option in exchange for a distribution from the Corporation in an amount equal to the excess of (a) the Option Surrender Value of the number of shares for which the option is surrendered over (b) the aggregate exercise price payable for such shares. The distribution may be made in shares of Common Stock valued at Fair Market Value on the option surrender date, in cash, or partly in shares and partly in cash, as the Plan Administrator shall in its sole discretion deem appropriate.

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**ARTICLE THREE**  
**STOCK ISSUANCE PROGRAM**

**V. STOCK ISSUANCE TERMS**

Shares of Common Stock may be issued under the Stock Issuance Program through direct and immediate issuances without any intervening options. Shares of Common Stock may also be issued under the Stock Issuance Program pursuant to share right awards which entitle the recipients to receive those shares upon the attainment of designated performance goals or Service requirements. Each such award shall be evidenced by one or more documents which comply with the terms specified below.

**A. Purchase Price.**

1. The purchase price per share of Common Stock subject to direct issuance shall be fixed by the Plan Administrator.

2. Subject to the provisions of Section II of Article Six, shares of Common Stock may be issued under the Stock Issuance Program for any of the following items of consideration which the Plan Administrator may deem appropriate in each individual instance:

- (i) cash or check made payable to the Corporation, or
- (ii) past services rendered to the Corporation (or any Parent or Subsidiary).

**B. Vesting/Issuance Provisions.**

1. The Plan Administrator may issue shares of Common Stock which are fully and immediately vested upon issuance or which are to vest in one or more installments over the Participant's period of Service or upon attainment of specified performance objectives. Alternatively, the Plan Administrator may issue share right awards which shall entitle the recipient to receive a specified number of vested shares of Common Stock upon the attainment of one or more performance goals or Service requirements established by the Plan Administrator.

2. Any new, substituted or additional securities or other property (including money paid other than as a regular cash dividend) which the Participant may have the right to receive with respect to his or her unvested shares of Common Stock by reason of any stock dividend, stock split, recapitalization, combination of shares, exchange of shares or other change affecting the outstanding Common Stock as a class without the Corporation's receipt of consideration shall be issued subject to (i) the same vesting requirements applicable to the Participant's unvested shares of Common Stock and (ii) such escrow arrangements as the Plan Administrator shall deem appropriate.

3. The Participant shall have full stockholder rights with respect to the issued

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shares of Common Stock, whether or not the Participant's interest in those shares is vested. Accordingly, the Participant shall have the right to vote such shares and to receive any regular cash dividends paid on such shares.

4. Should the Participant cease to remain in Service while holding one or more unvested shares of Common Stock, or should the performance objectives not be attained with respect to one or more such unvested shares of Common Stock, then those shares shall be immediately surrendered to the Corporation for cancellation, and the Participant shall have no further stockholder rights with respect to those shares. To the extent the surrendered shares were previously issued to the Participant for consideration paid in cash or cash equivalent (including the Participant's purchase-money indebtedness), the Corporation shall repay to the Participant the cash consideration paid for the surrendered shares and shall cancel the unpaid principal balance of any outstanding purchase-money note of the Participant attributable to the surrendered shares.

5. The Plan Administrator may waive the surrender and cancellation of one or more unvested shares of Common Stock (or other assets attributable thereto) which would otherwise occur upon the cessation of the Participant's Service or the non-attainment of the performance objectives applicable to those shares. Such waiver shall result in the immediate vesting of the Participant's interest in the shares of Common Stock as to which the waiver applies. Such waiver may be effected at any time, whether before or after the Participant's cessation of Service or the attainment or non-attainment of the applicable performance objectives.

6. Outstanding share right awards shall automatically terminate, and no shares of Common Stock shall actually be issued in satisfaction of those awards, if the performance goals or Service requirements established for such awards are not attained. The Plan Administrator, however, shall have the authority to issue shares of Common Stock in satisfaction of one or more outstanding share right awards as to which the designated performance goals or Service requirements are not attained.

## **VI. CHANGE IN CONTROL/HOSTILE TAKE-OVER**

A. All of the Corporation's outstanding repurchase rights shall terminate automatically, and all the shares of Common Stock subject to those terminated rights shall immediately vest in full, in the event of any Change in Control, except to the extent (i) those repurchase rights are assigned to the successor corporation (or parent thereof) or otherwise continue in full force and effect pursuant to the terms of the Change in Control or (ii) such accelerated vesting is precluded by other limitations imposed by the Plan Administrator at the time the repurchase right is issued.

B. The Plan Administrator may at any time provide for the automatic termination of one or more of those outstanding repurchase rights and the immediate vesting of the shares of Common Stock subject to those terminated rights upon (i) a Change in Control or Hostile Take-Over or (ii) an Involuntary Termination of the Participant's Service within a designated period (not to exceed eighteen (18) months) following the effective date of any Change in Control or Hostile Take-Over in which those repurchase rights are assigned to the successor corporation (or parent thereof) or otherwise continue in full force and effect.

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## VII. SHARE ESCROW/LEGENDS

Unvested shares may, in the Plan Administrator's discretion, be held in escrow by the Corporation until the Participant's interest in such shares vests or may be issued directly to the Participant with restrictive legends on the certificates evidencing those unvested shares.

### **ARTICLE FOUR** **AUTOMATIC OPTION GRANT PROGRAM**

## VIII. OPTION TERMS

**A. Grant Dates.** Options shall be made on the dates specified below:

1. Each individual who is first elected or appointed as a non-employee Board member at any time after the Underwriting Date shall automatically be granted, on the date of such initial election or appointment, a Non-Statutory Option to purchase Fifty Thousand (50,000) shares of Common Stock, provided that individual has not previously been in the employ of the Corporation (or any Parent or Subsidiary).

2. On the date of each Annual Stockholders Meeting beginning with the 2001 Annual Stockholder Meeting, each individual who has served as a non-employee Board member since the date of the Annual Stockholders Meeting in the immediately preceding year shall automatically be granted a Non-Statutory Option to purchase Fifteen Thousand (15,000) shares of Common Stock.

**B. Exercise Price.**

1. The exercise price per share shall be equal to one hundred percent (100%) of the Fair Market Value per share of Common Stock on the option grant date.

2. The exercise price shall be payable in one or more of the alternative forms authorized under the Discretionary Option Grant Program. Except to the extent the sale and remittance procedure specified thereunder is utilized, payment of the exercise price for the purchased shares must be made on the Exercise Date.

**C. Option Term.** Each option shall have a term of ten (10) years measured from the option grant date.

**D. Exercise and Vesting of Options.** Each option shall be immediately exercisable for any or all of the option shares. However, any shares purchased under the initial 50,000 share option shall be subject to repurchase by the Corporation, at the exercise price paid per share, upon the Optionee's cessation of Board service prior to vesting in those shares. Each initial 50,000-share option shall vest, and the Corporation's repurchase right shall lapse, in a series of four (4) successive equal annual installments over the Optionee's period of continued service as a Board member, with the first such installment to vest upon the Optionee's completion of one (1) year of Board service measured from the option grant date. Each annual 15,000-share option shall be fully vested at the time of grant.

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**E. Cessation of Board Service.** The following provisions shall govern the exercise of any options outstanding at the time of the Optionee's cessation of Board service:

(i) Any option outstanding at the time of the Optionee's cessation of Board service for any reason shall remain exercisable for a twelve (12)-month period following the date of such cessation of Board service, but in no event shall such option be exercisable after the expiration of the option term.

(ii) Any option exercisable in whole or in part by the Optionee at the time of death may be subsequently exercised by his or her Beneficiary.

(iii) Following the Optionee's cessation of Board service, the option may not be exercised in the aggregate for more than the number of shares for which the option was exercisable on the date of such cessation of Board service. Upon the expiration of the applicable exercise period or (if earlier) upon the expiration of the option term, the option shall terminate and cease to be outstanding for any vested shares for which the option has not been exercised. However, the option shall, immediately upon the Optionee's cessation of Board service, terminate and cease to be outstanding for any and all shares for which the option is not otherwise at that time exercisable.

(iv) However, should the Optionee cease to serve as a Board member by reason of death or Permanent Disability, then all shares at the time subject to the option shall immediately vest so that such option may, during the twelve (12)-month exercise period following such cessation of Board service, be exercised for all or any portion of those shares as fully-vested shares of Common Stock.

#### **IX. CHANGE IN CONTROL/HOSTILE TAKE-OVER**

**A.** In the event of any Change in Control or Hostile Take-Over, the shares of Common Stock at the time subject to each outstanding option but not otherwise vested shall automatically vest in full so that each such option may, immediately prior to the effective date of such Change in Control or Hostile Take-Over, become fully exercisable for all of the shares of Common Stock at the time subject to such option and may be exercised for all or any of those shares as fully-vested shares of Common Stock. Each such option accelerated in connection with a Change in Control shall terminate upon the Change in Control, except to the extent assumed by the successor corporation (or parent thereof) or otherwise continued in full force and effect pursuant to the terms of the Change in Control. Each such option accelerated in connection with a Hostile Take-Over shall remain exercisable until the expiration or sooner termination of the option term.

**B.** All outstanding repurchase rights shall automatically terminate and the shares of Common Stock subject to those terminated rights shall immediately vest in full, in the event of any Change in Control or Hostile Take-Over.

**C.** Upon the occurrence of a Hostile Take-Over, the Optionee shall have a thirty (30)-day period in which to surrender to the Corporation each of his or her outstanding options.

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The Optionee shall in return be entitled to a cash distribution from the Corporation in an amount equal to the excess of (i) the Option Surrender Value of the shares of Common Stock at the time subject to each surrendered option (whether or not the option is otherwise at the time exercisable for those shares) over (ii) the aggregate exercise price payable for such shares. Such cash distribution shall be paid within five (5) days following the surrender of the option to the Corporation.

D. Each option which is assumed in connection with a Change in Control shall be appropriately adjusted to apply to the number and class of securities which would have been issuable to the Optionee in consummation of such Change in Control had the option been exercised immediately prior to such Change in Control. Appropriate adjustments shall also be made to the exercise price payable per share under each outstanding option, *provided* the aggregate exercise price payable for such securities shall remain the same.

#### **X. REMAINING TERMS**

The remaining terms of each option granted under the Automatic Option Grant Program shall be the same as the terms in effect for options made under the Discretionary Option Grant Program.

### **ARTICLE FIVE** **DIRECTOR FEE OPTION GRANT PROGRAM**

#### **XI. OPTION GRANTS**

The Board implemented the Director Fee Option Grant Program as of January 1, 2004. Each non-employee Board member may elect to apply all or any portion of the annual retainer fee otherwise payable in cash for his or her service on the Board or any Board committee to the acquisition of a special option grant under this Director Fee Option Grant Program. Such election must be filed with the Corporation's Secretary prior to the first day of the 12-month period (July 1 to June 30 of the following year) for which the election is to be in effect. Each non-employee Board member who files such a timely election shall automatically be granted an option under this Director Fee Option Grant Program on the first trading day in July in the 12-month period for which that fee would otherwise be payable. For purposes of this Program, an "annual retainer fee" means the amount to which a non-employee director will be entitled to receive for serving as a director or a member of a standing committee of the Board in a relevant 12-month period, including service on any Board committee, but shall not include reimbursement of expenses, fees determined on a per-meeting attended basis, or fees with respect to any other services provided or to be provided to the Corporation.

#### **XII. OPTION TERMS**

Each option shall be a Non-Statutory Option governed by the terms and conditions specified below.

##### **A. Exercise Price.**

1. The exercise price per share shall be the Fair Market Value per share of Common Stock on the option grant date.

2. The exercise price shall become immediately due upon exercise of the option and shall be payable in one or more of the alternative forms authorized under the Discretionary Option Grant Program. Except to the extent the sale and remittance procedure specified thereunder is utilized, payment of the exercise price for the purchased shares must be made on the Exercise Date.

**B. Number of Option Shares.** The number of shares of Common Stock subject to the option shall be an amount necessary to make such option equal in value, using a modified Black-Scholes option valuation model, to that the portion of the annual retainer fee that the non-employee director elected to receive in the form of an option. The value of the option will be calculated by assuming that the value of an option to purchase one share of Common Stock equals the product of (i) a fraction determined by dividing one (1) by the Multiplier (as defined below) and (ii) the fair Market Value of a share of Common Stock on the option grant date.

The number of shares represented by an option granted pursuant to the Director Fee Option Grant Program shall be determined by (a) dividing the amount of the annual retainer that the non-employee director elects to receive in the form of options by the Fair Market Value of a share of Common Stock on the date of grant, and (b) multiplying the quotient so obtained by a multiplier determined using a modified Black-Scholes option valuation method (the "Multiplier"). The Board or the Plan Administrator shall determine the Multiplier prior to the beginning of a relevant 12-month period by considering the following factors: (i) the Fair Market Value of the Common Stock on the date the Multiplier is determined; (ii) the average length of time the stock options of the Corporation are held by optionees prior to exercise; (iii) the risk-free rate of return based on the term determined in (ii) above and U.S. government securities rates; (iv) the annual dividend yield for the Common stock, if any; and (v) the volatility of the Common Stock over the previous two-year period. The number of shares to be subject to the option shall be equal to the largest number of whole shares determined as follows:

$$\frac{\text{Amount of Retainer}}{\text{Fair Market Value on Grant Date}} \times \text{Multiplier} = \text{Number of Shares}$$

**C. Exercise and Term of Options.** The option shall become exercisable in a series of twelve (12) successive equal monthly installments upon the Optionee's completion of each month of Board service during the calendar year in which the option is granted. Each option shall have a maximum term of ten (10) years measured from the option grant date.

**D. Cessation of Board Service.** Should the Optionee cease Board service for any reason (other than death or Permanent Disability) while holding one or more options, then each such option shall remain exercisable, for any or all of the shares for which the option is exercisable at the time of such cessation of Board service, until the *earlier* of (i) the expiration of

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the ten (10)-year option term or (ii) the expiration of the three (3)-year period measured from the date of such cessation of Board service. However, each option held by the Optionee at the time of such cessation of Board service shall immediately terminate and cease to remain outstanding with respect to any and all shares of Common Stock for which the option is not otherwise at that time exercisable.

**E. Death or Permanent Disability.** Should the Optionee's service as a Board member cease by reason of death or Permanent Disability, then each option held by such Optionee shall immediately become exercisable for all the shares of Common Stock at the time subject to that option, and the option may be exercised for any or all of those shares as fully-vested shares until the *earlier* of (i) the expiration of the ten (10)-year option term or (ii) the expiration of the three (3)-year period measured from the date of such cessation of Board service.

Should the Optionee die after cessation of Board service but while holding one or more options, then each such option may be exercised, for any or all of the shares for which the option is exercisable at the time of the Optionee's cessation of Board service (less any shares subsequently purchased by Optionee prior to death), by the Optionee's Beneficiary. Such right of exercise shall lapse, and the option shall terminate, upon the *earlier* of (i) the expiration of the ten (10)-year option term or (ii) the three (3)-year period measured from the date of the Optionee's cessation of Board service.

### **XIII. CHANGE IN CONTROL/HOSTILE TAKE-OVER**

**A.** In the event of any Change in Control or Hostile Take-Over while the Optionee remains in Board service, each outstanding option held by such Optionee shall automatically accelerate so that each such option shall, immediately prior to the effective date of the Change in Control or Hostile Take-Over, become fully exercisable with respect to the total number of shares of Common Stock at the time subject to such option and may be exercised for any or all of those shares as fully-vested shares of Common Stock. Each such option accelerated in connection with a Change in Control shall terminate upon the Change in Control, except to the extent assumed by the successor corporation (or parent thereof) or otherwise expressly continued in full force and effect pursuant to the terms of the Change in Control. Each such option accelerated in connection with a Hostile Take-Over shall remain exercisable until the expiration or sooner termination of the option term.

**B.** Upon the occurrence of a Hostile Take-Over, the Optionee shall have a thirty (30)-day period in which to surrender to the Corporation each of his or her outstanding options. The Optionee shall in return be entitled to a cash distribution from the Corporation in an amount equal to the excess of (i) the Option Surrender Value of the shares of Common Stock at the time subject to each surrendered option (whether or not the Optionee is otherwise at the time vested in those shares) over (ii) the aggregate exercise price payable for such shares. Such cash distribution shall be paid within five (5) days following the surrender of the option to the Corporation.

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#### **XIV. REMAINING TERMS**

The remaining terms of each option granted under this Director Fee Option Grant Program shall be the same as the terms in effect for options made under the Discretionary Option Grant Program.

#### **ARTICLE SIX** **MISCELLANEOUS**

#### **XV. NO IMPAIRMENT OF AUTHORITY**

Outstanding awards shall in no way affect the right of the Corporation to adjust, reclassify, reorganize or otherwise change its capital or business structure or to merge, consolidate, dissolve, liquidate or sell or transfer all or any part of its business or assets.

#### **XVI. FINANCING**

The Plan Administrator may permit any Optionee or Participant to pay the option exercise price under the Discretionary Option Grant Program or the purchase price of shares issued under the Stock Issuance Program by delivering a full-recourse, interest bearing promissory note payable in one or more installments. The terms of any such promissory note (including the interest rate and the terms of repayment) shall be established by the Plan Administrator in its sole discretion. In no event may the maximum credit available to the Optionee or Participant exceed the sum of (i) the aggregate option exercise price or purchase price payable for the purchased shares plus (ii) any Federal, state and local income and employment tax liability incurred by the Optionee or the Participant in connection with the option exercise or share purchase.

#### **XVII. TAX WITHHOLDING**

**A.** The Corporation's obligation to deliver shares of Common Stock upon the exercise of options or the issuance or vesting of such shares under the Plan shall be subject to the satisfaction of all applicable Federal, state and local income and employment tax withholding requirements.

**B.** The Plan Administrator may, in its discretion, provide any or all holders of Non-Statutory Options or unvested shares of Common Stock under the Plan with the right to use shares of Common Stock in satisfaction of all or part of the Withholding Taxes incurred by such holders in connection with the exercise of their options or the vesting of their shares. Such right may be provided to any such holder in either or both of the following formats:

*Stock Withholding:* The election to have the Corporation withhold, from the shares of Common Stock otherwise issuable upon the exercise of such Non-Statutory Option or the vesting of such shares, a portion of those shares with an aggregate Fair Market Value equal to the percentage of the Withholding Taxes (not to exceed one hundred percent (100%)) designated by the holder.

*Stock Delivery:* The election to deliver to the Corporation, at the time the Non-Statutory Option is exercised or the shares vest, one or more shares of Common Stock previously acquired by such holder (other than in connection with

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the option exercise or share vesting triggering the Withholding Taxes) with an aggregate Fair Market Value equal to the percentage of the Taxes (not to exceed one hundred percent (100%)) designated by the holder.

#### **XVIII. FINANCIAL REPORTS**

The Corporation shall deliver a balance sheet and an income statement at least annually to each individual holding an outstanding option under the Plan, unless such individual is a key Employee whose duties in connection with the Corporation (or any Parent or Subsidiary) assure such individual access to equivalent information.

#### **XIX. EFFECTIVE DATE AND TERM OF THE PLAN**

**A.** The Plan shall become effective immediately upon the Plan Effective Date. However, the Director Fee Option Grant Program shall not be implemented until such time as the Primary Committee or the Board may deem appropriate. Options may be granted under the Discretionary Option Grant Program at any time on or after the Plan Effective Date. However, no options granted under the Plan may be exercised, and no shares shall be issued under the Plan, until the Plan is approved by the Corporation's stockholders. If such stockholder approval is not obtained within twelve (12) months after the Plan Effective Date, then all options previously granted under this Plan shall terminate and cease to be outstanding, and no further options shall be granted and no shares shall be issued under the Plan.

**B.** The Plan shall serve as the successor to the Predecessor Plan, and no further options or direct stock issuances shall be made under the Predecessor Plan after the Section 12 Registration Date. All options outstanding under the Predecessor Plan on the Section 12 Registration Date shall be incorporated into the Plan at that time and shall be treated as outstanding options under the Plan. However, each outstanding option so incorporated shall continue to be governed solely by the terms of the documents evidencing such option, and no provision of the Plan shall be deemed to affect or otherwise modify the rights or obligations of the holders of such incorporated options with respect to their acquisition of shares of Common Stock.

**C.** One or more provisions of the Plan, including (without limitation) the option/vesting acceleration provisions of Article Two relating to Changes in Control, may, in the Plan Administrator's discretion, be extended to one or more options incorporated from the Predecessor Plan which do not otherwise contain such provisions.

**D.** The Plan shall terminate upon the *earliest* of (i) June 8, 2009, (ii) the date on which all shares available for issuance under the Plan shall have been issued as fully-vested shares or (iii) the termination of all outstanding options in connection with a Change in Control. Upon such plan termination, all outstanding options and unvested stock issuances shall thereafter continue to have force and effect in accordance with the provisions of the documents evidencing such grants or issuances.

#### **XX. AMENDMENT OF THE PLAN**

**A.** The Board shall have complete and exclusive power and authority to amend or

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modify the Plan in any or all respects. However, no such amendment or modification shall adversely affect the rights and obligations with respect to stock options or unvested stock issuances at the time outstanding under the Plan unless the Optionee or the Participant consents to such amendment or modification. In addition, certain amendments may require stockholder approval pursuant to applicable laws or regulations.

**B.** Options to purchase shares of Common Stock may be granted under the Discretionary Option Grant Program and shares of Common Stock may be issued under the Stock Issuance Program that are in each instance in excess of the number of shares then available for issuance under the Plan, provided any excess shares actually issued under those programs shall be held in escrow until there is obtained stockholder approval of an amendment sufficiently increasing the number of shares of Common Stock available for issuance under the Plan. If such stockholder approval is not obtained within twelve (12) months after the date the first such excess issuances are made, then (i) any unexercised options granted on the basis of such excess shares shall terminate and cease to be outstanding and (ii) the Corporation shall promptly refund to the Optionees and the Participants the exercise or purchase price paid for any excess shares issued under the Plan and held in escrow, together with interest (at the applicable Short Term Federal Rate) for the period the shares were held in escrow, and such shares shall thereupon be automatically cancelled and cease to be outstanding.

#### **XXI. USE OF PROCEEDS**

Any cash proceeds received by the Corporation from the sale of shares of Common Stock under the Plan shall be used for general corporate purposes.

#### **XXII. REGULATORY APPROVALS**

**A.** The implementation of the Plan, the granting of any stock option under the Plan and the issuance of any shares of Common Stock (i) upon the exercise of any granted option or (ii) under the Stock Issuance Program shall be subject to the Corporation's procurement of all approvals and permits required by regulatory authorities having jurisdiction over the Plan, the stock options granted under it and the shares of Common Stock issued pursuant to it.

**B.** No shares of Common Stock or other assets shall be issued or delivered under the Plan unless and until there shall have been compliance with all applicable requirements of Federal and state securities laws, including the filing and effectiveness of the Form S-8 registration statement for the shares of Common Stock issuable under the Plan, and all applicable listing requirements of any stock exchange (or the Nasdaq National Market, if applicable) on which Common Stock is then listed for trading.

#### **XXIII. NO EMPLOYMENT/SERVICE RIGHTS**

Nothing in the Plan shall confer upon the Optionee or the Participant any right to continue in Service for any period of specific duration or interfere with or otherwise restrict in any way the rights of the Corporation (or any Parent or Subsidiary employing or retaining such person) or of the Optionee or the Participant, which rights are hereby expressly reserved by each, to terminate such person's Service at any time for any reason, with or without cause.

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**APPENDIX**

The following definitions shall be in effect under the Plan:

**A. Automatic Option Grant Program** shall mean the automatic option grant program in effect under the Plan.

**B. Beneficiary** shall mean, in the event the Plan Administrator implements a beneficiary designation procedure, the person designated by an Optionee or Participant, pursuant to such procedure, to succeed to such person's rights under any outstanding awards held by him or her at the time of death. In the absence of such designation or procedure, the Beneficiary shall be the personal representative of the estate of the Optionee or Participant or the person or persons to whom the award is transferred by will or the laws of descent and distribution.

**C. Board** shall mean the Corporation's Board of Directors.

**D. Change in Control** shall mean a change in ownership or control of the Corporation effected through any of the following transactions:

(i) a merger, consolidation or reorganization approved by the Corporation's stockholders, *unless* securities representing more than fifty percent (50%) of the total combined voting power of the voting securities of the successor corporation are immediately thereafter beneficially owned, directly or indirectly and in substantially the same proportion, by the persons who beneficially owned the Corporation's outstanding voting securities immediately prior to such transaction,

(ii) any stockholder-approved transfer or other disposition of all or substantially all of the Corporation's assets, or

(iii) the acquisition, directly or indirectly by any person or related group of persons (other than the Corporation or a person that directly or indirectly controls, is controlled by, or is under common control with, the Corporation), of beneficial ownership (within the meaning of Rule 13d-3 of the 1934 Act) of securities possessing more than fifty percent (50%) of the total combined voting power of the Corporation's outstanding securities pursuant to a tender or exchange offer made directly to the Corporation's stockholders which the Board recommends such stockholders accept.

**E. Code** shall mean the Internal Revenue Code of 1986, as amended.

**F. Common Stock** shall mean the Corporation's common stock.

**G. Compensation Committee** shall mean the Compensation Committee of the Corporation.

**H. Corporation** shall mean Quest Software, Inc., a California corporation, and any corporate successor to all or substantially all of the assets or voting stock of Quest Software, Inc. which shall by appropriate action adopt the Plan.

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**I. Director Fee Option Grant Program** shall mean the director fee option grant program in effect under the Plan.

**J. Discretionary Option Grant Program** shall mean the discretionary option grant program in effect under the Plan.

**K. Employee** shall mean an individual who is in the employ of the Corporation (or any Parent or Subsidiary), subject to the control and direction of the employer entity as to both the work to be performed and the manner and method of performance.

**L. Exercise Date** shall mean the date on which the Corporation shall have received written notice of the option exercise.

**M. Fair Market Value** per share of Common Stock on any relevant date shall be determined in accordance with the following provisions:

(i) If the Common Stock is at the time traded on the Nasdaq National Market, then the Fair Market Value shall be the closing selling price per share of Common Stock on the date in question, as such price is reported on the Nasdaq National Market or any successor system. If there is no closing selling price for the Common Stock on the date in question, then the Fair Market Value shall be the closing selling price on the last preceding date for which such quotation exists.

(ii) If the Common Stock is at the time listed on any Stock Exchange, then the Fair Market Value shall be the closing selling price per share of Common Stock on the date in question on the Stock Exchange determined by the Plan Administrator to be the primary market for the Common Stock, as such price is officially quoted in the composite tape of transactions on such exchange. If there is no closing selling price for the Common Stock on the date in question, then the Fair Market Value shall be the closing selling price on the last preceding date for which such quotation exists.

(iii) For purposes of any option grants made on the Underwriting Date, the Fair Market Value shall be deemed to be equal to the price per share at which the Common Stock is to be sold in the initial public offering pursuant to the Underwriting Agreement.

(iv) For purposes of any options made prior to the Underwriting Date, the Fair Market Value shall be determined by the Plan Administrator, after taking into account such factors as it deems appropriate.

**N. Hostile Take-Over** shall mean:

(i) the acquisition, directly or indirectly, by any person or related group of persons (other than the Corporation or a person that directly or indirectly controls, is controlled by, or is under common control with, the Corporation) of beneficial ownership (within the meaning of Rule 13d-3 of the 1934 Act) of securities possessing more than fifty percent (50%) of the total combined voting power of the Corporation's outstanding securities pursuant to a tender or exchange offer made directly to the Corporation's stockholders which the Board does not recommend such stockholders to accept, or

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(ii) a change in the composition of the Board over a period of thirty-six (36) consecutive months or less such that a majority of the Board members ceases, by reason of one or more contested elections for Board membership, to be comprised of individuals who either (A) have been Board members continuously since the beginning of such period or (B) have been elected or nominated for election as Board members during such period by at least a majority of the Board members described in clause (A) who were still in office at the time the Board approved such election or nomination.

**O. Incentive Option** shall mean an option which satisfies the requirements of Code Section 422.

**P. Independent** shall have such meaning as defined in Section 303A.02 of the New York Stock Exchange Listed Companies Manual.

**Q. Involuntary Termination** shall mean the termination of the Service of any individual which occurs by reason of:

(i) such individual's involuntary dismissal or discharge by the Corporation for reasons other than Misconduct, or

(ii) such individual's voluntary resignation following (A) a change in his or her position with the Corporation or Parent or Subsidiary employing the individual which materially reduces his or her duties and responsibilities or the level of management to which he or she reports, (B) a reduction in his or her level of compensation (including base salary, fringe benefits and target bonus under any performance based bonus or incentive programs) by more than fifteen percent (15%) or (C) a relocation of such individual's place of employment by more than fifty (50) miles, provided and only if such change, reduction or relocation is effected by the Corporation without the individual's consent.

**R. Misconduct** shall mean the commission of any act of fraud, embezzlement or dishonesty by the Optionee or Participant, any unauthorized use or disclosure by such person of confidential information or trade secrets of the Corporation (or any Parent or Subsidiary), or any intentional wrongdoing by such person, whether by omission or commission, which adversely affects the business or affairs of the Corporation (or any Parent or Subsidiary) in a material manner. This shall not limit the grounds for the dismissal or discharge of any person in the Service of the Corporation (or any Parent or Subsidiary).

**S. 1934 Act** shall mean the Securities Exchange Act of 1934, as amended.

**T. Non-Statutory Option** shall mean an option not intended to satisfy the requirements of Code Section 422.

**U. Option Surrender Value** shall mean the Fair Market Value per share of Common Stock on the date the option is surrendered to the Corporation or, in the event of a Hostile Take-Over, effected through a tender offer, the highest reported price per share of Common Stock paid by the tender offeror in effecting such Hostile Take-Over, if greater. However, if the surrendered option is an Incentive Option, the Option Surrender Value shall not exceed the Fair Market Value per share.

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**V. *Optionee*** shall mean any person to whom an option is granted under the Discretionary Option Grant, Automatic Option Grant or Director Fee Option Grant Program.

**W. *Parent*** shall mean any corporation (other than the Corporation) in an unbroken chain of corporations ending with the Corporation, provided each corporation in the unbroken chain (other than the Corporation) owns, at the time of the determination, stock possessing fifty percent (50%) or more of the total combined voting power of all classes of stock in one of the other corporations in such chain.

**X. *Participant*** shall mean any person who is issued shares of Common Stock under the Stock Issuance Program.

**Y. *Permanent Disability or Permanently Disabled*** shall mean the inability of the Optionee or the Participant to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment expected to result in death or to be of continuous duration of twelve (12) months or more. However, solely for purposes of the Automatic Option Grant and Director Fee Option Grant Programs, Permanent Disability or Permanently Disabled shall mean the inability of the non-employee Board member to perform his or her usual duties as a Board member by reason of any medically determinable physical or mental impairment expected to result in death or to be of continuous duration of twelve (12) months or more.

**Z. *Plan*** shall mean the Corporation's 1999 Stock Incentive Plan, as set forth in this document.

**AA. *Plan Administrator*** shall mean the particular entity, whether the Primary Committee, the Board or the Secondary Committee, which is authorized to administer the Discretionary Option Grant and Stock Issuance Programs with respect to one or more classes of eligible persons, to the extent such entity is carrying out its administrative functions under those programs with respect to the persons under its jurisdiction. However, the Primary Committee shall have the plenary authority to make all factual determinations and to construe and interpret any and all ambiguities under the Plan to the extent such authority is not otherwise expressly delegated to any other Plan Administrator.

**BB. *Plan Effective Date*** shall mean June 9, 1999, the date on which the Plan was adopted by the Board.

**CC. *Predecessor Plan*** shall mean the Corporation's pre-existing 1998 Stock Option/Stock Issuance Plan in effect immediately prior to the Plan Effective Date hereunder.

**DD. *Primary Committee*** shall mean the committee of two (2) or more members of the Compensation Committee appointed by the Board to administer the Discretionary Option Grant and Stock Issuance Programs with respect to eligible persons.

**EE. *Secondary Committee*** shall mean a subcommittee of two (2) or more members of the Compensation Committee appointed by the Board to administer the Discretionary Option Grant and Stock Issuance Programs with respect to eligible persons other than Section 16 Insiders.

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**FF. Section 12 Registration Date** shall mean the date on which the Common Stock is first registered under Section 12(g) of the 1934 Act.

**GG. Section 16 Insider** shall mean an officer or director of the Corporation subject to the short-swing profit liabilities of Section 16 of the 1934 Act.

**HH. Service** shall mean the performance of services for the Corporation (or any Parent or Subsidiary) by a person in the capacity of an Employee, a non-employee member of the board of directors or a consultant or independent advisor, except to the extent otherwise specifically provided in the documents evidencing the option grant or stock issuance.

**II. Stock Exchange** shall mean either the American Stock Exchange or the New York Stock Exchange.

**JJ. Stock Issuance Program** shall mean the stock issuance program in effect under the Plan.

**KK. Subsidiary** shall mean any corporation (other than the Corporation) in an unbroken chain of corporations beginning with the Corporation, provided each corporation (other than the last corporation) in the unbroken chain owns, at the time of the determination, stock possessing fifty percent (50%) or more of the total combined voting power of all classes of stock in one of the other corporations in such chain.

**LL. 10% Stockholder** shall mean the owner of stock (as determined under Code Section 424(d)) possessing more than ten percent (10%) of the total combined voting power of all classes of stock of the Corporation (or any Parent or Subsidiary).

**MM. Underwriting Agreement** shall mean the agreement between the Corporation and the underwriter or underwriters managing the initial public offering of the Common Stock.

**NN. Underwriting Date** shall mean the date on which the Underwriting Agreement is executed and priced in connection with an initial public offering of the Common Stock.

**OO. Withholding Taxes** shall mean the Federal, state and local income and employment withholding tax liabilities to which the holder of Non-Statutory Options or unvested shares of Common Stock may become subject in connection with the exercise of those options or the vesting of those shares.

**QUEST SOFTWARE, INC.**

**2001 STOCK INCENTIVE PLAN  
(as amended on November 1, 2007)**

**ARTICLE ONE**

**GENERAL PROVISIONS**

**I. PURPOSE OF THE PLAN**

This 2001 Stock Incentive Plan is intended to promote the interests of Quest Software, Inc., a California corporation, by providing eligible persons with the opportunity to acquire a proprietary interest, or otherwise increase their proprietary interest, in the Corporation as an incentive for them to remain in the service of the Corporation. Capitalized terms shall have the meanings assigned to such terms in the attached Appendix.

**II. STRUCTURE OF THE PLAN**

The Plan shall be divided into two separate equity programs: (i) the Discretionary Option Grant Program under which eligible persons may, at the discretion of the Plan Administrator, be granted options to purchase shares of Common Stock; and (ii) the Stock Issuance Program under which eligible persons may, at the discretion of the Plan Administrator, be issued shares of Common Stock directly, either through the immediate purchase of such shares or as a bonus for services rendered the Corporation (or any Parent or Subsidiary). The provisions of Articles One and Four shall apply to all equity programs under the Plan and shall govern the interests of all persons under the Plan.

**III. ADMINISTRATION OF THE PLAN**

**A.** The following provisions shall govern the administration of the Plan:

(i) The Board shall have the authority to administer the Discretionary Option Grant and Stock Issuance Programs with respect to Section 16 Insiders but may delegate such authority in whole or in part to the Primary Committee.

(ii) Administration of the Discretionary Option Grant and Stock Issuance Programs with respect to all other persons eligible to participate in those programs may, at the Board's discretion, be vested in the Primary Committee or a Secondary Committee, or the Board may retain the power to administer those programs with respect to all such persons.

**B.** Each Plan Administrator shall, within the scope of its administrative jurisdiction under the Plan, have full power and authority subject to the provisions of the Plan:

(i) to establish such rules as it may deem appropriate for proper administration of the Plan, to make all factual determinations, to construe and interpret the provisions of the Plan and the awards thereunder and to resolve any and all ambiguities thereunder;

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(ii) to determine, with respect to awards made under the Discretionary Option Grant and Stock Issuance Programs, which eligible persons are to receive such awards, the time or times when such awards are to be made, the number of shares to be covered by each such award, the vesting schedule (if any) applicable to the award, the status of a granted option as either an Incentive Option or a Non-Statutory Option and the maximum term for which the option is to remain outstanding;

(iii) to amend, modify or cancel any outstanding award with the consent of the holder or accelerate the vesting of such award; and

(iv) to take such other discretionary actions as permitted pursuant to the terms of the applicable program.

Decisions of each Plan Administrator within the scope of its administrative functions under the Plan shall be final and binding on all parties.

C. Members of the Primary Committee or any Secondary Committee shall serve for such period of time as the Board may determine and may be removed by the Board at any time. The Board may also at any time terminate the functions of any Secondary Committee and reassume all powers and authority previously delegated to such committee.

D. Service on the Primary Committee or the Secondary Committee shall constitute service as a Board member, and members of each such committee shall accordingly be entitled to full indemnification and reimbursement as Board members for their service on such committee. No member of the Primary Committee or the Secondary Committee shall be liable for any act or omission made in good faith with respect to the Plan or any options or stock issuances under the Plan.

#### **IV. ELIGIBILITY**

The persons eligible to participate in the Discretionary Option Grant and Stock Issuance Programs are: (i) Employees; (ii) non-employee members of the Board or the board of directors of any Parent or Subsidiary; and (iii) consultants and other independent advisors who provide services to the Corporation (or any Parent or Subsidiary); provided, however, that prior to the Shareholder Approval Date, no officers or directors of the Corporation shall be eligible to participate in the Plan.

#### **V. STOCK SUBJECT TO THE PLAN**

A. The stock issuable under the Plan shall be shares of authorized but unissued or reacquired Common Stock, including shares repurchased by the Corporation on the open market. The maximum number of shares of Common Stock reserved for issuance over the term of the Plan shall not exceed 5,000,000 shares.

B. No one person participating in the Plan may receive options, separately exercisable stock appreciation rights and direct stock issuances for more than Two Hundred Fifty Thousand (250,000) shares of Common Stock in the aggregate per calendar year.

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C. Shares of Common Stock subject to outstanding options shall be available for subsequent issuance under the Plan to the extent those options expire, terminate or are cancelled for any reason prior to exercise in full. Unvested shares issued under the Plan and subsequently repurchased by the Corporation, at the original exercise or issue price paid per share, pursuant to the Corporation's repurchase rights under the Plan shall be added back to the number of shares of Common Stock reserved for issuance under the Plan and shall accordingly be available for reissuance through one or more subsequent options or direct stock issuances under the Plan. However, should the exercise price of an option under the Plan be paid with shares of Common Stock or should shares of Common Stock otherwise issuable under the Plan be withheld by the Corporation in satisfaction of the withholding taxes incurred in connection with the exercise of an option or the vesting of a stock issuance under the Plan, then the number of shares of Common Stock available for issuance under the Plan shall be reduced by the gross number of shares for which the option is exercised or which vest under the stock issuance, and not by the net number of shares of Common Stock issued to the holder of such option or stock issuance. Shares of Common Stock underlying one or more stock appreciation rights exercised under the Plan shall NOT be available for subsequent issuance.

D. If any change is made to the Common Stock by reason of any stock split, stock dividend, recapitalization, combination of shares, exchange of shares or other change affecting the outstanding Common Stock as a class without the Corporation's receipt of consideration, appropriate adjustments shall be made to (i) the maximum number and/or class of securities issuable under the Plan, (ii) the number and/or class of securities by which the share reserve is to increase each calendar year pursuant to the automatic share increase provisions of the Plan, (iii) the number and/or class of securities for which any one person may be granted options, separately exercisable stock appreciation rights and direct stock issuances under the Plan per calendar year, and (iv) the number and/or class of securities and the exercise price per share in effect under each outstanding option under the Plan. Such adjustments to the outstanding options are to be effected in a manner which shall preclude the enlargement or dilution of rights and benefits under such options. The adjustments determined by the Plan Administrator shall be final, binding and conclusive.

## ARTICLE TWO

### DISCRETIONARY OPTION GRANT PROGRAM

#### I. OPTION TERMS

Each option shall be evidenced by one or more documents in the form approved by the Plan Administrator; provided, however, that each such document shall comply with the terms specified below. Each document evidencing an Incentive Option shall, in addition, be subject to the provisions of the Plan applicable to such options.

##### A. EXERCISE PRICE.

1. The exercise price per share shall be fixed by the Plan Administrator at the time of the option grant, provided that the exercise price per share shall not be less than one hundred percent (100%) of the Fair Market Value per share of Common Stock on the option grant date.

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2. The exercise price shall become immediately due upon exercise of the option and shall, subject to the provisions of Section II of Article Four and the documents evidencing the option, be payable in cash or check made payable to the Corporation. Should the Common Stock be registered under Section 12 of the 1934 Act at the time the option is exercised, then the exercise price may also be paid as follows:

(i) shares of Common Stock held for the requisite period necessary to avoid a charge to the Corporation's earnings for financial reporting purposes and valued at Fair Market Value on the Exercise Date, or

(ii) to the extent the option is exercised for vested shares, through a special sale and remittance procedure pursuant to which the Optionee shall concurrently provide irrevocable instructions to (a) a Corporation-approved brokerage firm to effect the immediate sale of the purchased shares and remit to the Corporation, out of the sale proceeds available on the settlement date, sufficient funds to cover the aggregate exercise price payable for the purchased shares plus all applicable Federal, state and local income and employment taxes required to be withheld by the Corporation by reason of such exercise and (b) the Corporation to deliver the certificates for the purchased shares directly to such brokerage firm in order to complete the sale.

Except to the extent such sale and remittance procedure is utilized, payment of the exercise price for the purchased shares must be made on the Exercise Date.

**B. EXERCISE AND TERM OF OPTIONS.** Each option shall be exercisable at such time or times, during such period and for such number of shares as shall be determined by the Plan Administrator and set forth in the documents evidencing the option. However, no option shall have a term in excess of ten (10) years measured from the option grant date.

**C. CESSATION OF SERVICE.**

1. The following provisions shall govern the exercise of any options outstanding at the time of the Optionee's cessation of Service or death:

(i) Any option outstanding at the time of the Optionee's cessation of Service for any reason shall remain exercisable for such period of time thereafter as shall be determined by the Plan Administrator and set forth in the documents evidencing the option, but no such option shall be exercisable after the expiration of the option term.

(ii) Any option exercisable in whole or in part by the Optionee at the time of death may be subsequently exercised by his or her Beneficiary.

(iii) During the applicable post-Service exercise period, the option may not be exercised in the aggregate for more than the number of vested shares for which the option is exercisable on the date of the Optionee's cessation of Service. Upon the expiration of the applicable exercise period or (if earlier) upon the expiration of the option term, the option shall

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terminate and cease to be outstanding for any vested shares for which the option has not been exercised. However, the option shall, immediately upon the Optionee's cessation of Service, terminate and cease to be outstanding to the extent the option is not otherwise at that time exercisable for vested shares.

(iv) Should the Optionee's Service be terminated for Misconduct or should the Optionee engage in Misconduct while his or her options are outstanding, then all such options shall terminate immediately and cease to be outstanding.

2. The Plan Administrator shall have complete discretion, exercisable either at the time an option is granted or at any time while the option remains outstanding:

(i) to extend the period of time for which the option is to remain exercisable following the Optionee's cessation of Service to such period of time as the Plan Administrator shall deem appropriate, but in no event beyond the expiration of the option term, and/or

(ii) to permit the option to be exercised, during the applicable post-Service exercise period, for one or more additional installments in which the Optionee would have vested had the Optionee continued in Service.

**D. STOCKHOLDER RIGHTS.** The holder of an option shall have no stockholder rights with respect to the shares subject to the option until such person shall have exercised the option, paid the exercise price and become a holder of record of the purchased shares.

**E. REPURCHASE RIGHTS.** The Plan Administrator shall have the discretion to grant options which are exercisable for unvested shares of Common Stock. Should the Optionee cease Service while holding such unvested shares, the Corporation shall have the right to repurchase, at the exercise price paid per share, any or all of those unvested shares. The terms upon which such repurchase right shall be exercisable (including the period and procedure for exercise and the appropriate vesting schedule for the purchased shares) shall be established by the Plan Administrator and set forth in the document evidencing such repurchase right.

**F. VESTING.** Options granted under the Plan to the Chief Executive Officer of the Company or Chairman of the Board of Directors shall be subject to a minimum vesting period and shall vest as follows: not more than twenty percent (20%) of any shares of Common Stock subject to an option shall vest after the first year following the date of grant and not more than ten percent (10%) after every six-month period thereafter, provided, however, the Compensation Committee shall have the authority, in its sole discretion, to reduce the minimum vesting period provided in this Article Two, Section I(F). Notwithstanding the foregoing, at such time as the Chairman is Independent, the minimum vesting period required by this Article Two, Section I(F) shall not apply to options granted to such Chairman.

## **II. INCENTIVE OPTIONS**

The terms specified below shall be applicable to all Incentive Options. Incentive Options

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may not be granted hereunder unless the Shareholder Approval Date occurs within 12 months of the Effective Date. Except as modified by the provisions of this Section II, all the provisions of Articles One and Two shall be applicable to Incentive Options. Options which are specifically designated as Non-Statutory Options when issued under the Plan shall not be subject to the terms of this Section II.

**A. ELIGIBILITY.** Incentive Options may only be granted to Employees.

**B. EXERCISE PRICE.** The exercise price per share shall not be less than one hundred percent (100%) of the Fair Market Value per share of Common Stock on the option grant date.

**C. DOLLAR LIMITATION.** The aggregate Fair Market Value of the shares of Common Stock (determined as of the respective date or dates of grant) for which one or more options granted to any Employee under the Plan (or any other option plan of the Corporation or any Parent or Subsidiary) may for the first time become exercisable as Incentive Options during any one calendar year shall not exceed the sum of One Hundred Thousand Dollars (\$100,000). To the extent the Employee holds two (2) or more such options which become exercisable for the first time in the same calendar year, the foregoing limitation on the exercisability of such options as Incentive Options shall be applied on the basis of the order in which such options are granted.

**D. 10% STOCKHOLDER.** If any Employee to whom an Incentive Option is granted is a 10% Stockholder, then the exercise price per share shall not be less than one hundred ten percent (110%) of the Fair Market Value per share of Common Stock on the option grant date, and the option term shall not exceed five (5) years measured from the option grant date.

**E. LIMITED TRANSFERABILITY OF INCENTIVE OPTIONS.** During the lifetime of the Optionee, Incentive Options shall be exercisable only by the Optionee and shall not be assignable or transferable other than to a Beneficiary following the Optionee's death.

### **III. CHANGE IN CONTROL/HOSTILE TAKE-OVER**

**A.** Each option outstanding at the time of a Change in Control but not otherwise fully-vested shall automatically accelerate so that each such option shall, immediately prior to the effective date of the Change in Control, become exercisable for all of the shares of Common Stock at the time subject to that option and may be exercised for any or all of those shares as fully-vested shares of Common Stock. However, an outstanding option shall not so accelerate if and to the extent: (i) such option is, in connection with the Change in Control, assumed or otherwise continued in full force and effect by the successor corporation (or parent thereof) pursuant to the terms of the Change in Control, (ii) such option is replaced with a cash incentive program of the successor corporation which preserves the spread existing at the time of the Change in Control on the shares of Common Stock for which the option is not otherwise at that time exercisable and provides for subsequent payout in accordance with the same vesting schedule applicable to those option shares or (iii) the acceleration of such option is subject to other limitations imposed by the Plan Administrator at the time of the option grant. Each option outstanding at the time of the Change in Control shall terminate as provided in Section III.C. of this Article Two.

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**B.** All outstanding repurchase rights shall also terminate automatically, and the shares of Common Stock subject to those terminated rights shall immediately vest in full, in the event of any Change in Control, except to the extent: (i) those repurchase rights are assigned to the successor corporation (or parent thereof) or otherwise continue in full force and effect pursuant to the terms of the Change in Control or (ii) such accelerated vesting is precluded by other limitations imposed by the Plan Administrator at the time the repurchase right is issued.

**C.** Immediately following the consummation of the Change in Control, all outstanding options shall terminate and cease to be outstanding, except to the extent assumed by the successor corporation (or parent thereof) or otherwise expressly continued in full force and effect pursuant to the terms of the Change in Control.

**D.** Each option which is assumed in connection with a Change in Control shall be appropriately adjusted, immediately after such Change in Control, to apply to the number and class of securities which would have been issuable to the Optionee in consummation of such Change in Control had the option been exercised immediately prior to such Change in Control. Appropriate adjustments to reflect such Change in Control shall also be made to (i) the exercise price payable per share under each outstanding option, provided the aggregate exercise price payable for such securities shall remain the same, (ii) the maximum number and/or class of securities available for issuance over the remaining term of the Plan and (iii) the maximum number and/or class of securities for which any one person may be granted options, separately exercisable stock appreciation rights and direct stock issuances under the Plan per calendar year.

**E.** The Plan Administrator may at any time provide that one or more options will automatically accelerate in connection with a Change in Control, whether or not those options are assumed or otherwise continued in full force and effect pursuant to the terms of the Change in Control. Any such option shall accordingly become exercisable, immediately prior to the effective date of such Change in Control, for all of the shares of Common Stock at the time subject to that option and may be exercised for any or all of those shares as fully-vested shares of Common Stock. In addition, the Plan Administrator may at any time provide that one or more of the Corporation's repurchase rights shall not be assignable in connection with such Change in Control and shall terminate upon the consummation of such Change in Control.

**F.** The Plan Administrator may at any time provide that one or more options will automatically accelerate upon an Involuntary Termination of the Optionee's Service within a designated period (not to exceed eighteen (18) months) following the effective date of any Change in Control in which those options do not otherwise accelerate. Any options so accelerated shall remain exercisable for fully-vested shares until the earlier of (i) the expiration of the option term or (ii) the expiration of the one (1) year period measured from the effective date of the Involuntary Termination. In addition, the Plan Administrator may at any time provide that one or more of the Corporation's repurchase rights shall immediately terminate upon such Involuntary Termination.

**G.** The Plan Administrator may at any time provide that one or more options will automatically accelerate in connection with a Hostile Take-Over. Any such option shall become exercisable, immediately prior to the effective date of such Hostile Take-Over, for all of the shares of Common Stock at the time subject to that option and may be exercised for any or all of

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those shares as fully-vested shares of Common Stock. In addition, the Plan Administrator may at any time provide that one or more of the Corporation's repurchase rights shall terminate automatically upon the consummation of such Hostile Take-Over. Alternatively, the Plan Administrator may condition such automatic acceleration and termination upon an Involuntary Termination of the Optionee's Service within a designated period (not to exceed eighteen (18) months) following the effective date of such Hostile Take-Over. Each option so accelerated shall remain exercisable for fully-vested shares until the expiration or sooner termination of the option term.

**H.** The portion of any Incentive Option accelerated in connection with a Change in Control or Hostile Take Over shall remain exercisable as an Incentive Option only to the extent the applicable One Hundred Thousand Dollar (\$100,000) limitation is not exceeded. To the extent such dollar limitation is exceeded, the accelerated portion of such option shall be exercisable as a Non-Statutory Option under the Federal tax laws.

#### **IV. STOCK APPRECIATION RIGHTS**

The Plan Administrator may, subject to such conditions as it may determine, grant to selected Optionees stock appreciation rights which will allow the holders of those rights to elect between the exercise of the underlying option for shares of Common Stock and the surrender of that option in exchange for a distribution from the Corporation in an amount equal to the excess of (a) the Option Surrender Value of the number of shares for which the option is surrendered over (b) the aggregate exercise price payable for such shares. The distribution may be made in shares of Common Stock valued at Fair Market Value on the option surrender date, in cash, or partly in shares and partly in cash, as the Plan Administrator shall in its sole discretion deem appropriate.

### **ARTICLE THREE**

#### **STOCK ISSUANCE PROGRAM**

#### **V. STOCK ISSUANCE TERMS**

Shares of Common Stock may be issued under the Stock Issuance Program through direct and immediate issuances without any intervening options. Shares of Common Stock may also be issued under the Stock Issuance Program pursuant to share right awards which entitle the recipients to receive those shares upon the attainment of designated performance goals or Service requirements. Each such award shall be evidenced by one or more documents which comply with the terms specified below.

##### **A. PURCHASE PRICE.**

**1.** The purchase price per share of Common Stock subject to direct issuance shall be fixed by the Plan Administrator. **2.** Subject to the provisions of Section II of Article Four, shares of Common Stock may be issued under the Stock Issuance Program for any of the following items of consideration which the Plan Administrator may deem appropriate in each individual instance: (i) cash or check made payable to the Corporation, or (ii) past services rendered to the Corporation (or any Parent or Subsidiary).

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## **B. VESTING/ISSUANCE PROVISIONS.**

1. The Plan Administrator may issue shares of Common Stock which are fully and immediately vested upon issuance or which are to vest in one or more installments over the Participant's period of Service or upon attainment of specified performance objectives. Alternatively, the Plan Administrator may issue share right awards which shall entitle the recipient to receive a specified number of vested shares of Common Stock upon the attainment of one or more performance goals or Service requirements established by the Plan Administrator.

2. Any new, substituted or additional securities or other property (including money paid other than as a regular cash dividend) which the Participant may have the right to receive with respect to his or her unvested shares of Common Stock by reason of any stock dividend, stock split, recapitalization, combination of shares, exchange of shares or other change affecting the outstanding Common Stock as a class without the Corporation's receipt of consideration shall be issued subject to (i) the same vesting requirements applicable to the Participant's unvested shares of Common Stock and (ii) such escrow arrangements as the Plan Administrator shall deem appropriate.

3. The Participant shall have full stockholder rights with respect to the issued shares of Common Stock, whether or not the Participant's interest in those shares is vested. Accordingly, the Participant shall have the right to vote such shares and to receive any regular cash dividends paid on such shares.

4. Should the Participant cease to remain in Service while holding one or more unvested shares of Common Stock, or should the performance objectives not be attained with respect to one or more such unvested shares of Common Stock, then those shares shall be immediately surrendered to the Corporation for cancellation, and the Participant shall have no further stockholder rights with respect to those shares. To the extent the surrendered shares were previously issued to the Participant for consideration paid in cash or cash equivalent (including the Participant's purchase-money indebtedness), the Corporation shall repay to the Participant the cash consideration paid for the surrendered shares and shall cancel the unpaid principal balance of any outstanding purchase-money note of the Participant attributable to the surrendered shares.

5. The Plan Administrator may waive the surrender and cancellation of one or more unvested shares of Common Stock (or other assets attributable thereto) which would otherwise occur upon the cessation of the Participant's Service or the non-attainment of the performance objectives applicable to those shares. Such waiver shall result in the immediate vesting of the Participant's interest in the shares of Common Stock as to which the waiver applies. Such waiver may be effected at any time, whether before or after the Participant's cessation of Service or the attainment or non-attainment of the applicable performance objectives.

6. Outstanding share right awards shall automatically terminate, and no shares of Common Stock shall actually be issued in satisfaction of those awards, if the performance goals or Service requirements established for such awards are not attained. The Plan Administrator, however, shall have the authority to issue shares of Common Stock in satisfaction of one or more outstanding share right awards as to which the designated performance goals or Service requirements are not attained.

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## **VI. CHANGE IN CONTROL/HOSTILE TAKE-OVER**

**A.** All of the Corporation's outstanding repurchase rights shall terminate automatically, and all the shares of Common Stock subject to those terminated rights shall immediately vest in full, in the event of any Change in Control, except to the extent (i) those repurchase rights are assigned to the successor corporation (or parent thereof) or otherwise continue in full force and effect pursuant to the terms of the Change in Control or (ii) such accelerated vesting is precluded by other limitations imposed by the Plan Administrator at the time the repurchase right is issued.

**B.** The Plan Administrator may at any time provide for the automatic termination of one or more of those outstanding repurchase rights and the immediate vesting of the shares of Common Stock subject to those terminated rights upon (i) a Change in Control or Hostile Take-Over or (ii) an Involuntary Termination of the Participant's Service within a designated period (not to exceed eighteen (18) months) following the effective date of any Change in Control or Hostile Take-Over in which those repurchase rights are assigned to the successor corporation (or parent thereof) or otherwise continue in full force and effect.

## **VII. SHARE ESCROW/LEGENDS**

Unvested shares may, in the Plan Administrator's discretion, be held in escrow by the Corporation until the Participant's interest in such shares vests or may be issued directly to the Participant with restrictive legends on the certificates evidencing those unvested shares.

## **ARTICLE FOUR**

### **MISCELLANEOUS**

## **VIII. NO IMPAIRMENT OF AUTHORITY**

Outstanding awards shall in no way affect the right of the Corporation to adjust, reclassify, reorganize or otherwise change its capital or business structure or to merge, consolidate, dissolve, liquidate or sell or transfer all or any part of its business or assets.

## **IX. FINANCING**

The Plan Administrator may permit any Optionee or Participant to pay the option exercise price under the Discretionary Option Grant Program or the purchase price of shares issued under the Stock Issuance Program by delivering a full-recourse, interest bearing promissory note payable in one or more installments. The terms of any such promissory note (including the interest rate and the terms of repayment) shall be established by the Plan Administrator in its sole discretion. In no event may the maximum credit available to the Optionee or Participant exceed the sum of (i) the aggregate option exercise price or purchase price payable for the purchased shares plus (ii) any Federal, state and local income and employment tax liability incurred by the Optionee or the Participant in connection with the option exercise or share purchase.

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## **X. TAX WITHHOLDING**

**A.** The Corporation's obligation to deliver shares of Common Stock upon the exercise of options or the issuance or vesting of such shares under the Plan shall be subject to the satisfaction of all applicable Federal, state and local income and employment tax withholding requirements.

**B.** The Plan Administrator may, in its discretion, provide any or all holders of Non-Statutory Options or unvested shares of Common Stock under the Plan with the right to use shares of Common Stock in satisfaction of all or part of the Withholding Taxes incurred by such holders in connection with the exercise of their options or the vesting of their shares. Such right may be provided to any such holder in either or both of the following formats:

**Stock Withholding:** The election to have the Corporation withhold, from the shares of Common Stock otherwise issuable upon the exercise of such Non-Statutory Option or the vesting of such shares, a portion of those shares with an aggregate Fair Market Value equal to the percentage of the Withholding Taxes (not to exceed one hundred percent (100%)) designated by the holder.

**Stock Delivery:** The election to deliver to the Corporation, at the time the Non-Statutory Option is exercised or the shares vest, one or more shares of Common Stock previously acquired by such holder (other than in connection with the option exercise or share vesting triggering the Withholding Taxes) with an aggregate Fair Market Value equal to the percentage of the Taxes (not to exceed one hundred percent (100%)) designated by the holder.

## **XI. EFFECTIVE DATE AND TERM OF THE PLAN**

**A.** The Plan shall become effective immediately upon the Plan Effective Date. Options may be granted under the Discretionary Option Grant Program at any time on or after the Plan Effective Date. However, prior to the Shareholder Approval Date, no officers or directors of the Corporation shall be eligible to participate in the Plan.

**B.** The Plan shall terminate upon the earliest of (i) March 1, 2011 (ii) the date on which all shares available for issuance under the Plan shall have been issued as fully-vested shares or (iii) the termination of all outstanding options in connection with a Change in Control. Upon such plan termination, all outstanding options and unvested stock issuances shall thereafter continue to have force and effect in accordance with the provisions of the documents evidencing such grants or issuances.

## **XII. AMENDMENT OF THE PLAN**

**A.** The Board shall have complete and exclusive power and authority to amend or modify the Plan in any or all respects. However, no such amendment or modification shall adversely affect the rights and obligations with respect to stock options or unvested stock issuances at the time outstanding under the Plan unless the Optionee or the Participant consents to such amendment or modification. In addition, certain amendments may require stockholder approval pursuant to applicable laws or regulations.

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**B.** Options to purchase shares of Common Stock may be granted under the Discretionary Option Grant and shares of Common Stock may be issued under the Stock Issuance Program that are in each instance in excess of the number of shares then available for issuance under the Plan, provided any excess shares actually issued under those programs shall be held in escrow until there is obtained stockholder approval of an amendment sufficiently increasing the number of shares of Common Stock available for issuance under the Plan. If such stockholder approval is not obtained within twelve (12) months after the date the first such excess issuances are made, then (i) any unexercised options granted on the basis of such excess shares shall terminate and cease to be outstanding and (ii) the Corporation shall promptly refund to the Optionees and the Participants the exercise or purchase price paid for any excess shares issued under the Plan and held in escrow, together with interest (at the applicable Short Term Federal Rate) for the period the shares were held in escrow, and such shares shall thereupon be automatically cancelled and cease to be outstanding.

### **XIII. USE OF PROCEEDS**

Any cash proceeds received by the Corporation from the sale of shares of Common Stock under the Plan shall be used for general corporate purposes.

### **XIV. REGULATORY APPROVALS**

**A.** The implementation of the Plan, the granting of any stock option under the Plan and the issuance of any shares of Common Stock (i) upon the exercise of any granted option or (ii) under the Stock Issuance Program shall be subject to the Corporation's procurement of all approvals and permits required by regulatory authorities having jurisdiction over the Plan, the stock options granted under it and the shares of Common Stock issued pursuant to it.

**B.** No shares of Common Stock or other assets shall be issued or delivered under the Plan unless and until there shall have been compliance with all applicable requirements of Federal and state securities laws, including the filing and effectiveness of the Form S-8 registration statement for the shares of Common Stock issuable under the Plan, and all applicable listing requirements of any stock exchange (or the Nasdaq National Market, if applicable) on which Common Stock is then listed for trading.

### **XV. NO EMPLOYMENT/SERVICE RIGHTS**

Nothing in the Plan shall confer upon the Optionee or the Participant any right to continue in Service for any period of specific duration or interfere with or otherwise restrict in any way the rights of the Corporation (or any Parent or Subsidiary employing or retaining such person) or of the Optionee or the Participant, which rights are hereby expressly reserved by each, to terminate such person's Service at any time for any reason, with or without cause.

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## APPENDIX

The following definitions shall be in effect under the Plan:

**A. Beneficiary** shall mean, in the event the Plan Administrator implements a beneficiary designation procedure, the person designated by an Optionee or Participant, pursuant to such procedure, to succeed to such person's rights under any outstanding awards held by him or her at the time of death. In the absence of such designation or procedure, the Beneficiary shall be the personal representative of the estate of the Optionee or Participant or the person or persons to whom the award is transferred by will or the laws of descent and distribution.

**B. Board** shall mean the Corporation's Board of Directors.

**C. Change In Control** shall mean a change in ownership or control of the Corporation effected through any of the following transactions:

(i) a merger, consolidation or reorganization approved by the Corporation's stockholders, unless securities representing more than fifty percent (50%) of the total combined voting power of the voting securities of the successor corporation are immediately thereafter beneficially owned, directly or indirectly and in substantially the same proportion, by the persons who beneficially owned the Corporation's outstanding voting securities immediately prior to such transaction,

(ii) any stockholder-approved transfer or other disposition of all or substantially all of the Corporation's assets, or

(iii) the acquisition, directly or indirectly by any person or related group of persons (other than the Corporation or a person that directly or indirectly controls, is controlled by, or is under common control with, the Corporation), of beneficial ownership (within the meaning of Rule 13d-3 of the 1934 Act) of securities possessing more than fifty percent (50%) of the total combined voting power of the Corporation's outstanding securities pursuant to a tender or exchange offer made directly to the Corporation's stockholders which the Board recommends such stockholders accept.

**D. Code** shall mean the Internal Revenue Code of 1986, as amended.

**E. Compensation Committee** shall mean the Compensation Committee of the Corporation.

**F. Common Stock** shall mean the Corporation's common stock.

**G. Corporation** shall mean Quest Software, Inc., a California corporation, and any corporate successor to all or substantially all of the assets or voting stock of Quest Software, Inc. which shall by appropriate action adopt the Plan.

**H. Discretionary Option Grant Program** shall mean the discretionary option grant program in effect under the Plan.

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**I. *Employee*** shall mean an individual who is in the employ of the Corporation (or any Parent or Subsidiary), subject to the control and direction of the employer entity as to both the work to be performed and the manner and method of performance.

**J. *Exercise Date*** shall mean the date on which the Corporation shall have received written notice of the option exercise.

**K. *Fair Market Value*** per share of Common Stock on any relevant date shall be determined in accordance with the following provisions:

(i) If the Common Stock is at the time traded on the Nasdaq National Market, then the Fair Market Value shall be the closing selling price per share of Common Stock on the date in question, as such price is reported on the Nasdaq National Market or any successor system. If there is no closing selling price for the Common Stock on the date in question, then the Fair Market Value shall be the closing selling price on the last preceding date for which such quotation exists.

(ii) If the Common Stock is at the time listed on any Stock Exchange, then the Fair Market Value shall be the closing selling price per share of Common Stock on the date in question on the Stock Exchange determined by the Plan Administrator to be the primary market for the Common Stock, as such price is officially quoted in the composite tape of transactions on such exchange. If there is no closing selling price for the Common Stock on the date in question, then the Fair Market Value shall be the closing selling price on the last preceding date for which such quotation exists.

(iii) If the Common Stock is not at the time traded on the Nasdaq National Market or listed on any Stock Exchange, then the Fair Market Value shall be determined by the Plan Administrator, after taking into account such factors as it deems appropriate.

**L. *Hostile Take-Over*** shall mean:

(i) the acquisition, directly or indirectly, by any person or related group of persons (other than the Corporation or a person that directly or indirectly controls, is controlled by, or is under common control with, the Corporation) of beneficial ownership (within the meaning of Rule 13d-3 of the 1934 Act) of securities possessing more than fifty percent (50%) of the total combined voting power of the Corporation's outstanding securities pursuant to a tender or exchange offer made directly to the Corporation's stockholders which the Board does not recommend such stockholders to accept, or

(ii) a change in the composition of the Board over a period of thirty-six (36) consecutive months or less such that a majority of the Board members ceases, by reason of one or more contested elections for Board membership, to be comprised of individuals who either (A) have been Board members continuously since the beginning of such period or (B) have been elected or nominated for election as Board members during such period by at least a majority of the Board members described in clause (A) who were still in office at the time the Board approved such election or nomination.

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**M. Incentive Option** shall mean an option which satisfies the requirements of Code Section 422.

**N. Independent** shall have such meaning as defined in Section 303A.02 of the New York Stock Exchange Listed Companies Manual.

**O. Involuntary Termination** shall mean the termination of the Service of any individual which occurs by reason of:

(i) such individual's involuntary dismissal or discharge by the Corporation for reasons other than Misconduct, or

(ii) such individual's voluntary resignation following (A) a change in his or her position with the Corporation or Parent or Subsidiary employing the individual which materially reduces his or her duties and responsibilities or the level of management to which he or she reports, (B) a reduction in his or her level of compensation (including base salary, fringe benefits and target bonus under any performance based bonus or incentive programs) by more than fifteen percent (15%) or (C) a relocation of such individual's place of employment by more than fifty (50) miles, provided and only if such change, reduction or relocation is effected by the Corporation without the individual's consent.

**P. Misconduct** shall mean the commission of any act of fraud, embezzlement or dishonesty by the Optionee or Participant, any unauthorized use or disclosure by such person of confidential information or trade secrets of the Corporation (or any Parent or Subsidiary), or any intentional wrongdoing by such person, whether by omission or commission, which adversely affects the business or affairs of the Corporation (or any Parent or Subsidiary) in a material manner. This shall not limit the grounds for the dismissal or discharge of any person in the Service of the Corporation (or any Parent or Subsidiary).

**Q. 1934 Act** shall mean the Securities Exchange Act of 1934, as amended.

**R. Non-Statutory Option** shall mean an option not intended to satisfy the requirements of Code Section 422.

**S. Option Surrender Value** shall mean the Fair Market Value per share of Common Stock on the date the option is surrendered to the Corporation or, in the event of a Hostile Take-Over, effected through a tender offer, the highest reported price per share of Common Stock paid by the tender offeror in effecting such Hostile Take-Over, if greater. However, if the surrendered option is an Incentive Option, the Option Surrender Value shall not exceed the Fair Market Value per share.

**T. Optionee** shall mean any person to whom an option is granted under the Discretionary Option Grant Program.

**U. Parent** shall mean any corporation (other than the Corporation) in an unbroken chain of corporations ending with the Corporation, provided each corporation in the unbroken chain (other than the Corporation) owns, at the time of the determination, stock possessing fifty percent (50%) or more of the total combined voting power of all classes of stock in one of the other corporations in such chain.

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**V. Participant** shall mean any person who is issued shares of Common Stock under the Stock Issuance Program.

**W. Permanent Disability Or Permanently Disabled** shall mean the inability of the Optionee or the Participant to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment expected to result in death or to be of continuous duration of twelve (12) months or more.

**X. Plan** shall mean the Corporation's 2001 Stock Incentive Plan, as set forth in this document.

**Y. Plan Administrator** shall mean the particular entity, whether the Primary Committee, the Board or the Secondary Committee, which is authorized to administer the Discretionary Option Grant and Stock Issuance Programs with respect to one or more classes of eligible persons, to the extent such entity is carrying out its administrative functions under those programs with respect to the persons under its jurisdiction. However, the Primary Committee shall have the plenary authority to make all factual determinations and to construe and interpret any and all ambiguities under the Plan to the extent such authority is not otherwise expressly delegated to any other Plan Administrator.

**Z. Plan Effective Date** shall mean March 28, 2001, the date on which the Plan was adopted by the Board.

**AA. Primary Committee** shall mean the committee of two (2) or more members of the Compensation Committee appointed by the Board to administer the Discretionary Option Grant and Stock Issuance Programs with respect to eligible persons.

**BB. Secondary Committee** shall mean a subcommittee of two (2) or more members of the Compensation Committee appointed by the Board to administer the Discretionary Option Grant and Stock Issuance Programs with respect to eligible persons other than Section 16 Insiders.

**CC. Section 16 Insider** shall mean an officer or director of the Corporation subject to the short-swing profit liabilities of Section 16 of the 1934 Act.

**DD. Service** shall mean the performance of services for the Corporation (or any Parent or Subsidiary) by a person in the capacity of an Employee, a non-employee member of the board of directors or a consultant or independent advisor, except to the extent otherwise specifically provided in the documents evidencing the option grant or stock issuance.

**EE. Shareholder Approval Date** shall mean the date on which the Plan and the issuance of shares of Common stock pursuant to the Plan shall have been approved by the Company's shareholders in satisfaction of applicable requirements of the Nasdaq National Market or Stock Exchange on which the Common Stock is traded or listed.

**FF. Stock Exchange** shall mean either the American Stock Exchange or the New York Stock Exchange.

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**GG. *Stock Issuance Program*** shall mean the stock issuance program in effect under the Plan.

**HH. *Subsidiary*** shall mean any corporation (other than the Corporation) in an unbroken chain of corporations beginning with the Corporation, provided each corporation (other than the last corporation) in the unbroken chain owns, at the time of the determination, stock possessing fifty percent (50%) or more of the total combined voting power of all classes of stock in one of the other corporations in such chain.

**II. *10% Stockholder*** shall mean the owner of stock (as determined under Code Section 424(d)) possessing more than ten percent (10%) of the total combined voting power of all classes of stock of the Corporation (or any Parent or Subsidiary).

**JJ. *Withholding Taxes*** shall mean the Federal, state and local income and employment withholding tax liabilities to which the holder of Non-Statutory Options or unvested shares of Common Stock may become subject in connection with the exercise of those options or the vesting of those shares.

## SUBSIDIARIES OF QUEST SOFTWARE, INC.

<u>Name</u>	<u>Jurisdiction Of Organization</u>
1397639 Ontario Ltd.	Ontario, Canada
881229 Alberta Ltd.	Alberta, Canada
Fastlane Technologies (UK) Limited	United Kingdom
Fastlane Technologies Corporation	Delaware
Fastlane Technologies GmbH	Germany
Active Concepts Pty, Ltd.	Australia
Active Concepts, Inc.	California
Fresh Dew Investments Limited	British Virgin Islands
Murecia Investments Limited	British Virgin Islands
Quest Software France SARL	France
Quest Software (UK) Ltd.	United Kingdom
Quest Software Pty., Ltd.	Australia
Q.S.I. Quest Software Israel Limited	Israel
Quest Software Company Limited	Ireland
Quest Software International Limited	Ireland
Quest Software GmbH	Germany
Quest Holding Company, LLC	California
Quest Softair, Inc.	California
Quest Software, Ltda	Brazil
Quest Software Espana, S.A.	Spain
Quest Software Mexico S. de R.L. de C.V.	Mexico
Quest Software Nederland B.V.	Netherlands
Quest Norge AS	Norway
Quest Scandinavia AS	Denmark
QSFT Svenska AB	Sweden
Sitraka Corporation	Minnesota
Quest Software Java Support Centre B.V.	Netherlands
Sitraka Deutschland GmbH	Germany
Safari Limited Partnership	Canada
Quest Software Canada	Canada
eCritical Corporation	California
Discus Data Solutions, Inc.	Delaware
QSI Development Corp.	Delaware
Quest Acquisition Corp.	California
Quest Software K.K.	Japan
Quest Software Sales Sdn Bhd	Malaysia
Quest Software Singapore Ptd LTD	Singapore
Quest Software Limited	Hong Kong
Quest Software Korea LTD	Korea
Aelita Software Corporation	Delaware
Aelita Software Limited	United Kingdom
Lecco Canada	Canada
Lecco Technology (UK) Limited	United Kingdom
Lecco Technology (USA), Inc.	Delaware
Quest Software Italia – S.R.L. Unipersonale	Italy
Quest Software Greater China Limited	Hong Kong
Vintela, Inc.	Utah
Vinela Europe, Inc.	Utah
Vintela Pty. Ltd.	Australia
Wedgetail Communications Incorporated	Delaware
Imceda Software, Inc.	Delaware
Imceda Technologies Pty. Ltd.	Australia
Imceda Software Australia Pty. Ltd.	Australia
DB Associates IT Pty. Ltd.	Australia
Wingra Technologies, LLC	Wisconsin
Quest Software New Zealand Limited	New Zealand
Charonware s.r.o.	Czech Republic
Magnum Technologies, Inc.	Minnesota
Invirtus	Delaware
Scriptlogic Corporation	Delaware
ScriptLogic UK Ltd.	United Kingdom
ScriptLogic Australia Pty. Ltd.	Australia

**CONSENT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

We consent to the incorporation by reference in Registration Statement Nos. 333-82784, 333-38002, 333-49668, 333-91429, 333-96183, 333-103010, 333-107045, 333-113927, 333-116761, 333-125398 and 333-126585 on Form S-8; and Registration Statement No. 333-63596 on Form S-4 of our reports dated December 7, 2007 relating to the consolidated financial statements of Quest Software, Inc. (the "Company") (which report expresses an unqualified opinion and includes an explanatory paragraph relating to the adoption of Statement of Financial Accounting Standards No. 123(R), *Share-based Payment*, and FASB Staff Position No. AUG AIR-1, *Accounting for Planned Major Maintenance Activities*, discussed in Note 1 and an explanatory paragraph relating to the restatement discussed in Note 2) and management's report on the effectiveness of internal control over financial reporting (which report expressed an unqualified opinion on management's assessment of the effectiveness of the Company's internal control over financial reporting and expressed an adverse opinion on the effectiveness on the Company's internal control over financial reporting because of material weaknesses) appearing in the Annual Report on Form 10-K of the Company for the year ended December 31, 2006.

/s/ Deloitte & Touche LLP

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Costa Mesa, California  
December 7, 2007

## CERTIFICATION

I, Vincent C. Smith, certify that:

1. I have reviewed this Annual Report on Form 10-K of Quest Software, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
  - a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
  - a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: December 7, 2007

/s/ Vincent C. Smith

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Vincent C. Smith,  
Chief Executive Officer

## CERTIFICATION

I, Scott J. Davidson, certify that:

1. I have reviewed this Annual Report on Form 10-K of Quest Software, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
  - a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
  - a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: December 7, 2007

/s/ Scott J. Davidson

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Scott J. Davidson,

Senior Vice President and Chief Financial Officer



**Certification of Chief Financial Officer Pursuant to  
18 U.S.C. Section 1350, as Adopted Pursuant to  
Section 906 of the Sarbanes-Oxley Act of 2002**

I, Scott J. Davidson, certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that the Annual Report of Quest Software, Inc. on Form 10-K for the year ended December 31, 2005, fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934 and that information contained in such Report fairly presents, in all material respects, the financial condition and results of operations of Quest Software, Inc.

Date: December 7, 2007

By: /s/ Scott J. Davidson  
Name: Scott J. Davidson  
Title: Senior Vice President and Chief  
Financial Officer

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