

ART TECHNOLOGY GROUP INC

Form 10-Q

May 09, 2005



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**ART TECHNOLOGY GROUP, INC.  
INDEX TO FORM 10-Q**

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## ART TECHNOLOGY GROUP, INC.

## CONDENSED CONSOLIDATED BALANCE SHEETS

(In thousands, except share and per share data)

(UNAUDITED)

|   | <b>March 31<br/>2005</b> | <b>December<br/>31<br/>2004</b> |
|---|--------------------------|---------------------------------|
| <b>ASSETS</b>   |                          |                                 |
| Current Assets:   |                          |                                 |
| Cash and cash equivalents                                     | \$ 18,683                | \$ 21,310                       |
| Marketable securities   | 8,667                    | 5,197                           |
| Accounts receivable, net of reserves of \$655 (\$680 in 2004) | 20,734                   | 24,430                          |
| Prepaid expenses and other current assets                     | 2,554                    | 1,694                           |
| <br>  |                          |                                 |
| Total current assets  | 50,638                   | 52,631                          |
| <br>  |                          |                                 |
| Property and equipment, net                                   | 2,705                    | 3,120                           |
| Long term marketable securities                               |                          | 4,001                           |
| Goodwill  | 27,458                   | 27,458                          |
| Intangible assets, net  | 6,598                    | 7,177                           |
| Other assets  | 2,970                    | 3,416                           |
| <br>  |                          |                                 |
|   | \$ 90,369                | \$ 97,803                       |
| <br><b>LIABILITIES AND STOCKHOLDERS EQUITY</b>                |                          |                                 |
| Current Liabilities:  |                          |                                 |
| Accounts payable  | \$ 1,989                 | \$ 5,186                        |
| Accrued expenses  | 11,891                   | 13,156                          |
| Capital lease obligations, current portion                    | 56                       | 56                              |
| Notes payable   | 271                      | 595                             |
| Deferred revenue  | 22,344                   | 25,355                          |
| Accrued restructuring, short-term                             | 5,398                    | 6,095                           |
| <br>  |                          |                                 |
| Total current liabilities                                     | 41,949                   | 50,443                          |
| <br>  |                          |                                 |
| Capital lease obligations, less current portion               | 99                       | 112                             |
| Accrued restructuring, less current portion                   | 3,903                    | 5,063                           |
| Commitments and contingencies (Notes 11 and 13)               |                          |                                 |

Stockholders' Equity:

|   |           |           |
|---|-----------|-----------|
| Preferred stock, \$0.01 par value Authorized 10,000,000 shares Issued and outstanding no shares   |           |           |
| Common stock, \$0.01 par value Authorized 200,000,000 shares Issued and outstanding 109,193,320 shares and 108,141,966 shares at March 31, 2005 and December 31, 2004, respectively | 1,092     | 1,081     |
| Additional paid-in capital  | 250,226   | 249,465   |
| Accumulated deficit   | (203,827) | (205,235) |
| Accumulated other comprehensive loss  | (3,073)   | (3,126)   |
| <br>  |           |           |
| Total stockholders' equity  | 44,418    | 42,185    |
|   | <br>      |           |
|   | \$ 90,369 | \$ 97,803 |

The accompanying notes are an integral part of these unaudited condensed consolidated financial statements.

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## ART TECHNOLOGY GROUP, INC.

## CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(In thousands, except per share data)  
(UNAUDITED)

|   | <b>Three Months Ended<br/>March 31,</b> |                |
|---|---|----------------|
|   | <b>2005</b>                             | <b>2004</b>    |
| Revenues:   |   |                |
| Product licenses                                    | \$ 7,383                                | \$ 6,364       |
| Services  | 14,611                                  | 10,446         |
| <br>Total revenues                                  | <br>21,994                              | <br>16,810     |
| Cost of Revenues:                                   |   |                |
| Product licenses                                    | 593                                     | 399            |
| Services  | 5,411                                   | 4,785          |
| <br>Total cost of revenues                          | <br>6,004                               | <br>5,184      |
| <br>Gross Profit                                    | <br>15,990                              | <br>11,626     |
| Operating Expenses:                                 |   |                |
| Research and development                            | 4,589                                   | 4,130          |
| Sales and marketing                                 | 6,799                                   | 7,341          |
| General and administrative                          | 2,988                                   | 1,930          |
| Restructuring charge                                | 204                                     |                |
| <br>Total operating expenses                        | <br>14,580                              | <br>13,401     |
| <br>Income (loss ) from operations                  | <br>1,410                               | <br>(1,775)    |
| Interest and other income (expense), net            | 11                                      | (47)           |
| <br>Income (loss) before provision for income taxes | <br>1,421                               | <br>(1,822)    |
| Provision (benefit) for income taxes                | 13                                      | (35)           |
| <br>Net income (loss)                               | <br>\$ 1,408                            | <br>\$ (1,787) |
| <br>Basic net income (loss) per share               | <br>\$ 0.01                             | <br>\$ (0.02)  |

|  |         |           |
|--|---------|-----------|
| Diluted net income (loss) per share                | \$ 0.01 | \$ (0.02) |
| Basic weighted average common shares outstanding   | 108,685 | 73,053    |
| Diluted weighted average common shares outstanding | 110,866 | 73,053    |

The accompanying notes are an integral part of these unaudited condensed consolidated financial statements.

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## ART TECHNOLOGY GROUP, INC.

## CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)  
(UNAUDITED)

|  | <b>Three Months Ended March</b> |             |
|--|---------------------------------|-------------|
|  | <b>31,</b>                      |             |
|  | <b>2005</b>                     | <b>2004</b> |
| Cash Flows from Operating Activities:  |                                 |             |
| Net income (loss)  | \$ 1,408                        | \$ (1,787)  |
| Adjustments to reconcile net income (loss) to net cash used in operating activities: |                                 |             |
| Stock-based compensation   |                                 | 11          |
| Depreciation and amortization  | 1,090                           | 581         |
| Loss on disposal of fixed assets, net  |                                 | 6           |
| Changes in current assets and liabilities:   |                                 |             |
| Accounts receivable, net   | 3,696                           | 259         |
| Prepaid expenses and other current assets  | (860)                           | (742)       |
| Deferred rent  | 242                             | 101         |
| Accounts payable   | (2,187)                         | 993         |
| Accrued expenses   | (1,265)                         | (1,415)     |
| Deferred revenues  | (3,011)                         | 183         |
| Accrued restructuring  | (1,857)                         | (5,479)     |
| Net cash used in operating activities  | (2,744)                         | (7,289)     |
| Cash Flows from Investing Activities:  |                                 |             |
| Purchases of marketable securities   | (992)                           | (8,244)     |
| Maturities of marketable securities  | 1,523                           | 5,645       |
| Purchases of property and equipment  | (96)                            | (258)       |
| Payment of acquisition costs   | (1,010)                         |             |
| Decrease (increase) in other assets  | 204                             | (24)        |
| Net cash used in investing activities  | (371)                           | (2,881)     |
| Cash Flows from Financing Activities:  |                                 |             |
| Proceeds from exercise of stock options  | 579                             | 191         |
| Proceeds from employee stock purchase plan   | 182                             | 273         |
| Principal payments on notes payable  | (324)                           |             |
| Payments on capital leases   | (13)                            |             |
| Net cash provided by financing activities  | 424                             | 464         |
| Effect of Foreign Exchange Rate Changes on Cash and Cash Equivalents                 | 64                              | (60)        |



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|  |           |           |
|--|-----------|-----------|
| Net Decrease in Cash and Cash Equivalents      | (2,627)   | (9,766)   |
| Cash and Cash Equivalents, Beginning of Period | 21,310    | 32,703    |
| <br>   |           |           |
| Cash and Cash Equivalents, End of Period       | \$ 18,683 | \$ 22,937 |

The accompanying notes are an integral part of these unaudited condensed consolidated financial statements.

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ART TECHNOLOGY GROUP, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

**(1) OPERATIONS AND BASIS OF PRESENTATION**

Art Technology Group, Inc. (ATG or the Company) offers an integrated suite of Internet online marketing, sales and service applications, as well as related application development, integration and support services.

ATG delivers software solutions to help consumer-facing organizations create an interactive experience for their customers and partners via the Internet and other channels. The Company's software helps its clients market, sell and provide self-service opportunities to their customers and partners, which can enhance clients' revenues, reduce their costs and improve their customers' satisfaction. The Company also offers related services, including support, education, professional services and application hosting services.

The accompanying unaudited condensed consolidated financial statements of the Company have been prepared pursuant to the rules of the Securities and Exchange Commission for quarterly reports on Form 10-Q. The disclosures do not include all of the information and footnotes required by accounting principles generally accepted in the United States, and while the Company believes that the disclosures presented are adequate to make information not misleading, these financial statements should be read in conjunction with the audited financial statements and related notes included in the Company's 2004 Annual Report on Form 10-K. In the opinion of management, the accompanying unaudited condensed consolidated financial statements and notes contain all adjustments, consisting of normal recurring accruals, considered necessary for a fair presentation of the Company's financial position, results of operations and cash flows at the dates and for the periods indicated. The operating results for the three months ended March 31, 2005 are not necessarily indicative of the results to be expected for the full year ending December 31, 2005.

On November 1, 2004, ATG acquired all of the shares of outstanding common stock of Primus Knowledge Solutions, Inc. ( Primus ). Primus is a provider of software solutions that enable companies to deliver a superior customer experience via contact centers, information technology help desks, web (intranet and internet) self-service and electronic communication channels.

The accompanying consolidated financial statements include the accounts of ATG and its wholly owned subsidiaries, including Primus. All significant intercompany balances have been eliminated in consolidation.

**(2) STOCKHOLDERS' EQUITY**

*Stock-Based Compensation*

ATG grants stock options for a fixed number of shares to employees with an exercise price equal to the fair value of the shares at the date of grant. ATG accounts for stock-based compensation for employees in accordance with Accounting Principles Board (APB) Opinion No. 25, *Accounting for Stock Issued to Employees* and related interpretations, and follows the disclosure-only alternative under Statement of Financial Accounting Standards (SFAS) No. 123, *Accounting for Stock Based Compensation*.

Had compensation expense for ATG's stock plans been determined consistent with SFAS 123, the pro forma net loss and net loss per share would have been as follows (in thousands, except per share amounts):

|   | <b>Three Months Ended March</b> |             |
|---|---------------------------------|-------------|
|   | <b>31,</b>                      |             |
|   | <b>2005</b>                     | <b>2004</b> |
| Net income (loss) as reported   | \$ 1,408                        | \$ (1,787)  |
| Add: Stock-based employee compensation expense included in reported net loss                              |                                 | 11          |
| Deduct: Stock-based employee compensation expense determined under fair value based method for all awards | (1,458)                         | (6,437)     |
| Pro forma net loss  | \$ (50)                         | \$ (8,213)  |
| Basic and diluted net income (loss) per share   |                                 |             |
| As reported   | \$ 0.01                         | \$ (0.02)   |
| Pro forma   | \$ (0.00)                       | \$ (0.11)   |

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**Table of Contents****(3) NET INCOME (LOSS) PER SHARE**

Net income (loss) per share is computed in accordance with SFAS No. 128, *Earnings Per Share*. Basic net income (loss) per share is computed by dividing net income (loss) by the weighted average number of shares of common stock outstanding during the period. Diluted net income (loss) per share is computed by dividing net income (loss) by the weighted average number of shares of common stock outstanding plus the dilutive effect of common stock equivalents, which consists of stock options, using the treasury stock method.

The following table sets forth the computation of basic and diluted net income (loss) per share (in thousands, except per-share amounts):

|  | <b>Three Months Ended March</b> |             |
|--|---------------------------------|-------------|
|  | <b>31,</b>                      |             |
|  | <b>2005</b>                     | <b>2004</b> |
| Net income (loss)  | \$ 1,408                        | \$ (1,787)  |
| Weighted average common shares outstanding used in computing basic net income (loss) per share                                     | 108,685                         | 73,053      |
| Weighted average common equivalent shares outstanding:   |                                 |             |
| Employee common stock options  | 2,181                           |             |
| Total weighted average common stock and common stock equivalents outstanding used in computing diluted net income (loss) per share | 110,866                         | 73,053      |
| Basic net income (loss) per share  | \$ 0.01                         | \$ (0.02)   |
| Diluted net income (loss) per share  | \$ 0.01                         | \$ (0.02)   |
| Antidilutive common stock equivalents  | 9,401                           | 13,119      |

**(4) REVENUE RECOGNITION**

ATG recognizes product license revenues from licensing the rights to use its software to end-users. ATG also generates service revenues from integrating its software with its customers' operating environments, the sale of maintenance services, the sale of certain other consulting and development services and application and managed hosting services. ATG generally has separate agreements with its customers that govern the terms and conditions of its software licenses, consulting and support and maintenance services. These separate agreements, along with ATG's business practices of selling services separately, provide the basis for establishing vendor-specific objective evidence of fair value. This allows ATG to allocate revenue among the undelivered elements in an arrangement and apply the residual method under Statement of Position (SOP) No. 97-2, *Software Revenue Recognition* and SOP 98-9, *Modification of SOP 97-2, Software Revenue Recognition, with Respect to Certain Transactions*.

ATG recognizes revenue in accordance with SOP 97-2 and SOP 98-9. Revenues from software product license agreements are recognized upon execution of a license agreement and delivery of the software, provided that the fee is fixed or determinable and deemed collectible by management. If conditions for acceptance are required subsequent to delivery, revenues are recognized upon customer acceptance if such acceptance is not deemed to be perfunctory. In multiple element arrangements, ATG uses the residual value method in accordance with SOP 97-2 and SOP 98-9. Revenue earned on software arrangements involving multiple elements that qualify for separate element accounting treatment is allocated to each undelivered element using the relative fair values of those elements based on vendor-specific objective evidence with the remaining value assigned to the delivered element, the software license. Typically, the Company's software licenses do not include significant post-delivery obligations to be fulfilled by the Company and payments are due within a three-month period from the date of delivery. Consequently, product license revenue is generally recognized when the product is shipped. Revenues from software maintenance or application hosting agreements are recognized ratably over the term of the support and maintenance or application hosting period, which for application hosting and support and maintenance is typically one year. Customers who have both purchased ATG's product licenses and have also entered into an application hosting agreement typically have a contractual right to cancel the application hosting agreement with a minimum notice period. ATG enters into reseller arrangements that typically provide for sublicense fees payable to ATG based upon a percentage of ATG's list price. Revenues are recognized under reseller agreements as earned for guaranteed minimum royalties, or based upon actual sales to the resellers. ATG does not grant its resellers the right of return or price protection.

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Revenues from professional service arrangements are recognized on either a time-and-materials, proportional performance method or percentage-of-completion basis as the services are performed, provided that amounts due from customers are fixed or determinable and deemed collectible by management. From time to time the Company enters into fixed price service arrangements. In those circumstances in which services are essential to the functionality of the software, the Company applies the percentage-of-completion method, and in those situations when only professional services are provided, the Company applies the proportional performance method. Both of these methods require that the Company track the effort expended and the effort expected to complete a project. Amounts collected or billed prior to satisfying the above revenue recognition criteria are reflected as deferred revenue. Deferred revenue primarily consists of advance payments related to support and maintenance, service agreements and deferred product license revenues.

**(5) INCOME TAXES**

ATG expects to have minimal or no Federal or foreign income taxes in 2005 due to the use of net operating loss carryforwards and the projection of a taxable loss in domestic and foreign locations in 2005. As a result of net operating losses incurred, and after evaluating its anticipated performance over its normal planning horizon, the Company has provided a full valuation allowance for its net operating loss carryforwards, research credit carryforwards and other net deferred tax assets. In the first quarter of 2005 and 2004 ATG reversed previously accrued taxes of \$0 and \$105,000, respectively, due to the closure of statutes of limitations in foreign locations.

**(6) CASH, CASH EQUIVALENTS AND MARKETABLE SECURITIES**

ATG accounts for investments in marketable securities under SFAS 115, *Accounting for Certain Investments in Debt and Equity Securities*. Under SFAS 115, investments for which ATG has the positive intent and the ability to hold to maturity, consisting of cash equivalents and marketable securities, are reported at amortized cost, which approximates fair market value. Cash equivalents are highly liquid investments with maturities at the date of acquisition of less than 90 days. Marketable securities are investment grade debt securities with maturities at the date of acquisition of greater than ninety days. At March 31, 2005 and December 31, 2004, all of ATG's marketable securities were classified as held-to-maturity. The average maturity of ATG's marketable securities was approximately 7.2 months and 9.6 months at March 31, 2005 and December 31, 2004, respectively. At March 31, 2005 all marketable securities were classified as short term. At December 31, 2004, the average maturity of the marketable securities classified as long-term was 13.6 months. At March 31, 2005 and December 31, 2004, the difference between the amortized cost and market value of ATG's marketable securities were losses of approximately \$83,000 and \$77,000, respectively. At March 31, 2005 and December 31, 2004, ATG's cash, cash equivalents and marketable securities consisted of the following (in thousands):

|  | <b>March 31,<br/>2005</b> | <b>December<br/>31,<br/>2004</b> |
|--|---------------------------|----------------------------------|
| Cash and cash equivalents:                     |                           |                                  |
| Cash   | \$ 8,062                  | \$ 4,360                         |
| Money market accounts                          | 6,206                     | 13,529                           |
| Commercial paper                               | 3,069                     | 799                              |
| U.S. Treasury and Government Agency securities | 1,346                     | 2,622                            |
| <br>   |                           |                                  |
| Total cash and cash equivalents                | \$ 18,683                 | \$ 21,310                        |

|  |    |       |          |
|--|----|-------|----------|
| Marketable securities                          |    |       |          |
| Corporate debt securities                      | \$ | 7,674 | \$ 7,754 |
| U.S. Treasury and Government Agency securities |    | 993   | 648      |
| Commercial paper                               |    |       | 796      |
| <br>   |    |       |          |
| Total marketable securities                    | \$ | 8,667 | \$ 9,198 |

## (7) GOODWILL

In accordance with SFAS 141, *Business Combinations*, the company accounts for its business combinations using the purchase method. In accordance with SFAS 142, *Goodwill and Other Intangible Assets*, the Company does not amortize goodwill, but instead tests for impairment at least annually and more frequently upon the occurrence of certain events which may indicate that impairment has occurred. Intangible assets acquired in conjunction with a business combination are required to be separately recognized if the benefit of the intangible asset obtained is through contractual or other legal rights, or if the intangible asset can be sold, transferred, licensed, rented or exchanged, regardless of the acquirer's intent to do so.

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The provisions of SFAS 142 require that a two-step impairment test be performed on goodwill. In the first step, the Company compares the fair value, which is determined by use of a discounted cash flow technique, of the reporting entity to its carrying value. If the fair value of the reporting entity exceeds the carrying value of the net assets of that entity, goodwill is not impaired and the Company is not required to perform further testing. If the carrying value of the net assets assigned to the reporting entity exceeds the fair value of that entity, then the Company must perform the second step of the impairment test in order to determine the implied fair value of the reporting entity's goodwill. If the carrying value of a reporting entity's goodwill exceeds its implied fair value, then the Company records an impairment loss equal to the difference.

Determining the fair value of a reporting entity is judgmental in nature and involves the use of significant estimates and assumptions. These estimates and assumptions may include revenue growth rates and operating margins used to calculate projected future cash flows, risk-adjusted discount rates, future economic and market conditions, and determination of appropriate market comparables. The Company bases its fair value estimates on assumptions it believes to be reasonable but that are unpredictable and inherently uncertain. Actual future results may differ from those estimates. In addition, the Company may make certain judgments and assumptions in allocating shared assets and liabilities to determine the carrying values of its reporting entities.

The Company performs the annual impairment assessment as of December 1 of each year.

**(8) LONG-LIVED ASSETS, INCLUDING INTANGIBLE ASSETS**

In accordance with SFAS 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, the Company reviews the carrying value of its long-lived assets, including intangible assets subject to amortization, for impairment whenever events and circumstances indicate that the carrying value of the assets may not be recoverable. Recoverability of these assets is measured by comparison of the carrying value of the assets to the undiscounted cash flows estimated to be generated by those assets over their remaining economic life. If the undiscounted cash flows are not sufficient to recover the carrying value of such assets the assets are considered impaired, and the impairment loss is measured by comparing the fair value of the assets to their carrying values. Fair value is determined by either a quoted market price or a value determined by a discounted cash flow technique, whichever is more appropriate under the circumstances involved. Intangible assets with determinable lives are amortized over their useful lives, based upon the pattern in which the expected benefits will be realized. The Company has recorded impairment charges as discussed in Note 14.

**(9) COMPREHENSIVE INCOME (LOSS)**

SFAS No. 130, *Reporting Comprehensive Income*, requires that a full set of general purpose financial statements include the reporting of comprehensive income (loss). Comprehensive income (loss) is comprised of two components, net income (loss) and other comprehensive income (loss). The following are the components of ATG's comprehensive income (loss) (in thousands):

|  | <b>Three Months Ended March</b> |             |
|--|---------------------------------|-------------|
|  | <b>31,</b>                      |             |
|  | <b>2005</b>                     | <b>2004</b> |
| Net income (loss)                        | \$ 1,408                        | \$ (1,787)  |
| Foreign currency translation gain (loss) | 53                              | (38)        |
| Comprehensive income (loss)              | \$ 1,461                        | \$ (1,825)  |



The accumulated other comprehensive loss at March 31, 2005 and December 31, 2004 of \$3.1 million consisted entirely of the cumulative foreign currency translation adjustment.

**(10) DISCLOSURES ABOUT SEGMENTS OF AN ENTERPRISE**

SFAS 131, *Disclosures About Segments of an Enterprise and Related Information*, establishes standards for reporting information regarding operating segments in annual financial statements and requires selected information for those segments to be presented in interim financial reports issued to stockholders. SFAS 131 also establishes standards for related disclosures about products and services and geographic areas. Operating segments are identified as components of an enterprise about which separate discrete financial information is available for evaluation by the chief operating decision-maker or decision-making group in making decisions on how to allocate resources and assess performance. The Company's chief operating decision-maker, as defined under SFAS 131, is its executive management team. To date, the Company has viewed its operations and manages its business as principally one segment with two product offerings: software licenses and services. The Company evaluates these product offerings based on their respective gross margins. As a result, the financial information disclosed in the consolidated financial statements represents all of the material financial information related to the Company's principal operating segment.

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Revenues from sources outside of the United States were approximately \$5.9 million and \$6.5 million for the three months ended March 31, 2005 and 2004, respectively. ATG's revenues from international sources were primarily generated from customers located in Europe and the Asia/ Pacific region. All of ATG's product sales for the three months ended March 31, 2005 and 2004 were delivered from its headquarters located in the United States.

The following table represents the percentage of total revenues by geographic region from customers for the three months ended March 31, 2005 and 2004:

|   | <b>Three Months Ended</b> |             |
|---|---------------------------|-------------|
|   | <b>March 31,</b>          |             |
|   | <b>2005</b>               | <b>2004</b> |
| United States                                 | 73%                       | 61%         |
| United Kingdom (UK)                           | 12                        | 16          |
| Europe, Middle East and Africa (excluding UK) | 13                        | 16          |
| Asia Pacific                                  | 1                         |             |
| Other   | 1                         | 7           |
|   | 100%                      | 100%        |

**(11) CREDIT FACILITY AND NOTES PAYABLE***Credit Facility*

On June 13, 2002, ATG entered into a \$15 million revolving line of credit with Silicon Valley Bank (the Bank) which provided for borrowings of up to the lesser of \$15 million or 80% of eligible accounts receivable. Effective December 24, 2002 the revolving line of credit increased to \$20 million. The line of credit bears interest at the Bank's prime rate (5.75% at March 31, 2005). The line of credit is secured by all of the Company's tangible and intangible intellectual and personal property and is subject to financial covenants including liquidity coverage and profitability. On December 24, 2004, the Company entered into the Seventh Loan Modification Agreement (the Seventh Amendment) with the Bank, which amended the Amended and Restated Loan and Security Agreement dated as of June 13, 2002. Under the Seventh Amendment, the profitability covenant was revised to allow for quarterly net losses not to exceed \$2.0 million for the first quarter of 2005, \$500,000 for the second quarter of 2005, \$1.5 million for the third quarter of 2005, and to require net profitability of at least \$1.00 for the fourth quarter of 2005 and for each quarter thereafter. The Company is required to maintain unrestricted and unencumbered cash, which includes cash equivalents and marketable securities, at the end of each month as follows:

For the months ending March 31, 2005 and June 30, 2005, and as of the last day of each month thereafter, \$20 million, and

For the months ending April 30, 2005, and May 31, 2005, the greater of (i) \$15.0 million or (ii) two times the amount of outstanding obligation, which include letters of credit, under the loan agreement

To avoid additional bank fees and expenses, the Company is required to maintain unrestricted cash, which includes cash equivalents and marketable securities, at the Bank in an amount equal to two times the amount of obligations outstanding, which includes letters of credit that have been issued but not drawn upon, under the loan agreement. In the event the Company's cash balance at the Bank falls below this amount, the Company will be required to pay fees and expenses to compensate the Bank for lost income. At March 31, 2005, ATG was in compliance with all related

financial covenants. In the event that ATG does not comply with any of the financial covenants within the line of credit or defaults on any of its provisions, the Bank's significant remedies include: (1) declaring all obligations immediately due and payable, which could include requiring ATG to cash collateralize its outstanding letters of credit (LCs); (2) ceasing to advance money or extend credit for the Company's benefit; (3) applying to the obligations any balances and deposits held by the Company or any amount held by the Bank owing to or for the credit or the account of ATG; and, (4) putting a hold on any deposit account held as collateral. If the agreement expires, or is not extended, the Bank will require outstanding LCs at that time to be cash secured on terms acceptable to the Bank. The revolving line of credit expires on December 24, 2005. While there were no outstanding borrowings under the facility at March 31, 2005, ATG has issued LCs totaling \$8.1 million, which are supported by this facility. The LCs have been issued in favor of various landlords and equipment leasing companies to secure obligations under ATG's facility leases pursuant to leases expiring from August 2006 through March 2009. As of March 31, 2005, approximately \$11.9 million was available under the facility.

**Table of Contents****Notes Payable**

In connection with the November 2004 acquisition of Primus, the Company assumed Primus' outstanding obligation of approximately \$297,000 under a credit facility with a bank. The facility is payable in monthly installments of approximately \$11,000, including interest at the bank's prime rate plus 2% (7.75% at March 31, 2005 and 6.75% at December 31, 2004), due June 2008. The facility is callable on demand. The loan is denominated in British pounds. At March 31, 2005 and December 31, 2004, the balance on the note was approximately \$271,000 and \$295,000, respectively.

On November 1, 2004, the Company entered into a settlement agreement with ServiceWare Technologies, Inc. (ServiceWare) related to their allegation that Primus had infringed certain patents owned by ServiceWare. As part of the settlement, the Company was required to make cash payments totaling \$800,000, of which \$500,000 was paid during 2004 and \$300,000 was paid in January 2005 and was included in notes payable at December 31, 2004.

**(12) ACQUISITION OF PRIMUS**

Effective November 1, 2004, the Company acquired all of the outstanding shares of common stock of Primus Knowledge Solutions, Inc. (Primus). Primus is a provider of software solutions that enable companies to deliver a superior customer experience via contact centers, information technology help desks, web (intranet and internet) self-service and electronic communication channels.

The aggregate purchase price was approximately \$31.7 million, which consisted of \$28.1 million of the Company's Common Stock, \$1.3 million for the fair value of fully-vested stock options exchanged in the acquisition and \$2.3 million of transaction costs, which primarily consisted of fees paid for financial advisory, legal and accounting services. The Company issued approximately 33.5 million shares of ATG Common Stock, the fair value of which was based upon a five-day average of the closing price two days before and two days after the terms of the acquisition were agreed to and publicly announced.

The consolidated financial statements include the results of Primus from the date of acquisition. The purchase price has been allocated based on estimated fair values as of the acquisition date. After allocating the purchase price to the acquired net tangible and intangible assets, the Company recorded \$27.5 million of goodwill. The allocation of the purchase price is preliminary and could be adjusted due to settlement of litigation (see Note 15) or other matters that were not identified at the acquisition date.

Intangible assets, which are being amortized based on the pattern in which the economic benefits of the intangible assets are being utilized, consist of the following (in thousands):

|                        | March 31,<br>2005           |                             |                      | December 31,<br>2004        |                             |                      |
|------------------------|-----------------------------|-----------------------------|----------------------|-----------------------------|-----------------------------|----------------------|
|                        | Gross<br>Carrying<br>Amount | Accumulated<br>Amortization | Net<br>Book<br>Value | Gross<br>Carrying<br>Amount | Accumulated<br>Amortization | Net<br>Book<br>Value |
| Purchased technology   | \$ 3,600                    | \$ (645)                    | \$ 2,955             | \$ 3,600                    | \$ (441)                    | \$ 3,159             |
| Customer relationships | 4,200                       | (901)                       | 3,299                | 4,200                       | (559)                       | 3,641                |
| Non-compete agreements | 400                         | (56)                        | 344                  | 400                         | (23)                        | 377                  |

|  |          |            |          |          |            |          |
|--|----------|------------|----------|----------|------------|----------|
| Total intangible assets,<br>excluding goodwill | \$ 8,200 | \$ (1,602) | \$ 6,598 | \$ 8,200 | \$ (1,023) | \$ 7,177 |
|--|----------|------------|----------|----------|------------|----------|

Amortization expense from intangible assets was \$579,000 for the three months ended March 31, 2005. As of March 31, 2005, amortization expense on existing intangibles for the next five years is as follows (in thousands):

|                   |              |
|-------------------|--------------|
| Remainder of 2005 | \$ 1,739     |
| 2006              | 2,055        |
| 2007              | 1,740        |
| 2008              | 848          |
| 2009              | 216          |
| <br>Total         | <br>\$ 6,598 |

In connection with the Primus acquisition, integration activities resulted in involuntary terminations and lease and contract terminations. As part of the purchase price of the acquisition, the company recorded restructuring costs of \$2.1 million for these activities comprised of \$1.7 million for involuntary termination benefits and \$.4 million for facility related costs. The liability for involuntary termination benefits is for 49 employees, primarily in general and administrative and research and development functions.

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The Company expects to pay the remaining balance for involuntary termination benefits and facilities-related costs in 2005.

The following summarizes the obligations in connection with the Primus acquisition and activity to date (in thousands):

| <b>Category</b>                  | <b>Balance at<br/>December 31,<br/>2004</b> | <b>Payments</b> | <b>Balance at<br/>March 31,<br/>2005</b> |
|----------------------------------|---|-----------------|--|
| Involuntary termination benefits | \$ 1,218                                    | \$ (483)        | \$ 735                                   |
| Facilities-related costs         | 279   | (84)            | 195                                      |
| <b>Total</b>                     | <b>\$ 1,497</b>                             | <b>\$ (567)</b> | <b>\$ 930</b>                            |

The balance of \$930,000 in costs associated with the integration activities at March 31, 2005 is included in accrued expenses.

**(13) COMMITMENTS AND CONTINGENCIES*****Leases***

ATG has offices, primarily for sales and support personnel, in five domestic locations as well as four foreign countries. At March 31, 2005, ATG had issued \$8.1 million of LCs under its line of credit in favor of various landlords and equipment leasing companies to secure obligations under its leases, which expire from 2005 through 2009.

The Company has both operating and capital lease obligations related to equipment leases. The obligations on these leases, which are included in the schedule of future minimum payments, represent the contractual minimum obligations. Certain equipment leases include purchase options at the end of the lease term.

The future minimum payments of ATG's facility leases and operating and capital lease obligations as of March 31, 2005, were as follows (in thousands):

|  | <b>Leases</b>    |
|--|------------------|
| Remainder of 2005                          | \$ 6,378         |
| 2006                                       | 5,926            |
| 2007                                       | 2,997            |
| 2008                                       | 2,488            |
| 2009                                       | 704              |
| <b>Total future minimum lease payments</b> | <b>\$ 18,493</b> |

Of the \$18.5 million in future minimum lease payments, \$11.4 million is included in the Company's accrued restructuring charges. The \$11.4 million is reduced to an \$8.4 million restructuring accrual after taking into consideration estimated sublease income, contracted sublease income, vacancy periods and operating costs of the various subleased properties (see Note 14).

Rent expense included in the accompanying statements of operations was approximately \$1.3 million and \$1.2 million for the three months ended March 31, 2005 and 2004, respectively.

### ***Indemnifications***

The Company frequently has agreed to indemnification provisions in software license agreements with customers and in its real estate leases in the ordinary course of its business.

With respect to software license agreements, these indemnifications generally include provisions indemnifying the customer against losses, expenses, and liabilities from damages that may be awarded against the customer in the event the Company's software is found to infringe upon the intellectual property of others. The software license agreements generally limit the scope of and remedies for such indemnification obligations in a variety of industry-standard respects. The Company believes its internal development processes and other policies and practices limit its exposure related to the indemnification provisions of the software license

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agreements. In addition, the Company requires its employees to sign a proprietary information and inventions agreement, which assigns the rights to its employees' development work to the Company. To date, the Company has not had to reimburse any of its customers for any losses related to these indemnification provisions and no material claims are outstanding as of March 31, 2005.

With respect to real estate lease agreements or settlement agreements with landlords, these indemnifications typically apply to claims asserted against the landlord relating to personal injury and property damage at the leased premises or to certain breaches of the Company's contractual obligations or representations and warranties included in the settlement agreements. These indemnification provisions generally survive the termination of the respective agreements, although the provision generally has the most relevance during the contract term and for a short period of time thereafter. The maximum potential amount of future payments that the Company could be required to make under these indemnification provisions is unlimited. The Company has purchased insurance that reduces its monetary exposure for landlord indemnifications. The Company has never paid any amounts to defend lawsuits or settle claims related to these indemnification provisions. Accordingly, the Company believes the estimated fair value of these indemnification arrangements is minimal.

**(14) RESTRUCTURING**

During the quarter ended March 31, 2005, the Company recorded a net restructuring charge of approximately \$204,000 due to adjustments in estimates related to the 2004 restructuring charge for employee severance benefits payable in international geographies. During the years ended 2004, 2003, 2002 and 2001, the Company recorded net restructuring charges/ (benefits) of \$3.6 million, \$(10.5) million, \$19.0 million and \$75.6 million, respectively, as a result of the global slowdown in information technology spending. The significant drop in demand in 2001 for technology oriented products, particularly internet related technologies, caused management to significantly scale back the Company's prior growth plans, resulting in a significant reduction in the Company's workforce and consolidation of the Company's facilities in 2001. Throughout 2002, the continued softness of demand for technology products, as well as near term revenue projections, caused management to further evaluate the Company's marketing, sales and service resource capabilities as well as its overall general and administrative cost structure, which resulted in additional restructuring actions being taken in 2002. These actions resulted in a further reduction in headcount and consolidation of additional facilities. In 2003, as the Company continued to refine its business strategy and to consider future revenue opportunities, the Company took further restructuring actions to reduce costs, including product development costs, in order to help move the Company towards profitability. In 2004, the Company's restructuring activities were undertaken to align the Company's headcount more closely with management's revenue projections and changing staff requirements as a result of strategic product realignments and the Company's acquisition of Primus Knowledge Solutions, Inc., and to eliminate facilities that were not needed in order to efficiently run the Company's operations. The charges referred to above primarily pertain to the closure and consolidation of excess facilities, impairment of assets, employee severance benefits, and the settlement of certain contractual obligations. The 2004 and 2003 charges were recorded in accordance with SFAS 146, Accounting for Costs Associated with Exit or Disposal Activities, SFAS 88, Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits and Staff Accounting Bulletin (SAB) 100, Restructuring and Impairment Charges. The 2002 and 2001 charges were recorded in accordance with Emerging Issues Task Force Issue No. 94-3, Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (Including Certain Costs Incurred in a Restructuring), SFAS 88 and SAB 100.

**2001 Actions**

Actions taken by the Company in 2001 included the consolidation and closure of excess facilities, a worldwide workforce reduction, the write-off of certain unrealizable assets and settling certain obligations that had no future benefit. In the second quarter of 2001, the Company recorded a restructuring charge of \$44.2 million, and in the fourth



quarter of 2001, the Company recorded a restructuring charge of \$31.4 million. In connection with these actions, the Company also recorded an impairment charge in cost of product licenses for purchased software of \$1.4 million. Total restructuring charges for 2001 totaled \$75.6 million.

A summary of the charges and related activity of the restructuring accruals is as follows (in thousands):

|  | <b>Accrued<br/>Restructuring<br/>Balance as of<br/>December 31,<br/>2004</b> | <b>Payments</b> | <b>Accrued<br/>Restructuring<br/>Balance as of<br/>March 31,<br/>2005</b> |
|--|--|-----------------|---|
| Facilities-related costs and impairments       | \$ 6,254   | \$ (779)        | \$ 5,475  |
| Employee severance, benefits and related costs | 57   | (57)            |   |
| Total  | \$ 6,311   | \$ (836)        | \$ 5,475  |

**Table of Contents*****Facilities-Related Costs and Impairments***

During 2001, the Company recorded facility-related charges of \$59.4 million of which \$38.1 million was recorded in the second quarter and \$21.3 million was recorded in the fourth quarter. The facilities-related charges comprise excess rental space for offices worldwide, net of estimates for vacancy periods and sublease income based on the then-current real estate market data, and related write-offs of abandoned leasehold improvements and fixed assets of \$7.7 million and \$2.2 million, respectively, which were directly related to excess office facilities. The estimated sublease income was \$25.9 million and based on rental rates ranging from \$18 to \$40 per square foot with estimated vacancy periods prior to the expected sublease income ranging from 10 to 15 months. During the fourth quarter of 2001, the Company recorded an adjustment to increase the facility-related costs for a change in estimate of the lease obligations for two leases by \$9.7 million as a result of a market analysis indicating lower sublease rates and longer vacancy periods due to the continued weakening of the real estate market. The sublease income was adjusted by decreasing anticipated sublease rates from the range of \$18 to \$40 to the range of \$18 to \$35 per square foot and extending the initial vacancy periods by approximately 9 months. In addition, the Company reduced its lease accruals by \$8.2 million for a lease settlement in consideration of a buy-out totaling \$9.3 million, which is being paid ratably over 4.5 years.

The leaseholds improvements, which will continue to be in use, related to the facilities the Company vacated and is subleasing or attempting to sublease, were written down to their estimated fair value of zero because the estimated cash flows to be generated by sublease income at those locations are not and will not be sufficient to recover the carrying value of the assets. Furniture and fixtures were written down to their fair value based on the expected discounted cash flows they will generate over their remaining economic life. Because these assets ceased being used as of the end of the period in which the write-downs were recorded, the fair value of these assets was estimated to be zero. The assets were abandoned and disposed of at the time of the charge.

During 2002, the Company recorded an adjustment to increase the facilities-related portion of the 2001 charge by an additional \$2.2 million for changes to sublease and vacancy assumptions due to the continued weakening in the real estate market. The sublease income was adjusted by decreasing two anticipated sublease rates to \$18 from \$25 per square foot and extending the initial vacancy periods by 7 months. In addition, during 2002, the Company executed sublease agreements for two locations and recorded a reduction to its lease accruals of \$853,000 due to favorable sublease terms compared to the Company's original estimates.

During 2003, the Company settled future lease obligations for five leases for aggregate payments of \$17.1 million, resulting in an aggregate reduction to its lease accruals relating to its 2001 restructuring of \$11.5 million, net of sublease and vacancy assumptions. The Company also recorded an additional charge of \$2.8 million for facilities-related costs comprising \$2.3 million for updated management assumptions of probable settlement outcomes based on the then-current negotiations and \$450,000 for updated sublease assumptions based on current real estate market conditions extending the vacancy period to 33 months from 12 months.

During 2004, the Company made adjustments in cost estimates related to space vacated in 2001. These adjustments resulted in an increase to the restructuring charge of \$112,000.

***Employee Severance, Benefits and Related Costs and Exchangeable Shares***

As part of the 2001 restructuring actions, the Company recorded charges of \$7.9 million for employee severance. The Company terminated the employment of 530 employees, or 46% of the Company's workforce, of which 249 were from sales and marketing, 117 from services, 101 from general and administrative and 63 from research and development. None of these employees remained employed as of June 30, 2002. In addition, the Company settled 11,762 exchangeable shares with a certain employee, who was terminated in connection with the restructuring action,

and recorded \$1.3 million as a charge to restructuring for this settlement. During 2003, the Company recorded additional charges of \$229,000 for severance related to a specific employee terminated as part of the 2001 restructuring action. During 2004, the Company reached final settlement with an employee that had been included in the 2001 charge. The settlement resulted in a reduction to the restructuring charge of \$172,000.

### ***Asset Impairments***

The asset impairment charges included the write off of approximately \$4.0 million of the remaining unamortized goodwill related to the two professional service organizations acquisitions completed in 2000. The Company had closed these operations and terminated the employees as part of the 2001 restructuring action, and as a result, the unamortized goodwill was impaired and had no future value. In addition, the Company recorded an impairment charge of approximately \$1.4 million in cost of product license revenues in the Consolidated Statements of Operations related to purchased software to record the software at its net realizable value of zero due to ATG abandoning a certain product development strategy. The purchased software had no future use to the Company.

### ***Marketing Costs and Legal & Accounting***

The Company recorded charges of \$851,000 to write-off certain prepaid costs for future marketing services to their fair value of zero due to changes in the Company's product development strategy. As a result, the prepaid marketing cost had no future utility to the Company. During 2002, the Company unexpectedly was able to recoup \$536,000 and recorded a credit for the amount received.

During 2001, the Company also recorded \$405,000 for legal and accounting services incurred in connection with the 2001 restructuring action.

The 2001 actions were substantially completed by February 28, 2002.

**Table of Contents****2002 Actions**

Actions taken by the Company in 2002 included the consolidation and closure of excess facilities, a worldwide workforce reduction and the write-off of certain idle assets. In the fourth quarter of 2002, the Company recorded a restructuring charge of \$18.2 million.

A summary of the charges and related activity of the restructuring accruals related to the 2002 restructuring actions is as follows (in thousands):

|  | <b>Accrued<br/>Restructuring<br/>Balance as of<br/>December 31,<br/>2004</b> | <b>Payments</b> | <b>Accrued<br/>Restructuring<br/>Balance as of<br/>March 31,<br/>2005</b> |
|--|--|-----------------|---|
| Facilities-related costs and impairments | \$ 1,155   | \$ (120)        | \$ 1,035  |

***Facilities-Related Costs and Impairments***

During 2002, the Company recorded facilities-related charges of \$14.6 million, which included \$12.0 million for operating lease obligations, net of assumptions for vacancy periods and sublease income based on the then-current real estate market data, related to office space that was either idle or vacated during the first quarter of 2003. This action was completed by January 31, 2003. This charge also included write-offs of leasehold improvements and furniture and fixtures associated with these facilities of \$948,000 and \$507,000, respectively, and computer equipment and software of \$1.2 million. The lease charge was for office space the Company vacated and intends to sublease. The estimated sublease income was \$4.8 million and based on rental rates ranging from \$23 to \$35 per square foot with estimated vacancy periods prior to the expected sublease income ranging from 12 to 21 months.

As a result of this action and the actions taken in 2001, the Company wrote off certain computer equipment and software, aggregating \$1.2 million, and furniture and fixtures, aggregating \$507,000, which was no longer being used due to the reduction in personnel and office locations. These assets were abandoned and written down to their fair value based on the expected discounted cash flows they would generate over their remaining economic life. Due to the short remaining economic life and current market conditions for such assets, the fair value of these assets was estimated to be zero. These assets ceased being used either as of December 31, 2002 or in the first quarter of 2003 and were disposed of in the quarter ended March 31, 2003. In addition, the Company wrote off leasehold improvements which will continue to be in use related to the facilities it is attempting to sublease to their fair value of zero because the estimated cash flows to be generated by sublease income at those locations will not be sufficient to recover the carrying value of the assets.

During 2003, the Company recorded an adjustment of \$1.9 million primarily to increase its lease obligation accrual at two locations because of changes in the assumptions of the vacancy period and sublease income. The sublease income was adjusted by decreasing anticipated sublease rates to \$18 from \$23 per square foot for one facility and from \$35 to \$30 per square foot at the other location. The Company also extended the initial vacancy periods from 12 to 21 months to 24 to 42 months. These changes resulted in an estimated reduction of sublease income of \$1.8 million. In addition, principally due to a favorable lease settlement relating to its 2002 restructuring activities, the Company reduced its lease obligations by \$7.2 million. The settlement resulted in the Company terminating a future lease obligation for an aggregate payment of \$3.3 million, which was paid in January 2004. As a result of this transaction, the Company recorded prepaid rent of \$2.2 million increasing the accrual adjustments to \$4.1 million.

During 2004, the Company recorded an adjustment to its estimates related to the 2002 actions, resulting in a credit to the restructuring charge of \$242,000.

***Employee Severance, Benefits and Related Costs***

As part of the 2002 restructuring action, the Company recorded a charge of \$3.6 million for severance and benefit costs related to cost reduction actions taken across the worldwide employee base. The severance and benefit costs were for 125 employees, or 23% of the Company's workforce. Of the 125 employees, 53 of the employees were from sales and marketing, 45 from services, 19 from general and administrative and 8 from research and development. The Company accrued employee benefits pursuant to ongoing benefits plans and statutory minimum requirements in foreign locations. The Company began the termination process on January 6, 2003 and all employees had been terminated by June 30, 2003. During the second quarter of 2003, the Company recorded an adjustment to increase the severance accrual by \$327,000 based on final severance settlements with certain employees at its foreign locations. During the fourth quarter of 2003, the Company reduced certain severance accruals by \$86,000, primarily at its foreign locations, due to amounts being settled at less than the amount recorded as a result of foreign currency exchange movements.

**Table of Contents****2003 Actions**

As a result of several reorganization decisions, the Company undertook plans to restructure operations in the second and third quarters of 2003. Actions taken by the Company included the closure of excess facilities, a worldwide workforce reduction and the write-off of certain idle assets.

A summary of the charges and related activity of the restructuring accruals is as follows (in thousands):

|  | <b>Accrued<br/>Restructuring<br/>Balance as of<br/>December 31,<br/>2004</b> | <b>Payments</b> | <b>Accrued<br/>Restructuring<br/>Balance as of<br/>March 31,<br/>2005</b> |
|--|--|-----------------|---|
| Facilities-related costs and impairments | \$ 1,373   | \$ (129)        | \$ 1,244  |

**Second Quarter 2003 Actions**

During the quarter ended June 30, 2003, the Company recorded a restructuring charge of \$2.0 million. The Company also recorded an impairment charge in cost of product licenses of \$169,000 related to certain purchased software.

***Facilities-Related Costs and Impairments***

During the second quarter of 2003, the Company recorded facilities-related charges of \$1.1 million comprising \$866,000 for an operating lease related to idle office space, \$144,000 of leasehold improvements and fixed assets written down to their fair value, and \$61,000 for various office equipment leases. The lease charge was for office space the Company vacated and intends to sublease. The amount of the operating lease charge was based on assumptions from current real estate market data for sublease income rates and vacancy rates at the location. The estimated sublease income was \$500,000 and based on a rental rate of \$35 per square foot with an estimated vacancy period prior to the expected sublease income of 24 months. In the fourth quarter of 2003, as result of updated market conditions, the estimated sublet rental rate was lowered to \$30 per square foot from \$35 per square foot and the vacancy period was extended to 36 months from 24 months resulting in an additional charge of \$227,000. In accordance with SFAS 146, the Company has recorded the present value of the net lease obligation.

As a result of a reduction of employees and closure of an office location, the Company wrote off computer and office equipment to their fair value based on the expected discounted cash flows they would generate over their remaining economic life. Due to the short remaining economic life and current market conditions for such assets, the fair value of these assets was estimated to be zero. These assets ceased being used by June 30, 2003 and were disposed of by September 30, 2003. In addition, the Company wrote off leasehold improvements which continue to be in use, related to the facility it is attempting to sublease to their fair value of zero because the estimated cash flows to be generated from that location will not be sufficient to recover the carrying value of the assets.

***Employee Severance, Benefits and Related Costs***

As part of the second quarter 2003 restructuring action, the Company recorded a charge of \$927,000 for severance and benefit costs related to cost reduction actions taken across the worldwide employee base. The severance and benefit costs were for 32 employees, or 7.4% of the Company's workforce, consisting of 11 employees from sales and

marketing, 3 from services, 3 from general and administrative and 15 from research and development. The Company accrued employee benefits pursuant to its ongoing benefit plans for domestic locations and under statutory minimum requirements in foreign locations. All employees were notified of their termination as of June 30, 2003. The termination process was completed during the fourth quarter of 2003. During the third quarter of 2003, the Company accrued an additional \$69,000 for employees at its foreign locations based on management's best estimate of the final payments for severance. During the fourth quarter of 2003, the Company reduced certain severance accruals by \$84,000 at its international locations as a result of final settlements.

### ***Asset Impairments***

The Company recorded a charge in cost of product license revenues of \$169,000 to reduce the carrying value of third-party software embedded into one of its products, which was a minor component of its suite of products, to its net realizable value of \$210,000 based on management's best estimate of future net cash flows to be generated from the sale of the software to customers. The Company discontinued marketing of this software and ceased future development work specifically related to this third-party software. However, the Company has not changed its overall product strategy for the purpose for which the software was acquired.

### **Third Quarter 2003 Actions**

During the third quarter of 2003, the Company recorded a restructuring charge of approximately \$771,000.

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***Facilities -Related Costs and Impairments***

The Company recorded facilities-related charges of \$393,000 comprising \$227,000 for an operating lease related to idle office space and \$166,000 of leasehold improvements and fixed assets written down to their fair value. The lease charge was for office space the Company vacated and intends to sublease. The amount of the operating lease charge was based on assumptions from current real estate market data for sublease income rates and vacancy rates at the location. The estimated sublease income was \$216,000 and based on a rental rate of \$19 per square foot with an estimated vacancy period prior to the expected sublease income of 12 months. During the fourth quarter, as a result of updated market conditions, the Company determined that it is unlikely it will sublet this space before its lease expires resulting in an additional charge of \$198,000. In accordance with SFAS 146, the Company has recorded the present value of the net lease obligation.

As a result of a reduction of employees and the closure of one office location, the Company wrote off computer and office equipment to their fair value based on the expected discounted cash flows they would generate over their remaining economic life. Due to the short remaining economic life and current market conditions for such assets, the fair value of these assets was estimated to be zero. These assets ceased being used prior to September 30, 2003 and were disposed of by December 31, 2003. In addition, the Company wrote down leasehold improvements to their fair value of zero because the estimated cash flows to be generated from that location will not be sufficient to recover the carrying value of the assets.

***Employee Severance, Benefits and Related Costs***

The Company recorded a charge of \$309,000 for severance and benefit costs related to cost reduction actions taken across the worldwide employee base. The severance and benefit costs were for 16 employees, or 4.3% of the Company's workforce, consisting of 7 employees from sales and marketing, 4 from services and 5 from research and development. The Company accrued employee benefits pursuant to its ongoing benefit plans. All employees were notified of their termination as of September 30, 2003. The termination process was completed during the fourth quarter of 2003.

During 2004, the Company made adjustments in cost estimates related to space vacated in 2003 and employee severance estimates related to 2003 actions. These adjustments resulted in a net reduction to the restructuring charge of \$77,000.

**2004 Actions**

During 2004, the Company recorded a restructuring charge of \$3.6 million, comprised of new actions of \$3.9 million and net credits resulting from changes in estimates related to prior actions of \$379,000.

***Facilities-Related Costs and Impairments***

During the fourth quarter of 2004, the Company recorded facilities-related charges of \$1.5 million primarily comprised of \$800,000 for an operating lease related to idle office space net of assumptions for vacancy period and sublease income based on the then current real estate market data, \$200,000 of leasehold improvements written down to their fair value and \$500,000 of prepaid rent related to the abandoned space, which was recorded as part of prior lease settlements. The lease charge was for office space the Company vacated before December 31, 2004 and intends to sublease. The estimated sublease income was \$350,000 based on a rental rate of \$13 per square foot with an estimated vacancy period prior to the expected sublease income of 6 months. In accordance with SFAS 146, the Company recorded the present value of the net lease obligation.



As a result of a reduction of employees and the closure of office space, the Company wrote off \$200,000 of leasehold improvements related to the vacated space to their estimated fair value of zero because the estimated cash flows to be generated from that location will not be sufficient to recover the carrying value of the assets.

***Employee Severance, Benefits and Related Costs***

As part of the fourth quarter 2004 restructuring action, the Company recorded a charge of \$2.5 million for severance and benefit costs related to cost reduction actions taken across the worldwide employee base. The severance and benefit costs were for 56 employees, or 14% of the Company's workforce, consisting of 27 employees from sales and marketing, 8 from services, 6 from general and administrative and 15 from research and development. The Company accrued employee benefits pursuant to its ongoing benefit plans for domestic locations and under statutory minimum requirements in foreign locations. All employees were notified of their termination as of December 31, 2004. As of December 31, 2004, 13 employees had been terminated. The termination process is expected to be completed during 2005.

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A summary of the charges and related activity of the restructuring accruals is as follows (in thousands):

|  | <b>Accrued<br/>Restructuring<br/>Balance as of<br/>December 31,<br/>2004</b> | <b>2005<br/>Adjustments<br/>in Estimates<br/>Resulting in<br/>Additional<br/>Charges</b> | <b>Payments</b> | <b>Accrued<br/>Restructuring<br/>Balance as<br/>of<br/>March 31,<br/>2005</b> |
|--|--|--|-----------------|---|
| Facilities-related costs and impairments       | \$ 750   | \$ 4   | \$ (142)        | \$ 612  |
| Employee severance, benefits and related costs | 1,569  | 200  | (834)           | 935   |
| Total  | \$ 2,319   | \$ 204   | \$ (976)        | \$ 1,547  |

During the quarter ended March 31, 2005, the Company recorded a net restructuring charge of approximately \$200,000, resulting from adjustments to estimates made in 2004 for employee severance benefits payable in international geographies.

**Abandoned Facilities Obligations**

At March 31, 2005, the Company had lease arrangements related to seven abandoned facilities. The lease arrangements with respect to six of these facilities are ongoing, and one is the subject of a lease settlement arrangement under which we are obligated to make payments through 2006. All locations for which we have recorded restructuring charges have been exited, and thus management's plans with respect to these leases have been completed. A summary of the remaining facility locations and the timing of the remaining cash payments are as follows (in thousands) (See Note 18):

| <b>Lease Locations</b>               | <b>2005</b> | <b>2006</b> | <b>2007</b> | <b>2008</b> | <b>2009</b> | <b>Total</b> |
|--------------------------------------|-------------|-------------|-------------|-------------|-------------|--------------|
| Cambridge, MA*                       | \$ 1,551    | \$ 1,035    |             |             |             | \$ 2,586     |
| Cambridge, MA                        | 101         | 91          |             |             |             | 192          |
| Cambridge, MA                        | 344         | 531         |             |             |             | 875          |
| Waltham, MA                          | 1,019       | 1,466       | \$ 1,466    | \$ 1,466    | \$ 122      | 5,539        |
| Chicago, IL                          | 489         | 435         |             |             |             | 924          |
| San Francisco, CA                    | 89          | 111         | 111         |             |             | 311          |
| Reading, UK                          | 427         | 570         | 570         | 570         | 142         | 2,279        |
| Facility obligations, gross          | 4,020       | 4,239       | 2,147       | 2,036       | 264         | 12,706       |
| Contracted and assumed sublet income | (460)       | (1,438)     | (1,302)     | (1,256)     | (150)       | (4,606)      |
| Net cash obligations                 | \$ 3,560    | \$ 2,801    | \$ 845      | \$ 780      | \$ 114      | \$ 8,100     |

|                          |        |        |        |        |       |          |
|--------------------------|--------|--------|--------|--------|-------|----------|
| Assumed sub-lease income | \$ 105 | \$ 320 | \$ 315 | \$ 270 | \$ 67 | \$ 1,077 |
|--------------------------|--------|--------|--------|--------|-------|----------|

\* represents a location for which we have executed a lease settlement agreement

## (15) LITIGATION

The Company and certain former officers have been named defendants in seven purported class action suits currently pending in the United States District Court for the District of Massachusetts. Each of these cases alleges that the Company and certain former officers have violated Sections 10(b) and 20(a) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder, which generally may subject issuers of securities and persons controlling those issuers to civil liabilities for fraudulent actions or defects in the public disclosure required by securities laws. Four of the cases were filed on various dates in October 2001 in the U.S. District Court for the District of Massachusetts. Three of the cases were initially filed in the Central District of California (the California actions ) on various dates in August and September 2001. The California actions were consolidated and transferred to the District of Massachusetts on or about November 27, 2001. On December 13, 2001, the Court issued an Order of Consolidation in which it consolidated all actions filed against the Company and appointed certain individuals as Lead Plaintiffs in the consolidated action. It also appointed two

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law firms as Co-Lead Counsel, and a third law firm as Liaison Counsel. Counsel for the plaintiffs has filed a Consolidated Amended Complaint applicable to all of the consolidated actions. On April 19, 2002, the Company filed a motion to dismiss the case. On September 4, 2003 the court issued a ruling dismissing all but one of the plaintiffs allegations. The remaining allegation is based on the veracity of a public statement made by a former officer of the Company and is the subject of a motion to dismiss and summary judgment filed by the Company on August 31, 2004 currently pending before the Court. Management continues to believe the remaining claim against the Company is without merit, and intends to defend the action vigorously. While we cannot predict with certainty the outcome of the litigation, we do not expect any material adverse impact to the Company's business, or the results of its operations, from this matter.

The Company's wholly owned subsidiary Primus Knowledge Solutions, Inc. (Primus), an officer and former officer of Primus and FleetBoston Robertson Stephens, Inc., J.P. Morgan Securities Inc., U.S. Bancorp Piper Jaffray Inc., CIBC World Markets, Dain Rauscher, Inc. and Salomon Smith Barney Holdings Inc., the underwriters of Primus initial public offering, have been named as defendants in an action filed during December 2001 in the United States District Court for the Southern District of New York on behalf of persons who purchased Primus common stock during the period from June 30, 1999 through December 6, 2000, which was issued pursuant to the June 30, 1999 registration statement and prospectus for Primus initial public offering. This is one of a number of actions coordinated for pretrial purposes. Plaintiffs in the coordinated proceeding have brought claims under the federal securities laws against numerous underwriters, companies, and individuals, alleging generally that defendant underwriters engaged in improper and undisclosed activities concerning the allocation of shares in the IPO's of more than 300 companies during the period from late 1998 through 2000. Specifically, among other things, the plaintiffs allege that the prospectus pursuant to which shares of Primus common stock were sold in the IPO contained certain false and misleading statements regarding the practices of Primus' underwriters with respect to their allocation of shares of common stock in Primus' IPO to their customers and their receipt of commissions from those customers related to such allocations, and that such statements and omissions caused Primus' post-IPO stock price to be artificially inflated. The individual defendants have been dismissed from the action without prejudice pursuant to a tolling agreement. In June 2003 the plaintiffs in this action announced a proposed settlement with the issuer defendants and their insurance carriers. Primus elected to participate in the settlement, which generally provides that plaintiffs will dismiss and release all claims against Primus and the individual defendants in exchange for a contingent payment by the insurance companies collectively responsible for insuring the issuers in all of the consolidated IPO cases, and for the assignment or release of certain potential claims that Primus may have against the underwriters. Primus will not be required to make any cash payments in the settlement, unless the pro rata amount paid by the insurers in the settlement on Primus behalf exceeds the amount of the insurance coverage, a circumstance that we believe is not likely to occur. A stipulation of settlement of claims against the issuer defendants, including Primus, was submitted to the Court for preliminary approval in June 2004. On February 15, 2005, the Court preliminarily approved the settlement contingent on specified modifications. The settlement is subject to final Court approval, after proposed settlement class members have an opportunity to object, and a number of other conditions. If the settlement does not occur, and litigation against Primus continues, we believe we have meritorious defenses and intend to defend the case vigorously. While we cannot predict with certainty the outcome of the litigation or whether the settlement will be approved, we do not expect any material adverse impact to the Company's business, or the results of its operations, from this matter.

The Company is also subject to various other claims and legal actions arising in the ordinary course of business. In the opinion of management, after consultation with legal counsel, the ultimate disposition of these matters is not expected to have a material effect on the Company's business, financial condition or results of operations.

**(16) CONCENTRATION OF CREDIT RISK**

ATG provides credit to customers in the normal course of business. Credit is extended to new customers based upon industry reputation and demonstrated financial stability. Credit is extended to existing customers based upon

prior payment history and demonstrated financial stability. Credit risk associated with accounts receivable is limited due to the large number of customers and their dispersion over multiple industries and geographic areas. ATG maintains an allowance for potential credit losses but historically has not experienced any significant losses related to individual customers or groups of customers in any particular industry or geographic area. There were no customers at March 31, 2005 that accounted for greater than 10% of accounts receivable. At December 31, 2004 one customer accounted for 11% of accounts receivable.

#### **(17) RECENT ACCOUNTING PRONOUNCEMENTS**

In December 2004, the Financial Accounting Standards Board issued SFAS No. 123R, *Share-Based Payment*, which replaces SFAS 123 and supersedes APB Opinion No. 25. SFAS 123R requires all share-based payments to employees, including grants of employee stock options, to be recognized in the financial statements based on their fair values. The pro forma disclosures previously permitted under SFAS 123 no longer will be an alternative to financial statement recognition. SFAS 123R is effective for fiscal periods beginning after December 15, 2005. Early application of SFAS 123R is encouraged, but not required. The Company will adopt SFAS 123R on January 1, 2006.

Public companies are required to adopt the new standard using a modified prospective method or may elect to restate prior periods using the modified retrospective method. Under the modified prospective method, companies are required to record compensation cost for new and modified awards over the related vesting period of such awards prospectively and record compensation cost prospectively for the unvested portion, at the date of adoption, of previously issued and outstanding awards over the remaining vesting period of such awards. No change to prior periods presented is permitted under the modified prospective method. Under the modified

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retrospective method, companies record compensation costs for prior periods retroactively through restatement of such periods using the exact pro forma amounts disclosed in the companies' footnotes. Also, in the period of adoption and after, companies record compensation cost utilizing the modified prospective method. The Company has not yet determined the method of adoption it will use and the Company has not completed its evaluation of the effects of adopting SFAS 123R.

### **(18) SUBSEQUENT EVENT**

In April 2005, the company relocated its San Francisco office and reduced the amount of space that it now occupies in San Francisco. As a result of this action and the cessation of the use of this facility in the second quarter of 2005 and other minor facilities charges, the Company anticipates that it will incur a restructuring charge in the second quarter of 2005 in the range of \$1.5 to \$2.0 million. Of this amount, approximately \$1.2 million will be a non-cash charge. The relocation will result in an aggregate net cash savings of approximately \$400,000 through the end of 2007. Beginning in the third quarter of 2005, these actions will reduce the Company's annual operating expenses by approximately \$700,000 to \$800,000 through the end of 2007.

## **Item 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

### **Overview**

The following discussion and analysis of our financial condition and results of operations should be read in conjunction with our consolidated financial statements and the related notes contained in Item 1 of this Quarterly Report on Form 10-Q. This discussion and analysis contains forward-looking statements that involve risks, uncertainties and assumptions. Our actual results may differ materially from those anticipated in these forward-looking statements as a result of a number of factors, including those set forth below under the heading "Risk Factors that May Affect Results" and elsewhere in this report.

We were founded in December 1991. From 1991 through 1995, we devoted our efforts principally to building, marketing and selling our professional services capabilities and to research and development activities related to our software products. Beginning in 1996, we began to focus on selling our software products. To date, we have enhanced and released several versions of our products. On November 1, 2004, we acquired all of the outstanding shares of common stock of Primus Knowledge Solutions, Inc. ( "Primus" ) Primus is a provider of software solutions that enable companies to deliver a superior customer experience via contact centers, information technology help desks, web (intranet and internet) self-service and electronic communication channels. The consolidated financial statements include Primus' financial results from the date of acquisition. We market and sell our products worldwide through our direct sales force, systems integrators, technology alliances and original equipment manufacturers.

We derive our revenues from the sale of software product licenses and related services. Our software licenses are priced based on either the size of the customer implementation or site license terms. Services revenues are derived from fees for professional services, training, software maintenance and support and application hosting. Professional services include implementation, custom application development and project and technical consulting. We bill professional service fees primarily on a time and materials basis or in some cases, on a fixed-price schedule defined specifically in our contracts. Software maintenance and support arrangements are priced based on the level of services provided. Generally, customers are entitled to receive software updates, maintenance releases as well as on-line and telephone technical support for an annual maintenance fee. Training is billed as services are provided. Application hosting services are typically billed monthly as the services are provided.

As of March 31, 2005 we had offices in the United States, United Kingdom, France, Spain and Northern Ireland with sales personnel in United States, United Kingdom, France, and Spain. Revenues from customers outside the United States accounted for 27% and 39% of our total revenues for the three months ended March 31, 2005 and 2004, respectively.

### **Critical Accounting Policies and Estimates**

This management's discussion of financial condition and results of operations analyzes our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States.

We believe the following critical accounting policies to be both those most important to the portrayal of our financial condition and those that require the most subjective judgment. The preparation of these financial statements requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. On an ongoing basis, management evaluates its estimates and judgments, including those related to revenue recognition, the allowance for doubtful accounts, research and development costs, restructuring expenses, the impairment of long-lived assets and income taxes. Management bases its estimates and judgments on historical experience, known trends or events and various other factors that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions.

We believe the following critical accounting policies to be both those most important to the portrayal of our financial condition and those that require the most subjective judgment.

**Table of Contents***Revenue Recognition*

Not only is revenue recognition a key component of our results of operations, the timing of our revenue recognition also determines the timing of certain expenses, such as commissions. In measuring revenues, we follow the specific guidelines of Statement of Position No. 97-2, *Software Revenue Recognition* and SOP 98-9, *Modification of SOP 97-2, Software Revenue Recognition, with Respect to Certain Transactions*. SOP 97-2 requires that four basic criteria must be met before revenue can be recognized: (1) persuasive evidence that an arrangement exists via a signed license agreement; (2) physical or electronic delivery has occurred including the availability of license keys or services rendered; (3) the fee is fixed or determinable representing amounts that are due unconditionally with no future obligations under customary payment terms; and (4) collection is probable. In addition, revenue results are difficult to predict and any shortfall or delay in recognizing revenue could cause our operational results to vary significantly from quarter to quarter and could result in future operating losses.

In accordance with SOP 97-2 and SOP 98-9, revenues from software product license agreements are recognized upon execution of a license agreement and delivery of the software, provided that the fee is fixed or determinable and deemed collectible by management. If conditions for acceptance are required subsequent to delivery, revenues are recognized upon customer acceptance if such acceptance is not deemed to be perfunctory. In multiple element arrangements, we use the residual value method in accordance with SOP 97-2 and SOP 98-9. Revenue earned on software arrangements involving multiple elements which qualify for separate element accounting treatment is allocated to each undelivered element using the relative fair values of those elements based on vendor specific objective evidence with the remaining value assigned to the delivered element, the software license. Typically our software licenses do not include significant post-delivery obligations to be fulfilled by us and payments are due within a three-month period from the date of delivery. Consequently, license fee revenue is generally recognized when the product is shipped. Revenues from software maintenance or hosting agreements are recognized ratably over the term of the maintenance or hosting period, which for application hosting and support and maintenance is typically one year. Customers who have purchased our product licenses and have also entered into a hosting agreement typically have a contractual right to cancel the hosting agreement with a minimum notice period. We enter into reseller arrangements that typically provide for sublicense fees payable to us based upon a percentage of our list price. Revenues are recognized under reseller agreements as earned for guaranteed minimum royalties, or based upon actual sales to the resellers. We do not grant our resellers the right of return or price protection.

Revenues from professional service arrangements are recognized as the services are performed, provided that amounts due from customers are fixed or determinable and deemed collectible by management. Amounts collected prior to satisfying the above revenue recognition criteria are reflected as deferred revenue. Unbilled services represent service revenues that have been earned by us in advance of billings. Deferred revenue primarily consists of advance payments related to support and maintenance, service agreements and deferred product license revenues.

We principally recognize professional services revenues on a time-and-material basis. From time to time we enter into fixed-price service arrangements. In those circumstances in which services are essential to the functionality of the software, we apply the percentage-of-completion method, and in those situations when only professional services are provided, we apply the proportional performance method. Both of these methods require that we track the effort expended and the effort expected to complete a project. The most significant assumption by management in accounting for this type of arrangement is the estimated time to complete the project. Significant deviations in actual results from management's estimates with respect to one or more projects could significantly impact the timing of revenue recognition and could result in significant losses on these projects. To date, our actual results in completing projects have not deviated significantly from management's estimates of the time to complete those projects.

*Accounts Receivable and Bad Debt*



We maintain allowances for doubtful accounts for estimated losses resulting from the inability of our customers to make required payments. We continuously monitor collections and payments from our customers and determine the allowance for doubtful accounts based upon historical experience and specific customer collection issues. If the financial condition of our customers were to deteriorate, resulting in an impairment of their ability to make payments, additional allowances would be required.

*Research and Development Costs*

We account for research and development costs in accordance with SFAS 2, *Accounting for Research and Development Costs*, and SFAS 86, *Accounting for the Costs of Computer Software to be Sold, Leased, or Otherwise Marketed*, which specifies that costs incurred internally to develop computer software products should be charged to expense as incurred until technological feasibility is reached for the product. Once technological feasibility is reached, all software costs should be capitalized until the product is made available for general release to customers. Judgment is required in determining when technological feasibility is established. We believe that the time period from reaching technological feasibility until the time of general product release is very short. Costs incurred after technological feasibility is reached are not material, and accordingly, all such costs are charged to research and development expense as incurred.

*Restructuring Expenses*

During the quarter ended March 31, 2005, the Company recorded a net restructuring charge of approximately \$204,000. During

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the years ended 2004, 2003, 2002 and 2001, the Company recorded net restructuring charges/ (benefits) of \$3.6 million, \$(10.5) million, \$19.0 million and \$75.6 million, respectively, pertaining to the closure and consolidation of excess facilities, impairment of assets as discussed below, employee severance benefits and settlement of certain contractual obligations. These charges and benefits were recorded in accordance with SFAS 146, *Accounting for Costs Associated with Exit or Disposal Activities*, SFAS 88, *Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits* and Staff Accounting Bulletin (SAB) No. 100 (SAB 100), *Restructuring and Impairment Charges*. The 2002 and 2001 charges were recorded in accordance with Emerging Issues Task Force, or EITF, Issue No. 94-3, *Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring)*, SFAS 88, and SAB 100. In determining the charges to record, we made certain estimates and judgments surrounding the amounts ultimately to be paid for the actions we have taken. At March 31, 2005, there were various accruals recorded for the costs to terminate employees and exit certain facilities and lease obligations, which may be adjusted periodically for either resolution of certain contractual commitments or changes in estimates of severance payments, sublease income or the period of time the facilities will be vacant and subleased. Although we do not anticipate additional significant changes to our restructuring accruals, the actual costs may differ from those recorded in the event that the subleasing assumptions require adjustment due to changes in economic conditions surrounding the real estate market or we terminate our lease obligations prior to the scheduled termination dates. Such changes had a material impact to our operating results in the past and could have a material impact on our operating results in the future.

In order to estimate the costs related to our restructuring efforts, management made its best estimates of the most likely expected outcomes of the significant actions to accomplish the restructuring. These estimates principally related to charges for excess facilities and included estimates of future sublease income, future net operating expenses of the facilities, brokerage commissions and other expenses. The most significant of these estimates related to the timing and extent of future sublease income that would reduce our lease obligations.

Included in our accrued restructuring balance at March 31, 2005 was estimated sublease income of \$1.0 million, net of adjustments. We based our estimates of sublease income on, among other things, (a) opinions of independent real estate experts, (b) current market conditions and rental rates, (c) an assessment of the time period over which reasonable estimates could be made, (d) the status of negotiations with potential subtenants and (e) the locations of the facilities. These estimates, together with other estimates made by us in connection with the restructuring actions, may vary significantly from the actual results, depending in part on factors beyond our control. For example, the actual results will depend on our success in negotiating with lessors, the time periods required for us to locate and contract suitable subleases and the market rental rates at the time of such subleases. Adjustments to the facilities reserve may be required if actual lease settlement costs or sublease income differ from the amounts previously estimated. We review the status of our restructuring activities on a quarterly basis and, if appropriate, record adjustments to our restructuring obligations in our financial statements for such quarter based on management's then-current estimates. Additionally, we estimate the required severance accrual at foreign locations based on the minimum statutory requirements of each country. The amount of severance that ultimately is paid may differ from the amount we have accrued. In our history, we have not experienced significant variations between the amounts initially accrued for severance at foreign locations and the amounts ultimately paid out.

*Impairment or Disposal of Long Lived Assets, including Intangible Assets*

We review our long-lived assets, including intangible assets subject to amortization, whenever events or changes in circumstances indicate that the carrying amount of such an asset may not be recoverable. Recoverability of these assets is measured by comparison of their carrying amount to the future undiscounted cash flows the assets are expected to generate. If such assets are considered impaired, the impairment to be recognized is equal to the amount by which the carrying value of the assets exceeds their fair market value determined by either a quoted market price, if any, or a value determined by utilizing a discounted cash flow technique. In assessing recoverability, we must make

assumptions regarding estimated future cash flows and discount factors. If these estimates or related assumptions change in the future, we may be required to record impairment charges. Intangible assets with determinable lives are amortized over their estimated useful lives, based upon the pattern in which the expected benefits will be realized, or on a straight-line basis, whichever is greater.

As a result of our restructuring activities in 2004, 2003 and 2002, we evaluated the realizability of our long-lived assets including fixed assets and leasehold improvements related to our restructured facility leases and intangible assets consisting primarily of unamortized goodwill. In 2004, 2003 and 2002, we determined that \$0, \$78,000 and \$1.7 million, respectively, of furniture and fixtures, computer equipment and software were impaired as a result of our decision to abandon the assets because of the termination of employees and related closures of offices in our 2004, 2003 and 2002 restructuring plans. These assets are no longer being used or will not be used in the future upon completion of the restructuring activities. In addition, in 2004, 2003 and 2002 we deemed \$147,000, \$232,000 and \$909,000, respectively, of leasehold improvements to be impaired due to exiting certain office locations, and the estimated sublease income was not sufficient to recover the assets carrying value. In addition we determined that approximately \$169,000 in 2003 of purchased software was impaired due to our revised product development strategy.

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*Goodwill*

We account for goodwill under SFAS 142, *Goodwill and Other Intangible Assets*. SFAS 142 requires that goodwill not be amortized but instead tested for impairment annually and more frequently upon the occurrence of certain events which may indicate that impairment has occurred.

The provisions of SFAS 142 require that a two-step impairment test be performed on goodwill. In the first step, we compare the fair value, which is determined by use of a discounted cash flow technique, of the reporting entity to its carrying value. If the fair value of the reporting entity exceeds the carrying value of the net assets of that entity, goodwill is not impaired and we are not required to perform further testing. If the carrying value of the net assets assigned to the reporting entity exceeds the fair value of that entity, then we must perform the second step of the impairment test in order to determine the implied fair value of the reporting entity's goodwill. If the carrying value of a reporting entity's goodwill exceeds its implied fair value, then we record an impairment loss equal to the difference.

Determining the fair value of a reporting entity is judgmental in nature and involves the use of significant estimates and assumptions. These estimates and assumptions may include revenue growth rates and operating margins used to calculate projected future cash flows, risk-adjusted discount rates, future economic and market conditions, and determination of appropriate market comparables. The estimates are based upon historical experience and projections of future activity, factoring in customer demand, changes in technology and a cost structure necessary to achieve the related revenues. We base our fair value estimates on assumptions we believe to be reasonable but that are unpredictable and inherently uncertain. Actual future results may differ from those estimates. In addition, we may make certain judgments and assumptions in allocating shared assets and liabilities to determine the carrying values of reporting entities.

We plan on performing the annual impairment assessment as of December 1 of each year.

*Accounting for Income Taxes*

We account for income taxes in accordance with SFAS 109, *Accounting for Income Taxes*, which requires that deferred tax assets and liabilities be recognized using enacted tax rates for the effect of temporary differences between the book and tax bases of recorded assets and liabilities. SFAS 109 also requires that deferred tax assets be reduced by a valuation allowance if it is more likely than not that some portion or all of the deferred tax assets will not be realized. We evaluate quarterly the realizability of our deferred tax assets and adjust the amount of such allowance, if necessary. At March 31, 2005 and December 31, 2004, we had provided a full valuation allowance against our net deferred tax assets due to the uncertainty of their realizability. If substantial changes in our ownership have occurred or should occur, as defined by Section 382 of the Internal Revenue Code, there could be annual limitations on the amount of net operating loss carryforwards that can be realized in future periods.

In addition, we have provided for potential amounts due in various foreign tax jurisdictions. Judgment is required in determining our worldwide income tax expense provision. In the ordinary course of global business, there are many transactions and calculations where the ultimate tax outcome is uncertain. Some of these uncertainties arise as a consequence of cost reimbursement arrangements among related entities. Although we believe our estimates are reasonable, no assurance can be given that the final tax outcome of these matters will not be different from that which is reflected in our historical income tax provisions and accruals. Such differences could have a material impact on our income tax provision and operating results in the period in which such determination is made.

**Table of Contents****Results of Operations**

The following table sets forth statement of operations data as percentages of total revenues for the periods indicated:

|                          | <b>Three Months Ended<br/>March 31,</b> |             |
|--------------------------|---|-------------|
|                          | <b>2005</b>                             | <b>2004</b> |
| Revenues:                |   |             |
| Product license          | 34%                                     | 38%         |
| Services                 | 66%                                     | 62%         |
| <br>                     |   |             |
| Total revenues           | 100%                                    | 100%        |
| <br>                     |   |             |
| Cost of revenues:        |   |             |
| Product license          | 3%                                      | 2%          |
| Services                 | 25%                                     | 29%         |
| <br>                     |   |             |
| Total cost of revenues   | 27%                                     | 31%         |
| <br>                     |   |             |
| Gross margin             | 73%                                     | 69%         |
| <br>                     |   |             |
| Operating expenses:      |   |             |
| Research and development | 21%                                     | 25%         |
| Sales and marketing      |   |             |