FORM 10-K
MICROMUSE INC – MUSEE

Filed: May 17, 2004 (period: December 31, 2003)

Annual report which provides a comprehensive overview of the company for the past year
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10–K

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

For the Fiscal Year Ended September 30, 2003

☐ 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. 000–23783

MICROMUSE INC.
(Exact name of registrant as specified in its charter)

Delaware
(State or other jurisdiction of incorporation or organization)

94–3288385
(IRS Employer Identification No.)

139 Townsend Street
San Francisco, California 94107
(415) 538–9090
(Address of Principal Executive Office, including ZIP code and telephone number)

Securities registered pursuant to Section 12(b) of the Act: None

Securities registered pursuant to Section 12(g) of the Act:
Common Stock, $.01 par value
(Title of class)

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 an accelerated filer (as defined in Exchange Act Rule 12b–2): Yes ☒ No ☐

The aggregate market value of the Registrant’s common stock held by non–affiliates of the Registrant on March 31, 2004, based upon the closing price of a share of the Registrant’s common stock as reported by the Nasdaq National Market on that date, was approximately $607.0 million. As of May 3, 2004, there were 78,270,124 shares of the Registrant’s common stock, $.01 par value, outstanding.

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This document contains forward-looking statements that involve risks and uncertainties. The Company's actual results may differ materially from the results discussed in such forward-looking statements. Factors that might cause such differences include, but are not limited to, fluctuations in customer demand, risks associated with competition and risks identified in the Company's Securities and Exchange Commission filings, including, but not limited to, those discussed elsewhere in this Form 10-K under the heading “Risk Factors” located at the end of Item 7, Management's Discussion and Analysis of Financial Condition and Results of Operations, of this Form 10-K.

Item 1. Business

Micromuse develops, markets and supports a family of scalable, highly configurable, rapidly deployable software solutions that enable service and business assurance—the effective monitoring of the status of multiple devices and elements underlying an Information Technology (IT) service delivery infrastructure, to help provide the continuous availability of IT-based services and businesses. The Micromuse Netcool® product suite collects, normalizes and consolidates high volumes of event information from heterogeneous network management environments into an active database that de-duplicates and correlates the resulting data in real-time. It then rapidly distributes graphical views of the information to operators and administrators responsible for monitoring service levels. Netcool's unique architecture allows for the rapid, programmerless association of devices and specific attributes of those devices to the business services they impact. This readily enables network operations teams to create and modify their service views during systems operations to monitor particular business services, rapidly identify which users are affected by which network faults, pinpoint sources of network problems, automate operator responses, facilitate problem resolution and report on the results.

We market and distribute to customers through our own sales force, OEMs, value-added resellers and systems integrators. For example, we currently have distribution agreements with Cisco Systems, IBM Global Services, Ericsson, Nortel, Alcatel, and Sun Microsystems. As of September 30, 2003, we had licensed our software to nearly 1,600 customers operating in and serving a variety of industries. Micromuse customers include Cable & Wireless, Charles Schwab, Citigroup, Deutsche Telekom, Digex, Earthlink, Electronic Data Systems, GE Appliances, ITC^*DeltaCom, J.P. Morgan Chase, T-Mobile, and Verizon.

Micromuse operates as a single operating segment, and further geographic and segment information is included in Note 8 “Geographic and Segment Information” of the Notes to Consolidated Financial Statements included in this Form 10-K. For a discussion of customers accounting for 10% or more of our consolidated revenue and credit concentration, see “Management's Discussion and Analysis of Financial Condition and Results of Operations—Revenues,” and Note 1 “Concentration of Credit Risk” of the Notes to Consolidated Financial Statements included in this Form 10-K.

Micromuse was founded in 1989 in London, England, and in 1997 reorganized as a Delaware corporation and relocated its headquarters to San Francisco, California.

Information Available on the Micromuse Website

The Micromuse website is www.micromuse.com.

Micromuse makes the following filings available on its website as soon as reasonably practicable after they are electronically filed with or furnished to the SEC: our Annual Report on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K, and any amendments to those reports filed or furnished under applicable provisions of the Securities Exchange Act of 1934 and SEC rules. You may access these filings on our website at http://www.micromuse.com/ by clicking on “Our Company,” then “Investor Relations,” and then “SEC filings.” Within the “SEC filings” section, we provide a link to view our SEC filings referred to above, and a separate link to view the “Section 16 Filings” that our directors and officers (and, if applicable, more than 10% stockholders) make to report initial beneficial ownership and changes in beneficial ownership of our common stock.
Micromuse also makes available, in a corporate governance section on our website, the charters of the Audit Committee, Nominating and Corporate Governance Committee, and Compensation Committee of the Micromuse Board of Directors, and the Micromuse Code of Business Conduct. You may access these documents on our website by clicking on “Our Company,” then “Investor Relations,” and finally “Corporate Governance.”

The Micromuse Code of Business Conduct is applicable to Micromuse directors, officers and employees, and meets the definition of a code of ethics set forth in SEC Regulation S-K Item 406. The code also includes a section entitled “Financial Code of Ethics for Employees with Financial Reporting Obligations” applicable to our Chief Executive Officer, Chief Financial Officer and other members of our finance department that contains specific ethical and related standards applicable to those with responsibilities for financial reporting and disclosure to investors. As permitted by SEC rules, in lieu of filing this code as an exhibit to this Form 10-K, we have made the code available on our website as described above.

Under revised Nasdaq listing standards, Micromuse may grant waivers of the Code of Business Conduct for directors and officers only if approved by the board of directors, and must make any such waivers along with the reasons for the waivers publicly available by filing a Form 8-K within 5 business days. Under SEC rules, Micromuse is required to file a Form 8-K to disclose any amendment of the code (other than non-substantive amendments) or any explicit or implicit waiver of the code (i.e., any material departure from the code) granted to the chief executive officer, chief financial or accounting officer, controller or persons performing similar functions, if the waiver relates to matters contained in the SEC’s definition of a code of ethics. As permitted by SEC rules, Micromuse intends to satisfy the requirement under SEC rules to disclose amendments and waivers of the code by posting this information on the Micromuse website under the corporate governance link indicated above. To the extent the Nasdaq rules do not permit this alternate means of disclosure allowed by SEC rules, Micromuse will file a Form 8-K to report waivers, if any.

All of the filings and governance documents available under the Investor Relations link on our website are free of charge.

Restatement of Financial Statements

The Company has restated its consolidated financial statements for the fiscal years ended September 30, 2001 and 2002 and for the quarters ended December 31, 2000 through June 30, 2003. We have also adjusted the consolidated financial statement information for the quarter and fiscal year ended September 30, 2003 announced on October 29, 2003 and the preliminary financial information for the quarter ended December 31, 2003 announced on February 10, 2004. All applicable financial information contained in this Annual Report on Form 10-K gives effect to these restatements. Accordingly, the financial statements for those fiscal periods described above that have been included in the Company’s previous filings with the Securities and Exchange Commission or included in previous announcements should not be relied upon.

For information concerning the background of the restatements and the specific adjustments made on an annual and quarterly basis, see Item 7, “Management’s Discussion and Analysis of Financial Condition and Results of Operations—Restatement of Financial Statements”, and Notes 2 and 11 of the Notes to Consolidated Financial Statements included in Item 8. Remedial measures that were recommended or identified in the course of the restatement process are summarized in Item 9A, “Controls and Procedures.”

Business Developments

Changes in Executive Officers

On January 12, 2004, the Company announced the appointment of Arun Oberoi as Executive Vice President, Global Sales and Technical Services. See Item 10 of this Form 10-K for a description of Mr. Oberoi’s business background.
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Effective September 30, 2003, Michael S. Donohue resigned his executive officer status as Senior Vice President, Sales and Business Operations.

On July 29, 2003, the Company announced the appointment of Lloyd A. Carney as Chairman and Chief Executive Officer. See Item 10 of this Form 10-K for a description of Mr. Carney’s business background.

Effective December 31, 2002, Gregory Q. Brown resigned as Chairman and Chief Executive Officer, to assume a position as an officer of another company. As a result of his resignation, and until the appointment of Mr. Carney, Director David C. Schwab served as Chairman, and Michael L. Luetkemeyer, served as interim Chief Executive Officer while retaining his responsibilities as Chief Financial Officer.

Fiscal 2003 Employee Reduction
On October 29, 2002, the Company announced plans to reduce headcount by approximately 18% during the first quarter of fiscal 2003, from a base of 660 employees as of September 30, 2002. As of September 30, 2003, we had 573 employees, including those who joined the Company from two acquisitions described below that were completed in fiscal 2003.

Acquisitions
On December 19, 2002, the Company acquired all of the outstanding common stock of Lumos Technologies Inc. ("Lumos"), a privately-held developer of sophisticated technology for managing Layer 1 networks. By integrating their capabilities with existing Netcool applications, the Company intends to deliver comprehensive Layer 1 network visibility, event correlation, and problem resolution to current and future users of the Netcool suite. Under the terms of the acquisition agreement, the Company agreed to pay up to $2.7 million in cash and assume $0.9 million in outstanding debt. Approximately $1.0 million of the cash purchase price was paid at closing, a further $1.2 million was paid as of September 30, 2003 in connection with certain earnouts in relation to revenue, development and employment retention goals. The remaining earnouts of $0.3 million and $0.2 million were paid in the quarters ended December 31, 2003 and March 31, 2004, respectively. The transaction was accounted for under the purchase method of accounting with Lumos’ results of operations included from the acquisition date.

On August 20, 2003, the Company announced it had completed the acquisition of NETWORK HARMONi (NHI) for approximately $23.0 million in cash. NHI’s HARMONi suite of intelligent agents provides the core data collection technology within Netcool®/System Service Monitors® (Netcool/SSMs) and Netcool®/Application Service Monitors® (Netcool/ASMs), which gather realtime information about distributed systems, servers, and applications across the IT infrastructure. In addition to the extensive library of intelligent HARMONi agents, Micromuse acquired NHI’s OpCenter product, a lightweight, centralized IT management and problem resolution system that is ideally tailored for mid-sized enterprise IT infrastructures. Micromuse also assumed several pending patent applications that had previously been filed by NHI.

Products and Technology
Micromuse provides a suite of software products that enable business and service assurance for enterprises and service providers. Our Netcool solutions include the flagship Netcool/OMNibus® product family, which collects, consolidates, de-duplicates and correlates information from more than 1,000 network management platforms and devices and presents realtime user-configurable views of faults, network, service and business status. This product family allows network operations personnel to react to problems in their network infrastructure before they cause outages in service availability and/or to identify outages and their probable causes. These capabilities enable network managers to improve the reliability and functionality of their networks, thereby enhancing operating efficiencies, productivity and profitability of network operators and users. The components of the Netcool/OMNiBus Product Family are described in the section entitled "Netcool/OMNiBus Product Family."
Micromuse also provides several other product families that work in conjunction with Netcool/OMNIbus and provide enhanced business and service assurance capabilities. These include the Netcool/Service Monitors™ product family, the Netcool/Precision™ product family, the Netcool/Impact™ product family and the Netcool/Dashboards™ product family.

In addition, the Netcool suite includes packaged software "solutions" comprised of product family components and targeted to specific customer environments. These solutions include:

- Netcool for Voice Networks™
- Netcool for Security Management™
- Netcool for Asset Management™
- Netcool for Voice Over IP™

Brief descriptions of the Netcool product families are provided below:

**Netcool/OMNIbus Product Family**

Micromuse’s flagship Netcool/OMNIbus product family provides realtime business and service assurance. As the cornerstone of the Netcool suite, it collects and consolidates events and alarms from more than 1,000 IT environments in realtime—and presents this information to IT executives and operations personnel in an intuitive, graphical console. Netcool/OMNIbus provides realtime monitoring, management, and event de-duplication and helps organizations proactively manage their IT infrastructures to ensure continuous uptime of business services and applications. Environments supported by Netcool/OMNIbus include business applications, Windows and UNIX systems, data switches, voice switches, IP routers, frameworks and others.

The Netcool ObjectServer™, the core component of Netcool/OMNIbus, is a high-speed database that collects event information from throughout the infrastructure. Netcool Probes & Monitors collect event messages from throughout the IT infrastructure and forward them to the Netcool ObjectServer for consolidation, filtering, de-duplication, suppression, and analysis.

The Netcool suite also provides Executive Dashboards™ that allow you to customize realtime views of operations and business services, based on geography, department, or supporting IT resources. Point-and-click interfaces allow you to address and prioritize the resolution of IT problems based upon their business or customer impact. Designed to meet the needs of both IT executives and operations personnel, the Netcool dashboards provide a ‘birds-eye’ view of services as well as detailed analysis of specific IT resources.

**Netcool Probes & Monitors Product Family**

Supporting a variety of IP, Internet and wireless-based services and applications, Netcool/Probes & Monitors collect and consolidate data from over 1,000 environments off-the-shelf. Netcool manages events at the device and system level while also testing service and application availability from the service user’s perspective.

**Netcool Gateways™** interface to third-party databases and applications that need to share event data interactively with the Netcool/OMNIbus realtime event database engine. Examples of gateway-supported environments include Oracle, Sybase, SQL Server, Informix, Remedy, Clarify (Amdocs), Vantive (PeopleSoft), Siebel, and Metasolv.

Using generic probes, proprietary probes, standards-based probes (such as SNMP trapd and TL1), gateways, and monitors, Netcool/OMNIbus can collect data from virtually any networking environment.

**Netcool/Monitors Product Family**

Supporting a variety of IP, Internet and wireless-based services and applications, Netcool/Monitors use ‘synthetic transactions’ to monitor availability and performance over fixed line and wireless infrastructures.
Netcool/Application Service Monitors™ (ASMs) provide detailed application and database monitoring for Oracle, Microsoft SQL, Microsoft Exchange, Apache and MS IIS. Netcool/ASMs monitor a variety of metrics from these applications and offer suggested resolution procedures aimed at repairing problems.

Netcool/System Service Monitors™ (SSMs) accurately measure the availability and performance of host systems and applications running on them. Its distributed systems management includes CPU utilization, memory utilization, and disk space and can track blocks, inodes, total and free files in each file system. Netcool/SSMs can also manage running processes and execute restarts when they go down.

Netcool/Data Center Monitors™ (DCMs) consolidate realtime management from IBM mainframe and midrange systems—the IBM S/390 (IBM zSeries) and IBM AS/400 (IBM iSeries). Netcool/DCMs allow you to monitor events across mainframe alerts such as VTAM sessions and MVS subsystems as well as midrange—computing systems. Netcool/DCMs identify problems before applications and services are affected.

Netcool/Internet Service Monitors™ (ISMs) for managing HTTP and HTTPS web pages and financial transactions help determine the cause of problems affecting eCommerce transactions. Netcool/ISMs measure the availability and performance of Web—based applications and offer Web—based historical reports that can be measured against service agreements. Netcool/ISMs that provide support for SMTP, POP3, and IMAP protocols ensure the availability and response time of email services. Netcool/ISMs also manage the underlying infrastructure protocols, such as DHCP, DNS, FTP, ICMP, NNTP, NTP, TCP Port, and Radius. Netcool/ISMs help ensure the availability of Internet, voice and wireless infrastructures.

The Netcool/Usage Service Monitors™ (USMs) provide usage—metering and show the status of network usage in realtime or over a period of time. These usage monitors measure how many people are using a device and/or service. They also allow you to view the usage for a given department or business unit such as the quantity of hits, or bandwidth usage.

The Netcool/Wireless Service Monitors™ (WSMs) for managing end—end availability and performance of WAP and SMS—based services act like a wireless service user to simulate transactions. These Netcool/Service Monitors can test page availability and content accuracy by connecting to defined WAP pages via WAP Gateways.

Netcool/Precision Product Family

The Netcool/Precision product family is built on a flexible architecture designed specifically for modern networks. Utilizing its accurate topology and network connectivity information, Netcool/Precision monitors the network to locate and isolate network problems as they develop and reports these problems to network staff. This enables administrators to resolve problems fast, before they escalate into more serious outages that impact the availability and performance of critical business services.

Netcool/Precision for IP Networks™ (Netcool/PrecisionIP) automatically discovers IP networks, gathering topology data to deliver a complete picture of devices and layer 2 and layer 3 connectivity, including MPLS, ATM and Frame networks. It monitors all discovered elements for status and continually updates its database with new device information as the network changes. When network problems occur, Netcool/PrecisionIP analyzes events and identifies the root cause of the problem—significantly reducing the time it takes to isolate network faults. Fully integrated with the Netcool suite, Netcool/ PrecisionIP delivers a complete picture of network connectivity, and quickly isolates the source of network downtime.

Netcool/Precision for Transmission Networks™ (Netcool/PrecisionTN) automatically discovers transmission layer (Layer 1) networks, deepening the visibility provided by Netcool/Precision IP at network layers 2 and 3. Netcool/Precision TN collects and sends alarm, inventory, facility, and connection information to Netcool/OMNibus from any TL1— or SNMP—managed NEs so that you can drill down to the very shelf, card, and
port involved in the alarm—and all in realtime. This information can be used to visualize the problems with Netcool/Precision TN’s rich web-based GUI or with common reporting tools. And the information is stored in a MySQL or an Oracle database, providing additional opportunities to generate reports and analyze network data.

Like an “engineer in a box,” Netcool/Visionary™ analyzes information from industry-standard SNMP devices and applications and provides real-time, device-centric diagnoses. Its patent-pending MicroCorrelation™ technology analyzes the SNMP Management Information Base information to pinpoint the underlying cause of hundreds of unique problems that pertain to specific devices. Whenever a device such as a server, switch or router shows a deviation from normal behavior, Netcool/Visionary provides an explanation for the condition—showing details on why problems occur and the recommended solution. Netcool/Visionary sends this data to Netcool/OMNibus.

Netcool/Impact Product Family

Tightly integrated with Netcool/OMNibus, Netcool/Impact shows the realtime business impact analysis of specific faults within the infrastructure. It allows you to see how Netcool-collected events will impact IT-based business processes, services, and business-critical applications.

Netcool/Impact retrieves business process, customer and service information from a variety of databases and files. When events occur, Netcool/Impact automatically enriches Netcool/OMNibus events by linking the right information with each event. This “enriched” event gives you the knowledge needed to define resolution policies and instruct Netcool/Impact to take automatic corrective action on faults. In addition it can escalate events to email, pagers and other systems—ensuring fast and efficient notification. Netcool/Impact’s analysis of events helps you prioritize work and focus on business-critical events.

Netcool/SLA Manager™ delivers realtime service modeling and reporting, allowing you to monitor the impact of IT performance on services and SLAs. From the bottom up, you can drill into services and view the collection of network and Web devices and server farms supporting them. Its graphical views can be customized to provide a complete picture of business process, IT workflow and faults—calculating how services are performing relative to SLAs historically and in realtime.

Netcool/SLA Manager (Netcool/SLAM) incorporates data across IT components that make up a service, including network devices such as routers and switches, wireless and broadband components, systems and applications. This information is correlated to measure service availability, performance and usage as well as the overall customer experience. By assimilating this information into a broader service model, Netcool/SLAM can show both IT and business executives an “at-a-glance” view of service and application health as well as impending problems.

Netcool/Desktop™ is the proprietary client interface into Netcool/OMNibus, providing dynamic, intuitive, realtime views of the IT infrastructure. You can toggle easily among list-based, map-based, logical, topological, and graphical views of device-level and service-affecting events. Tools, notifications, and other applications can be launched from within the Netcool Desktop, enabling true, realtime, centralized IT management.

Netcool/Webtop™ is a richly-featured, web-based version of Netcool/Desktop, enabling Netcool views to be configured and accessed across a secure Web interface. In addition to providing “anytime, anywhere” access over any Web-connected PC, Netcool/Webtop can be ported to any other type of web-enabled device, including PDAs and wireless devices. Netcool/Webtop can be configured easily into a wide range of operational and executive views for all types of users.

Netcool/Reporter™ receives event data from the Netcool/OMNibus™ application and translates it into meaningful reports. By analyzing and presenting data generated over time, Netcool/Reporter provides long-term,
retrospective information about the behavior of devices, systems and services. Its drill-down features and access to journals, details, and event histories allows managers to troubleshoot specific problems quickly and effectively. Netcool/Reporter offers an intelligent window into event trends, revealing "hot spots" so you can intervene before larger problems occur. Its easy, intuitive reports enable you to understand the behavior of your infrastructure over time. Designed to help you more effectively manage service and application availability over time, Netcool/Reporter also offers device availability reports, personnel response-time measures, and other statistics to help you report against committed service-level agreements.

Sales and Marketing

We market our software and services primarily through our direct sales organization with United States offices in Chicago, Dallas, New York, San Francisco, and McLean, Virginia; and international offices in Australia, Austria, Brazil, China, France, Germany, Italy, Japan, Mexico, the Netherlands, Poland, Singapore, Spain, and the United Kingdom, among other locations. Additionally, we have a growing channel consisting of OEMs, value-added resellers (VARs) and systems integrators.

Typically, the sales process will include an initial sales presentation, a product demonstration, at times a proof of concept evaluation, a closing meeting and a purchase process. The sales process typically takes six to nine months, although we have experienced shorter, longer and less predictable cycles. Companies often start with a moderate deployment of certain Netcool software components, and upon its demonstrated effectiveness subsequently make additional and larger purchases. A majority of our sales are from repeat customers who renew maintenance agreements and often purchase additional software as their networks expand, or as additional sites within the customer account learn of the services provided by, and the benefits of, the Netcool software.

We have a number of marketing programs designed to inform potential customers about the capabilities and benefits of our products. Our marketing efforts include investing in our technical leadership, participation in industry trade shows, technical conferences and technology seminars, preparation of competitive analyses, analyzing returns on investment in our software, sales training, publication of technical and educational articles in industry journals, advertising and sponsorships.

If we are to achieve significant revenue growth in the future, we must successfully train and retain our existing sales force and recruit additional premier sales personnel, if needed, and increase their productivity. Competition for such individuals is intense, and there can be no assurance that we will be able to either retain and adequately train our current sales force or attract qualified sales personnel in the future. If we are unable to retain, train or hire such people and make them productive on a timely basis, our business, operating results or financial condition would be adversely affected. See “Risk Factors—We depend on our key personnel, and the loss of any of our key personnel could harm our business.”

To achieve significant growth in revenues in the future we must continue to expand and improve the performance of our network of distribution partners. Our network of distribution partners currently includes OEMs, VARs, and systems integrators, such as Cisco Systems, IBM Global Services, Ericsson, Nortel, Alcatel and Sun Microsystems. These partners license our products at a discount to list price for re-licensing and may provide training, support and technical and customer services to the end users of our products. At times, members of our technical services organization will assist a channel partner with training and technical support. We offer a comprehensive channel-partnering program consisting of training, certification, technical support, priority communications regarding upcoming activities and products, and joint sales and marketing activities. There can be no assurance that we will be able to continue to attract and retain OEMs, VARs, and systems integrators or that such organizations will be able to market and sell our products effectively. In addition, there can be no assurance that our existing or future channel partners will continue to represent our products. See “Risk Factors—We need to continue to expand our distribution channels and retain our existing third-party distributors.”

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In part, because we first sold our software in the United Kingdom and were previously domiciled in London, sales of our software to end–users located outside of the United States (i.e., “international sales”) have historically comprised a significant portion of our total revenue. International sales accounted for 39%, 49% and 39% of total revenues in fiscal 2003, 2002 and 2001, respectively. A majority of these international sales were made to customers in the United Kingdom and Continental Europe. While we believe there are significant opportunities in Europe, we expect international revenues from Europe as a percentage of total revenues to decline in future periods as we more fully exploit opportunities in the United States and in the Pacific Rim. See “Risk Factors—Our business is subject to risks from global operations and we are exposed to fluctuations in currency exchange rates.”

Technical Services

Our technical services organization provides customers with a broad range of support services including pre–sales demonstrations, evaluations, implementations, consulting services, training and ongoing technical support. In addition, the technical services organization serves a variety of internal functions, including drafting support and training documentation, product management, product testing and research and development related to specific customer industries.

Our expansion of the customer base of Netcool has increased the demands on our technical services organization. Competition for qualified technical personnel is intense. There can be no assurance that the current resources in our technical services organization will be sufficient to manage any future growth in our business. The failure to align our technical services organization at least commensurate with the expansion in the installed base of Netcool products would have a material adverse effect on our business, operating results and financial condition. See “Risk Factors—We depend on our key personnel, and the loss of any of our key personnel could harm our business.”

Customer Support

The customer support organization is responsible for providing ongoing technical support for our customers after implementation of the product and for training the next generation of our software engineers and technical services personnel. Based on feedback by customers, we believe that the quality and responsiveness of our customer support organization provides us with a significant competitive advantage. See “Risk Factors—We depend on our key personnel, and the loss of any of our key personnel could harm our business.”

For an annual maintenance fee, a customer will receive toll–free telephone and email support, as well as certain new releases of our products. We offer two support packages to our customers: 8 hours a day, 5 days a week support or 24 hours a day, 7 days a week support. While support personnel generally answer the technical support calls and resolve most problems over the phone, we will deploy one of our technical support personnel in the event that an on–site visit is necessary. As our installed base of Netcool customers has grown, revenue from maintenance fees has grown. Due to more recent general economic and specific customer factors, some customers have chosen to reduce or forego their maintenance coverage. We are implementing initiatives to counter these trends but there can be no assurance that maintenance revenue will continue at its current level or will continue its historic growth. The failure to grow maintenance revenue would have a material adverse impact on our business results and financial condition.

Research and Development

We believe that our future success depends in large part on our ability to continue to enhance existing products and develop new products that maintain technological and operational competitiveness and leadership and deliver a rapid ROI to our customers. We have historically developed and expect to continue to develop our products in conjunction with our existing and potential customers. Extensive product development input is obtained through customers, through our monitoring of end–user needs and changes in the marketplace and through partnerships with leading research institutes.
Our research and development organization spans the United States, United Kingdom and Australia and includes team members who have joined Micromuse through our acquisitions of Calvin Alexander Networking (“CAN”), NetOps, RiverSoft plc, Lumos Technologies Inc. and NHI. Research and development teams are organized around specific products and product families. These teams work closely with customers, product managers, technical service engineers, and salespeople to ensure that product specifications and enhancements are aligned to market requirements.

We have made and intend to continue to make substantial investments in research and development. Our total expenses for research and development for fiscal 2003, 2002 and 2001 were $29.4 million, $32.4 million and $33.4 million, respectively. To date, our development efforts have not resulted in any capitalized software development costs.

The market for our products is characterized by rapidly changing technologies, evolving industry standards, changing regulatory environments, frequent new product introductions and rapid changes in customer requirements. The introduction or announcement of products by the Company or our competitors embodying new technologies and the emergence of new industry standards and practices can render existing products obsolete and unmarketable. As a result, the life cycles of our products are difficult to estimate. Our future success will depend on our ability to enhance our existing products and to develop and introduce, on a timely and cost-effective basis, new products and product features that keep pace with technological developments and emerging industry standards and that address the increasingly sophisticated needs of our customers. There can be no assurance that we will be successful in developing and marketing new products or product features that respond to technological change or evolving industry standards, that we will not experience difficulties that could delay or prevent the successful development, introduction and marketing of these new products and features, or that our new products or product features will adequately meet the requirements of the marketplace and achieve market acceptance. In addition, to the extent that any product upgrade or enhancement requires extensive installation and configuration, current customers may postpone or forgo the purchase of new versions of our products. If we are unable, for technological or other reasons, to develop and introduce enhancements of existing products or new products in a timely manner, our business, operating results and financial condition will be materially adversely affected.

Competition

As noted above, our products are designed for use in the evolving business and service assurance and enterprise network management markets. Competition in these markets is intense and is characterized by rapidly changing technologies, new and evolving industry standards, frequent new product introductions and rapid changes in customer requirements. Our current and prospective competitors offer a variety of solutions to address the infrastructure management, service-level management, and security management markets. Competitors generally fall within the following four categories: (i) customer’s internal design and development organizations that produce “homegrown” Service Level Management (SLM) and network management applications for their particular needs; (ii) vendors who provide enterprise network and systems management frameworks including Computer Associates International, Inc. and BMC Software, Inc.; (iii) vendors who provide service provider network and systems management frameworks including Hewlett Packard and Team Telecom, Inc.; and (iv) vendors who provide niche management applications. In the future, as we enter new markets, we expect that such markets may have additional, market-specific competitors. Increased
competition may result in price reductions, reduced gross margins and/or loss of market share, any of which could materially adversely affect our business, operating results or financial condition.

Some of our existing and potential customers and distributors continuously evaluate whether to design and develop their own network operations support and management applications or purchase them from outside vendors. Sometimes these customers internally design and develop their own software solutions for their particular needs and therefore may be reluctant to purchase products offered by independent vendors. As a result, we must continuously educate existing and prospective customers as to the advantages of our products versus internally developed network operations support and management applications.

Many of our current and potential competitors have longer operating histories and have significantly greater financial, technical, sales, marketing and other resources, as well as greater name recognition and a larger customer base, than we do. As a result, they may be able to devote greater resources to the development, promotion, sale and support of their products or to respond more quickly to new or emerging technologies and changes in customer requirements than we can. Existing competitors could also increase their market share by bundling products having management functionality offered by our products with their current applications. Moreover, our current and potential competitors may increase their share of the service and business assurance market through strategic alliances and/or the acquisition of competing companies. In addition, network operating system vendors could introduce new or upgrade and extend existing operating systems or environments that include management functionality offered by our products, which could render our products obsolete and unmarketable. There can be no assurance that we will be able to compete successfully against current or future competitors or that competitive pressures faced by us will not materially adversely affect our business, operating results or financial condition. See “Risk Factors—We face intense competition including from larger competitors with greater resources than our own, which could result in our losing market share or experiencing a decline in gross margins.”

Intellectual Property and Other Proprietary Rights

Our success and ability to compete is significantly dependent upon our proprietary software technology. We rely on a combination of trade secret, copyright, patent and trademark laws, nondisclosure and other contractual agreements and technical measures to protect our proprietary rights. 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. There can be no assurance that the steps taken by us to protect our proprietary technology will prevent misappropriation of such technology, and such protections may not preclude competitors from developing products with functionality or features similar to our products. In addition, effective patent, copyright and trade secret protection may be unavailable or limited in certain foreign countries. While we believe that our products and trademarks do not infringe upon the proprietary rights of third parties, there can be no assurance that we will not receive future communications or claims from third parties asserting that our products infringe, or may infringe, the proprietary rights of third parties. We expect that software product developers will be increasingly subject to infringement claims as the number of products and competitors in our industry segment grows and the functionality of products in different industry segments overlaps. Any such claims, with or without merit, could be time-consuming, result in costly litigation and diversion of technical and management personnel, cause product shipment delays or require us to develop non-infringing technology or enter into royalty or licensing agreements. Such royalty or licensing agreements, if required, may not be available on terms acceptable to us or at all. In the event of a successful claim of product infringement against us and our failure or inability to develop non-infringing technology or license the infringed or similar technology, our business, operating results or financial condition could be materially adversely affected. See Part I, Item 3 “Legal Proceedings” for a description of pending litigation relating to claims of infringement against us.

We rely on certain software that we license from third parties, including software that is integrated with internally developed software and used in our products to perform key functions. There can be no assurance that these third-party software licenses will continue to be available to us on commercially reasonable terms or at all.
Although we believe alternative software is available from other third-party suppliers, the loss of or inability to maintain any of these software licenses or the inability of the third parties to enhance in a timely and cost-effective manner their products in response to changing customer needs, industry standards or technological developments could result in delays or reductions in our product shipments until equivalent software could be developed internally or identified, licensed and integrated, which would have a material adverse effect on our business, operating results and financial condition. See “Risk Factors—Our efforts to protect our intellectual property may not be adequate, or a third-party could claim that we are infringing its proprietary rights” and “We rely on software that we have licensed from third-party developers to perform key functions in our products.”

Employees

As of September 30, 2003, we had 573 employees. None of our employees are represented by a collective bargaining agreement, nor have we experienced work stoppages.

We believe that our future success will depend in large part on our ability to align our employee skills and population with market requirements, including our ability to retain and even attract highly skilled managerial, sales, technical services, customer support and product development personnel. We have at times experienced and continue to experience difficulty in retaining and recruiting qualified personnel. Competition for qualified personnel in the software industry is intense, and there can be no assurance that we will be successful in retaining such personnel. Failure to do so could materially adversely affect our business, operating results or financial condition. See “Risk Factors—Failure to manage our growth may adversely affect our business; Our restructuring of operations may not achieve the results we intend and may harm our business; and We depend on our key personnel, and the loss of any of our key personnel could harm our business.”

Item 2. Properties

Our headquarters are located in approximately 21,935 square feet of office space in San Francisco, under a lease that expires in January 2008. Our principal product development operations as well as our European headquarters are located in approximately 30,077 square feet of office space in London pursuant to a lease that expires in April 2009. We also maintain offices in Chicago, Dallas, McLean, New York, Santa Monica, Beijing, Dusseldorf, Frankfurt, Hong Kong, Madrid, Mexico, Milan, Boston, Paris, Perth, Russia, Sao Paulo, Shanghai, Singapore, Sydney, Taipei, Tokyo, Utrecht, Vienna and Warsaw. We believe that our current facilities are adequate for our needs through the next twelve months, and that, should it be needed, suitable additional space will be available to accommodate expansion of our operations on commercially reasonable terms, although there can be no assurance in this regard.

Item 3. Legal Proceedings

On December 9, 2002, Aprisma Management Technologies, Inc. (“Aprisma”) filed a complaint against the Company in the U.S. District Court for the District of New Hampshire. The complaint alleges that the Company’s network and systems management products, including our Netcool products, infringe six patents held by Aprisma. The complaint seeks injunctive relief as well as unspecified compensatory and enhanced damages, attorneys’ fees, interest, costs and expenses. The complaint was served on the Company’s counsel on February 20, 2003. The Company filed its answer to the complaint on April 11, 2003, in which the Company alleged affirmative defenses of patent invalidity and non-infringement of the patents by the Company’s products, as well as other equitable defenses. The Company has also asserted counterclaims against Aprisma regarding patent invalidity, non-infringement and patent unenforceability, including without limitation on the grounds that Aprisma failed to disclose material prior art to the Patent Office. The parties are now completing discovery (the exchange of documents and the taking of depositions) and preparing for the court’s hearing on the legal scope of the patents’ claims. Based upon current knowledge, the Company maintains that it has not infringed and does not infringe the patents in suit, and it will continue to vigorously defend its position and pursue the counterclaims against Aprisma.
On November 10, 2003, Agilent Technologies, Inc. ("Agilent") filed a complaint against the Company in the United States District Court for the Eastern District of Virginia. The complaint alleges that the Company infringes two patents, one of which is held by Agilent and the other of which is jointly owned by Agilent and Hewlett-Packard Company ("HP"). The complaint seeks injunctive relief, as well as unspecified compensatory and enhanced damages, attorneys' fees, interest, costs and expenses. In response, the Company moved to: (i) dismiss the case or require Agilent to file a more definite statement of its claims; (ii) join HP as a necessary party; and (iii) transfer the case to the Southern District of New York, or in the alternative, to the Northern District of California. In a ruling dated April 15, 2004, the court granted Micromuse's motion to transfer and ordered that the lawsuit be moved to the United States District Court for the Southern District of New York, where the remaining motions described in (i) and (ii) above are expected to be decided. Based upon current knowledge, the Company maintains that it has not infringed and does not infringe the patents in suit, and the Company intends to vigorously defend against the action.

Between January 12, 2004 and March 5, 2004, seven securities class action complaints were filed in the United States District Court for the Northern District of California against the Company and certain of its current and former officers and directors. The complaints were filed as purported class actions by individuals who allege that they purchased the Company's common stock during a purported class period and seek an unspecified amount of damages. The complaints assert causes of action for alleged violations of Section 10(b) and 20(a) of the Securities Exchange Act of 1934 and SEC Rule 10b-5, arising out of the Company's decision to restate its previously issued financial statements for the fiscal years ended September 30, 2001 and 2002 and for the quarters ended December 31, 2000 through June 30, 2003 and the Company's decision to adjust its preliminary consolidated financial statement information for the quarter and fiscal year ended September 30, 2003, as initially announced on October 29, 2003. Plaintiffs have moved to consolidate those actions and name the law firm of Berman, DeValerio, Please, Tabacco, Burt & Pacillo as Lead Plaintiffs' Counsel. The Court has yet to rule on that motion. Lead Plaintiffs will file a consolidated amended complaint after the Company files its restated financial statements. The Company will respond to that consolidated amended complaint after it is filed. The Company intends to vigorously defend these lawsuits.

Between February 2, 2004 and March 16, 2004, the Company was also named as a nominal defendant along with certain of its current and former officers and directors in three derivative actions, purportedly brought by shareholders on the Company's behalf, filed in the Superior Court of California, County of San Francisco. On April 21, those actions were consolidated and the law firm of Robbins, Umeda & Fink was named as Lead Plaintiffs' Counsel in those actions. On March 3, 2004, the Company was also named as a nominal defendant along with certain of its current and former officers and directors in another derivative action, purportedly brought by shareholders on the Company's behalf, filed in the District Court for the Northern District of California. The derivative complaints allege that, as a result of the events underlying the restatement, certain of the Company's current and former officers and directors breached their fiduciary duties to the Company, and that certain current and former officers and directors engaged in insider trading in violation of California law. The plaintiffs seek unspecified damages on the Company's behalf from the defendants. The Company has not yet responded to the complaints.

On January 15, 2004, the Securities & Exchange Commission notified the Company that it had initiated an informal inquiry regarding the Company. This inquiry is ongoing and the Company is cooperating fully. It is our understanding that it is customary for the SEC to undertake an informal inquiry of many announced accounting restatements. The detailed information contained in this Form 10-K relating to the restatement of financial statements has not been reviewed previously by the SEC.

The Company is also subject to other pending or threatened litigation from time to time in addition to the matters specifically listed above, including other cases now pending. The Company has recorded certain liabilities it does not believe to be material related to some of the pending litigation (other than the patent and securities litigation specifically listed above) based on claims for which management believes a loss is probable and for which management can reasonably estimate the amount and range of loss.
The litigation matters specifically listed above and other pending or future litigation are inherently unpredictable, could be costly and divert our management’s attention away from our business, and could have a material adverse effect on our business, financial results or condition, or cash flow. See also Risk Factors in Part II, Item 7, “Our efforts to protect our intellectual property may not be adequate, and third-parties have in the recent past claimed and may claim in the future that we are infringing their proprietary rights” and “We restated our annual and quarterly financial statements for 2001, 2002, and the first three quarters of 2003, we did not file our Annual Report on Form 10-K for fiscal year 2003 on a timely basis, and we did not file our Quarterly Report on Form 10-Q for the first quarter of 2004 on a timely basis. Litigation and regulatory proceedings regarding the restatement of our Consolidated Financial Statements could seriously harm our business.”

Due to the inherent unpredictability of litigation, the Company cannot predict the outcome of these or other pending matters with any certainty. Because of the uncertainties related to both the amount and range of losses in the event of an unfavorable outcome in the lawsuits listed above or in certain other pending proceedings for which loss estimates have not been recorded, management of the Company is unable to make a reasonable estimate of the losses that could result from these matters.

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

There were no matters submitted to a vote of security holders during the fourth quarter of the fiscal year ended September 30, 2003.