

ART TECHNOLOGY GROUP INC

Form 10-Q

May 10, 2004

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**SECURITIES AND EXCHANGE COMMISSION**

**Washington, D.C. 20549**

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**FORM 10-Q**

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

**For the Quarterly Period Ended March 31, 2004**

**OR**

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

**For the Transition Period from            to**

**Commission file number 000-26679**

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**ART TECHNOLOGY GROUP, INC.**

(Exact name of registrant as specified in its charter)

**Delaware**

(State or other jurisdiction of incorporation or organization)

**04-3141918**

(I.R.S. Employer Identification Number)

**25 First Street, Cambridge, Massachusetts**

(Address of principal executive offices)

**02141**

(Zip Code)

**(617) 386-1000**

(Registrant's telephone number, including area code)

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Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Sections 13 or 15 (d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No

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

As of May 7, 2004 there were 73,528,709 shares of the Registrant's common stock outstanding.

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**PART I. FINANCIAL INFORMATION****Item 1. Financial Statements**

## ART TECHNOLOGY GROUP, INC.

## CONDENSED CONSOLIDATED BALANCE SHEETS

(In thousands, except share and per share data)

(UNAUDITED)

	<b>March 31 2004</b>	<b>December 31 2003</b>
	<u>                    </u>	<u>                    </u>
<b>ASSETS</b>		
Current Assets:		
Cash and cash equivalents	\$ 22,937	\$ 32,703
Marketable securities	5,321	9,650
Accounts receivable, net of reserves of \$727 (\$799 in 2003)	15,105	15,364
Prepaid expenses and other current assets	1,922	1,180
	<u>                    </u>	<u>                    </u>
Total current assets	45,285	58,897
Property and equipment, net	3,444	3,751
Long term marketable securities	6,928	
Other assets	4,635	4,712
	<u>                    </u>	<u>                    </u>
	\$ 60,292	\$ 67,360
	<u>                    </u>	<u>                    </u>
<b>LIABILITIES AND STOCKHOLDERS EQUITY</b>		
Current Liabilities:		
Accounts payable	\$ 2,139	\$ 1,146
Accrued expenses	10,948	12,363
Deferred revenue	15,098	14,915
Accrued restructuring, short-term	4,665	9,427
	<u>                    </u>	<u>                    </u>
Total current liabilities	32,850	37,851
Accrued restructuring, less current portion	7,855	8,572
Commitments and contingencies (Notes 8 and 9)		
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 73,383,847 shares and 72,936,165 shares at March 31, 2004 and December 31, 2003, respectively	734	729
Additional paid-in capital	219,386	218,927
Deferred compensation		(11)
Accumulated deficit	(197,478)	(195,691)
Accumulated other comprehensive loss	(3,055)	(3,017)
	<u>          </u>	<u>          </u>
Total Stockholders Equity	19,587	20,937
	<u>          </u>	<u>          </u>
	\$ 60,292	\$ 67,360
	<u>          </u>	<u>          </u>

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 March 31,</b>	
	<b>2004</b>	<b>2003</b>
Revenues:		
Product licenses	\$ 6,364	\$ 7,505
Services	10,446	11,920
	<hr/>	<hr/>
Total Revenues	16,810	19,425
Cost of Revenues:		
Product licenses	399	485
Services	4,785	5,739
	<hr/>	<hr/>
Total Cost of Revenues	5,184	6,224
	<hr/>	<hr/>
Gross Profit	11,626	13,201
Operating Expenses:		
Research and development	4,130	4,873
Sales and marketing	7,341	8,786
General and administrative	1,930	2,657
	<hr/>	<hr/>
Total Operating Expenses	13,401	16,316
	<hr/>	<hr/>
Loss from Operations	(1,775)	(3,115)
Interest and Other Income (Expense), Net	(47)	361
	<hr/>	<hr/>
Net loss before provision for income taxes	(1,822)	(2,754)
Provision for Income Taxes	35	
	<hr/>	<hr/>
Net loss	\$ (1,787)	\$ (2,754)
	<hr/>	<hr/>

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Basic and diluted net loss per share	<u>\$ (0.02)</u>	<u>\$ (0.04)</u>
Basic and diluted weighted average common shares outstanding	<u>73,053</u>	<u>70,982</u>

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 31,</b>	
	<b>2004</b>	<b>2003</b>
<b>Cash Flows from Operating Activities:</b>		
Net loss	\$ (1,787)	\$ (2,754)
Adjustments to reconcile net loss to net cash used in operating activities		
Stock-based compensation	11	81
Depreciation and amortization	581	1,320
Loss on disposal of fixed assets, net	6	185
Changes in current assets and liabilities		
Accounts receivable, net	259	7,364
Unbilled services		(15)
Prepaid expenses and other current assets	(742)	(157)
Deferred Rent	101	
Accounts payable	993	(397)
Accrued expenses	(1,415)	(3,565)
Deferred revenues	183	498
Accrued restructuring	(5,479)	(4,657)
	<u>          </u>	<u>          </u>
Net cash used in operating activities	<u>(7,289)</u>	<u>(2,097)</u>
<b>Cash Flows from Investing Activities:</b>		
Net proceeds from maturity (purchases of) marketable securities	(2,599)	5,112
Purchases of property and equipment	(258)	(46)
Proceeds on sale of fixed assets		41
(Increase) decrease in other assets	(24)	160
	<u>          </u>	<u>          </u>
Net cash (used in) provided by investing activities	<u>(2,881)</u>	<u>5,267</u>
<b>Cash Flows from Financing Activities:</b>		
Proceeds from exercise of stock options	191	
Proceeds from employee stock purchase plan	273	296
	<u>          </u>	<u>          </u>

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Net cash provided by financing activities	464	296
	<u>          </u>	<u>          </u>
Effect of Foreign Exchange Rate Changes on Cash and Cash Equivalents	(60)	(273)
Net Increase (Decrease) in Cash and Cash Equivalents	(9,766)	3,193
Cash and Cash Equivalents, Beginning of Period	32,703	45,829
	<u>          </u>	<u>          </u>
Cash and Cash Equivalents, End of Period	\$ 22,937	\$ 49,022
	<u>          </u>	<u>          </u>

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 and professional 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 2003 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, 2004 are not necessarily indicative of the results to be expected for the full year ending December 31, 2004.

The accompanying consolidated financial statements include the accounts of ATG and its wholly owned subsidiaries. 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* (APB 25) and related Interpretations, and follows the disclosure-only alternative under FAS 123, *Accounting for Stock Based Compensation*.

Had compensation expense for ATG's Stock Plans been recorded consistent with FAS 123, the pro forma net loss and net loss per share would have been as follows (in thousands):

	<b>Three Months Ended March 31,</b>	
	<b>2004</b>	<b>2003</b>
Net loss as reported	\$ (1,787)	\$ (2,754)

Add: Stock-based employee compensation expense included in reported net loss	11	81
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards	<u>(6,437)</u>	<u>(14,107)</u>
Pro forma net loss	<u>\$ (8,213)</u>	<u>\$ (16,780)</u>
Basic and diluted net loss per share		
As reported	\$ (0.02)	\$ (0.04)
Pro forma	\$ (0.11)	\$ (0.24)

*Increase in shares available under option plans*

During 2003, the Company increased the number of shares of common stock available for issuance under the 1999 Outside Director Stock Option Plan and the 1999 Employee Stock Purchase Plan to 800,000 shares from 300,000 shares, and to 5,000,000 shares from 3,000,000 shares, respectively.

*Amendments to the Amended and Restated 1996 Stock Option Plan and the 1999 Outside Director Stock Option Plan*

During the three months ended March 31, 2004, the Company's Board of Directors approved resolutions, subject to shareholder approval, to further amend the Amended and Restated 1996 Stock Option Plan to allow for the grant of restricted stock awards, performance share awards and other forms of equity based compensation that are not provided for in the current plan and extend the term of the plan until December 31, 2013. Additionally, the Company's Board of Directors approved resolutions, subject to shareholder approval, to further amend the Amended and Restated 1999 Outside Director Stock Option Plan to allow for the grant of restricted stock and extend the term of the Plan until December 31, 2013. If the resolutions are approved by shareholders, \$2,500 of each director's annual retainer will be paid in the form of restricted stock.

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

Net income (loss) per share is computed under Statement of Financial Accounting Standards (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 consist of stock options using the treasury stock method.

The following table sets forth basic and diluted net income (loss) per share computational data for the three months ended March 31, 2004 and 2003 (in thousands, except per-share amounts):

	<b>Three Months Ended March 31,</b>	
	<b>2004</b>	<b>2003</b>
Net loss	\$ (1,787)	\$ (2,754)
Weighted average common shares outstanding used in computing basic net loss per share	73,053	70,982
Weighted average common equivalent shares outstanding: Employee common stock options	_____	_____
Total weighted average common stock and common stock equivalents outstanding used in computing diluted net loss per share	73,053	70,982
Basic net loss per share	\$ (0.02)	\$ (0.04)
Diluted net loss per share	\$ (0.02)	\$ (0.04)
Antidilutive common stock equivalents	13,119	12,514

**(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 and the sale of certain other consulting and development services. ATG generally has separate agreements with its customers which govern the terms and conditions of its software licenses, consulting and support and maintenance services. These separate agreements, along with ATG's price list and business practices of selling services separately, provide the basis for establishing vendor-specific objective evidence of fair value. This allows

ATG to appropriately allocate fair value among the multiple elements in an arrangement and apply the residual method under Statement of Position (SOP) No. 97-2, *Software Revenue Recognition* (SOP 97-2) and SOP 98-9, *Modification of SOP 97-2, Software Revenue Recognition, with Respect to Certain Transactions* (SOP 98-9).

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 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, 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, license fee revenue is generally recognized when the product is shipped. Revenues from software maintenance agreements are recognized ratably over the term of the maintenance period, which is typically one year. 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 by the resellers. ATG does not grant its resellers the right of return or price protection.

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 and service agreements.

**Table of Contents****(5) CASH, CASH EQUIVALENTS AND MARKETABLE SECURITIES**

ATG accounts for investments in marketable securities under FAS 115, *Accounting for Certain Investments in Debt and Equity Securities* (FAS 115). Under FAS 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, 2004 and December 31, 2003, all of ATG's marketable securities were classified as held-to-maturity. The average maturity of ATG's marketable securities was approximately 10.2 months and 3.5 months at March 31, 2004 and December 31, 2003, respectively. At March 31, 2004 and December 31, 2003, the difference between the amortized cost and market value of ATG's marketable securities were gains of approximately \$10,000 and \$4,000, respectively. At March 31, 2004 and December 31, 2003, ATG's cash, cash equivalents and marketable securities consisted of the following (in thousands):

	<b>March 31, 2004</b>	<b>December 31, 2003</b>
	<hr/>	<hr/>
Cash and cash equivalents		
Cash	\$ 9,307	\$12,536
Money market accounts	12,433	20,167
Commercial Paper	1,197	
	<hr/>	<hr/>
Total cash and cash equivalents	\$22,937	\$32,703
	<hr/>	<hr/>
Marketable securities		
Corporate securities	\$11,245	\$ 8,642
U.S. Government Agency Securities	1,004	1,008
	<hr/>	<hr/>
Total marketable securities	\$12,249	\$ 9,650
	<hr/>	<hr/>

**(6) 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 loss (in thousands):

	<b>Three Months Ended March 31,</b>	
	<hr/>	
	<b>2004</b>	<b>2003</b>

Net loss	\$ (1,787)	\$ (2,754)
Foreign currency translation loss	(38)	(280)
Comprehensive loss	\$ (1,825)	\$ (3,034)

The accumulated other comprehensive loss at March 31, 2004 and December 31, 2003, of \$3.1 million and \$3.0 million respectively, consisted entirely of the cumulative foreign currency translation adjustment.

## (7) DISCLOSURES ABOUT SEGMENTS OF AN ENTERPRISE

SFAS No. 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 No. 131 also establishes standards for related disclosures about products and services and geographic areas. Operating segments are identified as components of an enterprise for which separate discrete financial information is available for evaluation by the chief operating decision maker, or decision-making group, to assess performance and allocate resources. ATG's chief operating decision-makers, as defined under SFAS No. 131, are the members of its executive management team. To date, the Company has viewed its operations and manages its business as principally one segment with two major offerings: software licenses and services. ATG evaluates these product offerings based on their respective gross margins. As a result, the financial information disclosed herein represents all of the material financial information related to the Company's principal operating segment.

Revenues from sources outside of the United States were approximately \$6.5 million and \$4.8 million for the three months ended March 31, 2004 and 2003, respectively. ATG's revenues from international sources were primarily generated from customers located in Europe and Asia/Pacific. All of ATG's software licenses for the three months ended March 31, 2004 and 2003 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, 2004 and 2003:

	<b>Three Months Ended March 31,</b>	
	<b>2004</b>	<b>2003</b>
United States	61%	75%
United Kingdom (UK)	16	17
Europe, Middle East and Africa (excluding UK)	16	4
Other	7	4
	<u>100%</u>	<u>100%</u>





**Table of Contents****(8) LONG-TERM OBLIGATIONS***Credit Facility*

Effective 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. The line of credit bore interest at the Bank's prime rate. Effective December 24, 2002 the revolving line of credit increased to \$20 million. 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.

Effective November 25, 2003, ATG modified its existing working capital facility with the Bank. The line of credit is secured by all of ATG's tangible and intangible intellectual and personal property and is subject to financial covenants including liquidity coverage and profitability. The liquidity covenant mandates ATG maintain \$25.0 million in cash at the end of each month throughout the duration of the facility. The profitability covenant allows for net losses not to exceed: \$3.0 million for the first quarter of 2004, and \$2.0 million for the second and third quarters of 2004 and \$1.0 million for the fourth quarter of 2004. ATG is required to maintain \$25 million in unrestricted cash at the Bank. In the event ATG's cash balances at the Bank fall below \$25 million, ATG will be required to pay fees and expenses to compensate the Bank for lost income. At March 31, 2004, 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; (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 Letters of Credit (LC's) at that time to be cash secured on terms acceptable to the Bank. The revolving line of credit expires on November 25, 2004.

While there were no outstanding borrowings under the facility at March 31, 2004, ATG has issued LC's totaling \$11.2 million, which are supported by this facility. The LC's have been issued in favor of various landlords and equipment vendors to secure lease obligations pursuant to leases expiring from August 2004 through August 2009. The line of credit bears interest at the Bank's prime rate (4.00% at March 31, 2004). As of March 31, 2004, approximately \$8.8 million was available under the facility.

**(9) COMMITMENTS AND CONTINGENCIES***Leases*

ATG has offices, primarily for sales and support personnel, in 8 domestic locations as well as four foreign countries. At March 31, 2004, ATG has issued \$11.2 million of LC's under its line of credit in favor of various landlords and equipment vendors to secure lease obligations, which expire from 2004 through 2009.

The approximate future minimum payments of ATG's facility leases and certain operating equipment leases as of March 31, 2004, are as follows (in thousands):

	<b>Operating Leases</b>
Remainder of 2004	\$ 4,977
2005	6,563

2006	5,106
2007	2,299
2008	1,846
Thereafter	461
	<hr/>
Total future minimum lease payments	\$21,252
	<hr/>

Of the \$21.3 million in future minimum lease payments, \$13.6 million was included in the Company's restructuring charges. The \$13.6 million has been reduced to a \$11.3 million restructuring accrual after taking into consideration estimated sublease income, contracted sublease income, vacancy periods and operating costs of the various subleased properties (Note 10).

Rent expense included in the accompanying statements of operations was approximately \$1.2 million and \$1.5 million for the three months ended March 31, 2004 and 2003, 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 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, 2004.

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.

**Table of Contents****(10) RESTRUCTURING**

During the years ended 2003, 2002 and 2001, the Company recorded net restructuring charges/ (benefits) of (\$10.5) million, \$19.0 million and \$75.6 million, respectively, as a result of the global slowdown in information technology spending. The charges primarily pertain to the closure and consolidation of excess facilities, impairment of assets, employee severance benefits, and the settlement of certain contractual obligations. The 2003 charges were recorded in accordance with FAS 146, Accounting for Costs Associated with Exit or Disposal Activities, FAS 88, Employers Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits (FAS 88) 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) , FAS 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 Restructuring Balance as of December 31, 2003</b>	<b>Payments</b>	<b>Accrued Restructuring Balance as of March 31, 2004</b>
	<u>          </u>	<u>          </u>	<u>          </u>
Facilities-related costs and impairments	\$ 10,208	\$(891)	\$ 9,317
Employee severance, benefits and related costs	229	—	229
	<u>          </u>	<u>          </u>	<u>          </u>
Total	\$ 10,437	\$(891)	\$ 9,546
	<u>          </u>	<u>          </u>	<u>          </u>

***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.

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.

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.

#### ***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 of these employees 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.

#### ***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 accompanying 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.

**Table of Contents*****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.

**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 \$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 Restructuring Balance as of December 31, 2003</b>	<b>Payments</b>	<b>Accrued Restructuring Balance as of March 31, 2004</b>
Facilities-related costs and impairments	\$ 5,887	\$(4,188)	\$ 1,699
Total	\$ 5,887	\$(4,188)	\$ 1,699

***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 \$1,158,000. 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.

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.

As a result of this action and the actions taken in 2001, the Company wrote-off certain computer equipment and software, aggregating \$1,158,000, and furniture and fixtures, aggregating \$507,000, which were 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.

#### ***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, none of whom remained employed at December 31, 2003. 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, primarily as a result of amounts being settled at less than the amount recorded due to 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>Balance at December 31, 2003</b>	<b>Payments</b>	<b>Balance at March 31, 2004</b>
	<u>          </u>	<u>          </u>	<u>          </u>
Facilities-related costs and impairments	\$ 1,614	\$(368)	\$1,246
Employee severance, benefits and related costs	61	(32)	29
	<u>          </u>	<u>          </u>	<u>          </u>
Total	\$ 1,675	\$(400)	\$1,275
	<u>          </u>	<u>          </u>	<u>          </u>

**Second Quarter 2003 Action**

During the quarter ended June 30, 2003, the Company recorded a initial 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, 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 FAS 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 were 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 is a minor component of our 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 has discontinued marketing of this software and has 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 Action**

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

### ***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 FAS 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.

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***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.

As of March 31, 2004 the Company had an accrued restructuring liability of \$12.5 million, of which \$9.5 million related to 2001 restructuring charges, \$1.7 million relates to 2002 restructuring charges, and \$1.3 million related to 2003 restructuring charges. The long-term portion of the accrued restructuring liability was \$7.9 million.

**(11) 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 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, we 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. While management believes the remaining claim against the Company is without merit, and intends to defend the action vigorously, the litigation is still in the preliminary stage.

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.

**(12) FOREIGN CURRENCY TRANSLATION**

The financial statements of the Company's foreign subsidiaries are translated in accordance with FAS 52, *Foreign Currency Translation* (FAS 52). The Company has determined that the functional currency of its foreign subsidiaries is the local currency. As a result, the Company translates the assets and liabilities of its foreign subsidiaries at the exchange rates in effect at quarter-end. Prior to translation, the Company re-measures foreign currency denominated assets and liabilities into the functional currency of the respective Company entity, resulting in unrealized gains or losses recorded in Interest and Other Income, Net in the accompanying Condensed Consolidated Statements of Operations. Revenues and expenses are translated using average exchange rates in effect during the year. Gains and losses from foreign currency translation are credited or charged to Accumulated Other Comprehensive Loss included in Stockholders' Equity in the accompanying Condensed Consolidated Balance Sheets. During the three months ended March 31, 2004 and 2003, the Company recorded gains (losses) of (\$123,000), and \$157,000, respectively, from transactional gains and losses and re-measurement gains and losses.

### **(13) HEDGING ACTIVITIES**

A portion of the Company's revenues, earnings and cash flows are exposed to changes in foreign exchange rates. On September 18, 2002, the Company's Board of Directors formally approved a foreign currency-hedging program to mitigate the risk of foreign currency fluctuations on earnings and cash flows. Under this program, the Company may at times seek to manage its foreign exchange risk through the use of foreign currency forward-exchange contracts. ATG may use these contracts to offset the potential foreign currency impact to earnings and cash flows from short-term foreign currency assets and liabilities that arise from operations. FAS 133, *Accounting for Derivative Instruments and Hedging Activities*, requires that all derivative contracts and hedging activities be recorded at fair value in the financial statements. Such contracts are marked to market in each reporting period with the resulting change in fair value recognized immediately in Other Income in the Consolidated Statements of Operations as unrealized gains and losses up through their maturity, at which time the gains or losses become realized. These gains and losses offset the changes in fair value of the asset or liability being hedged. As of March 31, 2004 and 2003, there were no foreign currency-hedging contracts or other option or derivative contracts outstanding.

### **(14) RECENT ACCOUNTING PRONOUNCEMENTS**

In April 2003, the FASB released FAS 149, Amendment of Statement 133 on Derivative Instruments and Hedging Activities, which clarifies the accounting for derivatives, amending the previously issued FAS 133, *Accounting for Derivative Instruments and Hedging Activities*. FAS 149 clarifies under what circumstances a contract with an initial net investment meets the characteristics of a derivative, amends the definition of an underlying contract, and clarifies when a derivative contains a financing component in order to increase the comparability of accounting practices under FAS 133. FAS 149 is effective for contracts entered into or modified after September 30, 2003. The adoption of FAS 149 did not have a material impact on the Company's financial position or results of operations.

In May 2003 the FASB issued FAS 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity* (FAS 150). FAS 150 establishes standards for how an issuer classifies and measures certain financial instruments with characteristics of both liabilities and equity. FAS 150 applies specifically to a number of financial instruments that companies have historically presented within their financial statements either as equity or between the liabilities section and the equity section, rather than as liabilities. FAS 150 is effective for financial instruments entered into or modified after May 31, 2003, and otherwise is effective at the beginning of the first interim period beginning after June 15, 2003. The adoption of FAS 150 did not have a material impact on the Company's financial position or results of operations.

### **(15) FINANCIAL STATEMENT RECLASSIFICATIONS**

For the period ended March 31, 2003, the Company reclassified stock-based compensation, which previously had been reported as a separate line item in the Consolidated Statement of Operations, to cost of revenues, research and development, sales and marketing and general and administrative expenses.

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**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 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. We market and sell our products worldwide through our direct sales force, systems integrators, technology alliances, value added resellers and original equipment manufacturers.

We derive our revenues from the sale of software product licenses and related services. Product license revenues are derived from the sale of software licenses of our products. 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 and software maintenance and support. 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 and on-line and telephone technical support for an annual maintenance fee, which is calculated as a certain percentage of the list price of the licensed product, or on a net purchase price for site licenses. Training is billed as services are provided.

As of March 31, 2004 we had offices in France, Germany, Italy, the United Kingdom and the United States. Revenues from customers outside the United States accounted for 39% and 25% of our total revenues for the three months ended March 31, 2004 and 2003, 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.

*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 SOP 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) collectibility 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 agreements are recognized ratably over the term of the maintenance period, which is typically one year. 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 by 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 and service agreements.

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.

**Table of Contents***Research and Development Costs*

We account for research and development costs in accordance with Statement of Financial Accounting Standards No. 2, *Accounting for Research and Development Costs* (FAS 2), and FAS 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 2003, 2002 and 2001, we recorded net restructuring (benefits)/ charges of (\$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 FAS 146, *Accounting for Costs Associated with Exit or Disposal Activities*, FAS 88, *Employers Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits and Staff Accounting Bulletin*, and Staff Accounting Bulletin 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)*, FAS 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, 2004, there are various accruals recorded for the costs to exit certain facilities and lease obligations, which may be adjusted periodically for either resolution of certain contractual commitments or changes in estimates of 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 2003 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, 2004 was estimated sublease income of \$0.8 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 changes to our restructuring obligations in our financial statements for such quarter based on management's then-current estimates.



Assumed rental rates vary from \$15.00 per square foot to \$30.00 per square foot depending upon local market rates. Remaining vacancy periods as of March 31, 2004 vary from 15 months to 30 months depending upon rentable square feet in the local market and recent vacancy histories. Rental assumptions or sublease start dates may vary considerably from the above assumptions, which could cause us to take an additional charge. If the estimated sublease dates were to be extended by six months, based on our current estimates, we would potentially have to recognize an additional \$138,000 in our statement of operations for restructuring and other related charges. In addition, we have a history of settling lease obligations favorably as compared with the amounts we have accrued, which could result in a benefit.

The assumed net cash requirements and assumed sublease income on lease obligations included in accrued restructuring at March 31, 2004 is as follows (in millions):

	<u>2004</u>	<u>2005</u>	<u>2006</u>	<u>2007</u>	<u>2008</u>	<u>2009</u>
Assumed net cash requirements	\$3.0	\$4.5	\$2.6	\$0.9	\$0.8	\$0.2
Assumed sublease income	\$0.0	\$0.0	\$0.2	\$0.3	\$0.2	\$0.1

#### *Impairment or Disposal of Long Lived Assets*

We review our long-lived assets 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 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 exceed 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.

As a result of our restructuring activities in 2003 and 2002, we evaluated the realizability of our long-lived assets including fixed assets and leasehold improvements related to our restructured facility leases. In 2003 and 2002, we determined that \$479,000 and \$2.6 million, respectively, of leasehold improvements, furniture and fixtures, computer equipment and software were impaired as a result of our decision to abandon the assets due to the termination of employees and related office closures. These assets are no longer being used or will not be used in the future upon completion of the restructuring activities.

#### *Accounting for Income Taxes*

We account for income taxes in accordance with FAS 109, *Accounting for Income Taxes* (FAS 109) 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. FAS 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

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quarterly the realizability of our deferred tax assets and adjust the amount of such allowance, if necessary. At March 31, 2004 and December 31, 2003, we have provided a full valuation allowance against our net deferred tax assets due to the uncertainty of their realizability.

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. In the fourth quarter of 2003 we reversed previously accrued taxes of \$332,000 for foreign locations due to a change in our estimates of potential amounts due in those locations. In the first quarter of 2004 we reversed previously accrued taxes of \$105,000 also due to changes in estimates of potential amounts due.

**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 March 31,</b>	
	<b>2004</b>	<b>2003</b>
Revenues:		
Product license	38%	39%
Services	62%	61%
	<hr/>	<hr/>
Total revenues	100%	100%
Cost of revenues:		
Product license	2%	2%
Services	29%	30%
	<hr/>	<hr/>
Total cost of revenues	31%	32%
	<hr/>	<hr/>
Gross margin	69%	68%
	<hr/>	<hr/>
Operating expenses:		
Research and development	25%	25%
Sales and marketing	44%	45%
General and administrative	11%	14%

	—	—
Total operating expenses	80%	84%
	—	—
Income (loss) from operations	(11%)	(16%)
Interest and other income (expense), net		2%
	—	—
Income (loss) before provision for income taxes	(11%)	(14%)
Provision for income taxes		
	—	—
Net income (loss)	(11%)	(14%)
	—	—

The following table sets forth, for the periods indicated, the cost of product license revenues as a percentage of product license revenues and the cost of services revenues as a percentage of services revenues and the related gross margins:

	<b>Three Months Ended March 31,</b>	
	<b>2004</b>	<b>2003</b>
	—	—
Cost of product license revenues	6%	6%
Gross Margin on product license revenues	94%	94%
Cost of services revenues	46%	48%
Gross Margin on services revenues	54%	52%

### **Three Months ended March 31, 2004 and 2003**

#### *Revenues*

Total revenues decreased 13% to \$16.8 million for the three months ended March 31, 2004 from \$19.4 million for the three months ended March 31, 2003. The decrease was primarily attributable to a shift in our business focus from infrastructure products to application products, particularly in the e-commerce and self-service area. As a result we experienced a decrease in product license revenues and services revenues relating to our infrastructure products business. Our focus in the first quarter of 2004 was and going forward is expected to be principally on e-commerce and self-service applications. Revenues generated from international customers increased to \$6.5 million, or 39% of total revenues, for the three months ended March 31, 2004, from \$4.8 million, or 25% of total revenues, for the three months ended March 31, 2003. We expect total revenues to be flat to slightly higher in 2004 as compared to 2003 and the international revenues as a percentage of total revenues to be approximately 30% to 35% of total revenues for the remainder of 2004.

One customer accounted for more than 10% of total revenues for the three months ended March 31, 2004. No customers accounted for more than 10% of total revenues for the three months ended March 31, 2003.

*Product License Revenues*

Product license revenues decreased 15% to \$6.4 million for the three months ended March 31, 2004 from \$7.5 million for the three months ended March 31, 2003. The decrease was primarily attributable to a shift in our business focus from infrastructure products to application products particularly in the e-commerce and

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self-service area. As a result we experienced a decrease in our product license revenues from our infrastructure products. Our focus in the first quarter of 2004 was and going forward is expected to be principally on e-commerce and self-service applications. Product license revenues generated from international customers increased to \$3.4 million for the three months ended March 31, 2004 from \$1.2 million for the three months ended March 31, 2003 due primarily to one large product deal that represented over 10% of revenues for the quarter.

Product license revenues as a percentage of total revenues for the three months ended March 31, 2004 and 2003 were 38% and 39%, respectively. We expect product license revenues to be flat to slightly higher in 2004 as compared to 2003 and to remain about the same as a percentage of total revenues.

Our resellers generally receive a discount from our list prices. The extent of any discount is based on negotiated contractual agreements between us and the reseller. We do not grant our resellers the right of return, price protection or favorable terms. We rely upon resellers to market and sell our products to governmental entities and to customers in geographic regions where it is not cost effective for us to reach out to end users directly. We have approximately 50 active resellers. No single reseller generates a significant amount of our total revenues.

The table below sets forth, for the periods indicated, product revenues recognized from reseller arrangements (in thousands):

	<b>Three Months Ended March 31,</b>	
	<b>2004</b>	<b>2003</b>
Reseller revenues	\$ 896	\$ 696
% of product revenues	14%	9%

*Services Revenues*

Services revenues decreased 12% to \$10.4 million for the three months ended March 31, 2004 from \$11.9 million for the three months ended March 31, 2003. The decrease was primarily attributable to decreased services volume associated with decreased product license revenues as well as a reduction in our services capacity due to reduced headcount in professional services. We expect services revenues to be flat to slightly higher in 2004 as compared to 2003 and to remain about the same as a percentage of total revenues.

Support and maintenance revenues were 68% of total service revenues for the three months ended March 31, 2004 as compared to 64% for the three months ended March 31, 2003. Support and maintenance revenues, on a dollar value basis, were lower for the three months ended March 31, 2004 due to a decrease in product revenues and the fact that some customers have elected to decrease or terminate their support coverage.

*Cost of Product License Revenues*

Cost of product license revenues decreased 18% to \$399,000 for the three months ended March 31, 2004 from \$485,000 for the three months ended March 31, 2003. This decrease is primarily related to lower product revenues during the first quarter of 2004 and lower royalties paid on third party software embedded into one of our products.

For the three months ended March 31, 2004 and 2003, cost of product license revenues as a percentage of total revenues was 2%. We anticipate the cost of product license revenues, as a percentage of total revenues, to be about the same for the remainder of 2004.

#### *Gross Margin on Product License Revenues*

For the three months ended March 31, 2004 and 2003, gross margin on product license revenues were 94%, or \$6.0 million, and 94%, or \$7.0 million, respectively. We expect this percentage to remain about the same for the remainder of 2004.

#### *Cost of Services Revenues*

Cost of services revenues includes salary and other related costs for our professional services and technical support staff, as well as third-party contractor expenses. Cost of services revenues will vary significantly from period to period depending on the level of professional services staffing, the effective utilization rates of our professional services staff, the mix of services performed, including product license technical support services, the extent to which these services are performed by us or by third-party contractors, and the level of third-party contractors' fees.

Cost of services revenues decreased 17% to \$4.8 million for the three months ended March 31, 2004 from \$5.7 million for the three months ended March 31, 2003. The decrease was primarily attributable to a reduction in our professional services workforce. Approximately 28% of the decrease is the result of reduced compensation costs due to a reduction in our work force. Approximately 11% of the decrease results from a reduction in travel and entertainment costs also related to the reduction in our workforce. The remaining 61% of the decrease was due to a decrease in rent expense, operating costs and lower infrastructure expenses as a result of our restructuring efforts.

For the three months ended March 31, 2004 and 2003, cost of services revenues as a percentage of total revenues were 29% and 30%, respectively. We anticipate the cost of services revenues, as a percentage of total revenues, to be in the 25% to 28% range for the remainder of 2004.

#### *Gross Margin on Services Revenues*

For the three months ended March 31, 2004 and 2003, gross margin on services revenues were 54%, or \$5.7 million, and 52%, or \$6.2 million, respectively. The increase in gross margin percentage is attributed primarily to the increase in support and maintenance revenue as a percentage of total services revenue, increased utilization rates and a decrease in our professional services workforce and operating expenses.

#### *Research and Development Expenses*

Research and development expenses consist primarily of salary and related costs to support product development. To date, all software development costs have been expensed as research and development in the period incurred.

Research and development expenses decreased 15% to \$4.1 million for the three months ended March 31, 2004 from \$4.9 million for the three months ended March 31, 2003. The decrease was primarily attributable to a reduction in our workforce. Approximately 67% of the decrease is related to decreased salaries and related benefits. The remaining 33% of the decrease was due to a decrease in operating expenses as a result of our restructuring efforts.

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For the three months ended March 31, 2004 and 2003, research and development expenses as a percentage of total revenues were 25%, respectively. Based on cost reduction initiatives, we anticipate that research and development expenses as a percentage of total revenues will be about 22% to 24% for the remainder of 2004.

### *Sales and Marketing Expenses*

Sales and marketing expenses consist primarily of salaries, commissions and other related costs for sales and marketing personnel, travel, public relations and marketing materials and events.

Sales and marketing expenses decreased 16% to \$7.3 million for the three months ended March 31, 2004 from \$8.8 million for the three months ended March 31, 2003. The decrease is primarily attributable to cost saving initiatives that resulted from a reduction in the workforce of our sales and marketing group, a reduction in our spending on marketing programs and a reduction in commissions from decreased product revenues. Approximately 73% of the decrease was related to a decrease in compensation, commissions and benefits costs, and 10% of the decrease was related to a reduction in our marketing and promotional expenses. The remaining 17% was due to a decrease in operating expenses resulting from our restructuring efforts.

For three months ended March 31, 2004 and 2003, sales and marketing expenses as a percentage of total revenues were 44% and 45%, respectively. We expect that the level of sales and marketing expenses for the remainder of 2004 will, as compared to the first quarter, increase slightly in absolute dollars and remain relatively flat as a percentage of total revenues. However, sales and marketing expenses can fluctuate as a percentage of total revenues depending on economic conditions, level and timing of global expansion, program spending, the rate at which new sales personnel become productive and the level of revenue.

### *General and Administrative Expenses*

General and administrative expenses consist primarily of salaries and other related costs for operations and finance employees and legal and accounting fees.

General and administrative expenses decreased 27% to \$1.9 million for the three months ended March 31, 2004 from \$2.7 million for the three months ended March 31, 2003. Approximately 41% of the decrease was related to a decrease in rent expense and facilities related charges, with the remainder related to a decrease in insurance expense as well as other operating expenses resulting from our restructuring efforts and cost containment initiatives.

For the three months ended March 31, 2004 and 2003, general and administrative expenses as a percentage of total revenues were 11% and 14%, respectively. Due to cost reduction initiatives we anticipate that the level of general and administrative expenses will, as compared to the first quarter, trend lower as a percentage of total revenues and in absolute dollars for the remainder of 2004.

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

Interest and Other Income (Expense), Net decreased to (\$47,000) for the three months ended March 31, 2004 from \$361,000 for the three months ended March 31, 2003. The decrease was primarily due to a decrease in foreign currency related gains (losses) of \$280,000. Interest income was also lower during the three months ended March 31, 2004 compared to the three months ended March 31, 2003 due to a lower average balance of cash and cash equivalents and marketable securities.

### *Provision for Income Taxes*

As a result of net operating losses incurred, and after evaluating our anticipated performance over our normal planning horizon, we have provided a full valuation allowance for our net operating loss carryforwards and other net deferred tax assets. Due to the uncertainty surrounding the utilization of our net deferred tax assets, net operating losses and research credits carryforwards, we have recorded a 100% valuation allowance. In the first quarter of 2004 we reversed previously accrued taxes of \$105,000 due to a one-time event while accruing an additional \$70,000 for current period foreign taxes.

### **Liquidity and Capital Resources**

Our capital requirements relate primarily to facilities, employee infrastructure and working capital requirements. Historically, we have funded our cash requirements primarily through the public and private sales of equity securities, and commercial credit facilities. At April 30, 2004, we had \$18.0 million in cash and cash equivalents and \$12.2 million in marketable securities.

Cash used in operating activities was \$7.3 million for the three months ended March 31, 2004. This consisted of operating losses of \$1.8 million, depreciation and amortization of \$581,000, a decrease in accounts receivable of \$259,000, offset by a decrease in accrued restructuring of \$5.5 million. Other changes in working capital items consisted primarily of \$1.4 million in cash used for accrued expenses, an increase in prepaid expenses of \$742,000, an increase in accounts payable of \$993,000 and an increase in deferred revenues of \$183,000. Cash used in operating activities was \$2.1 million for the three months ended March 31, 2003. This consisted of operating losses of \$2.8 million, depreciation and amortization of \$1.3 million, a decrease in accounts receivable of \$7.4 million, offset by a decrease in accrued restructuring of \$4.7 million. Other changes in working capital items consisted primarily of \$3.6 million in cash used for accrued expenses and an increase in deferred revenues of \$498,000.

Our investing activities for the three months ended March 31, 2004 used \$2.9 million and consisted primarily of capital expenditures of \$258,000, net purchases of marketable securities of \$2.6 million, and a decrease in other assets of \$24,000. We expect that capital expenditures will total approximately \$1.5 million for the year ended December 31, 2004. Our investing activities for the three months ended March 31, 2003 provided \$5.3 million and consisted primarily of capital expenditures of \$46,000, net maturity of marketable securities of \$5.1 million and a decrease in other assets of \$160,000.

Net cash provided by financing activities was \$464,000 for the three months ended March 31, 2004, representing proceeds from the employee stock purchase plan and the exercise of stock options. Net cash provided by financing activities was \$296,000 for the three months ended March 31, 2003 representing proceeds from the employee stock purchase plan.



**Table of Contents***Accounts Receivable and Days Sales Outstanding*

Our accounts receivable balance and days sales outstanding, or DSO, as of March 31, 2004 and December 31, 2003 were as follows:

	<b>March 31, 2004</b>	<b>December 31, 2003</b>
	<b>(dollars in thousands)</b>	
DSO	81	88
Accounts Receivable	\$ 15,105	\$ 15,364

We note that as of March 31, 2004 the DSO had decreased from the DSO at December 31, 2003 due to collections on support and maintenance renewals as well as collections during the quarter on certain product license deals that closed early in the quarter.

Effective June 13, 2002, we entered into a \$15 million revolving line of credit with Silicon Valley Bank, or the Bank, which provided for borrowings of up to the lesser of \$15 million or 80% of eligible accounts receivable. The line of credit bore interest at the Bank's prime rate. Effective December 24, 2002 the revolving line of credit increased to \$20 million. The line of credit is secured by all of our tangible and intangible intellectual and personal property and is subject to financial covenants including liquidity coverage and profitability.

Effective November 25, 2003, we modified our existing working capital facility with the Bank. Our line of credit is secured by all of our tangible and intangible intellectual and personal property and is subject to financial covenants including liquidity coverage and profitability. The liquidity covenant mandates we maintain \$25.0 million in cash at the end of each month throughout the duration of the facility. The profitability covenant allows for net losses not to exceed: \$3.0 million for the first quarter of 2004, and \$2.0 million for the second and third quarters of 2004 and \$1.0 million for the fourth quarter of 2004. We are required to maintain \$25 million in unrestricted cash at the Bank. In the event our cash balances at the Bank fall below \$25 million, we will be required to pay fees and expenses to compensate the Bank for lost income. At March 31, 2004, we were in compliance with all related financial covenants. In the event that we do 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:

Declaring all obligations immediately due and payable;

Ceasing to advance money or extend credit for our benefit;

Applying to the obligations any balances and deposits held by us or any amount held by the Bank owing to or for the credit of our account;

Putting a hold on any deposit account held as collateral.

If the agreement expires, or is not extended, the Bank will require outstanding Letters of Credit (LC's) at that time to be cash secured on terms acceptable to the Bank. The revolving line of credit expires on November 25, 2004.

While there were no outstanding borrowings under the facility at March 31, 2004, we have issued LC's totaling \$11.2 million, which are supported by this facility. The LC's have been issued in favor of various landlords and equipment vendors to secure obligations pursuant to leases expiring from August 2004 through August 2009. The line of credit bears interest at the Bank's prime rate (4.00% at March 31, 2004). As of March 31, 2004, approximately \$8.8

million was available under the facility.

We believe that our existing financial resources, together with cash generated by our operations, will be able to meet our cash requirements for at least the next twelve months. However, our actual cash requirements will depend on many factors, including particularly, overall economic conditions both domestically and abroad. We may seek additional external funds through public or private securities offerings, strategic alliances or other financing sources. There can be no assurance that if we seek external funding, it will be available on favorable terms, if at all.

### *Contractual Obligations*

On March 31, 2004, our contractual cash obligations, which consist solely of operating leases, were as follows (in thousands):

<b>Contractual Obligations</b>	<b>Payments Due by Period</b>				
	<b>Total</b>	<b>Remainder of 2004</b>	<b>1-3 years</b>	<b>4-5 years</b>	<b>After 5 years</b>
Lease Commitments	\$21,252	\$ 4,977	\$11,669	\$4,145	\$461

### **Recent Accounting Pronouncements**

In January 2003, the FASB issued FASB Interpretation No. 46 ( FIN 46 ), *Consolidation of Variable Interest Entities, an Interpretation of ARB No. 51*. FIN 46 requires certain variable interest entities to be consolidated by the primary beneficiary of the entity if the equity investors in the entity do not have the characteristics of a controlling financial interest or do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support from other parties. In December 2003, the FASB issued FIN 46R, a revision to FIN 46. FIN 46R provides a broad deferral of the latest date by which all public entities must apply FIN 46 to certain variable interest entities to the first reporting period ending after March 15, 2004. The adoption of FIN 46 or FIN 46R did not have a material impact upon our financial position, cash flows or results of operations.

In April 2003, the FASB released FAS 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities*, or FAS 149, clarifies the accounting for derivatives, amending the previously issued FAS 133, *Accounting for Derivative Instruments and Hedging Activities*, or FAS 133. FAS 149 clarifies under what circumstances a contract with an initial net investment meets the characteristics of a derivative, amends the definition of an underlying contract, and clarifies when a derivative contains a financing component in order to increase the comparability of accounting practices under FAS 133. FAS 149 is effective for contracts entered into or modified after September 30, 2003. The adoption of FAS 149 did not have a material impact on our financial position or results of operations.

In May 2003 the FASB issued FAS 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*, or FAS 150. FAS 150 establishes standards for how an issuer classifies and measures certain financial instruments with characteristics of both liabilities and equity. FAS 150 applies specifically to a number of financial instruments that companies have historically presented within their financial statements either as equity or between the liabilities section and the equity section, rather than as liabilities. FAS 150 is effective for financial instruments entered into or modified after May 31, 2003, and otherwise is effective at the beginning of the first interim period beginning after June 15, 2003. The adoption of FAS 150 did not have a material impact on our financial position or results of operations.



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**RISK FACTORS THAT MAY AFFECT RESULTS**

This quarterly report contains forward-looking statements, including statements about our growth and future operating results. For this purpose, any statement that is not a statement of historical fact should be considered a forward-looking statement. We often use the words believes, anticipates, plans, expects, intends and similar expressions to help identify forward-looking statements.

There are a number of important factors that could cause our actual results to differ materially from those indicated or implied by forward-looking statements. Factors that could cause or contribute to such differences include those discussed below, as well as those discussed elsewhere in this quarterly report.

**Risks Related To Our Business**

**Risks Related To Our Business**

*We may not be able to sustain or increase our revenue or attain profitability on a quarterly or annual basis, which could lead to a material decrease in the price of our common stock.*

We incurred losses in the first quarter of 2004, in the first and third quarters of 2003 and in each quarter of 2002. As of March 31, 2004, we had an accumulated deficit of \$197.5 million. Our revenues decreased 13% to \$16.8 million for the three months ended March 31, 2004 compared with \$19.4 million for the three months ended March 31, 2003. We believe the recent economic downturn within the software industry could continue to have an adverse effect on demand for our products and services, and therefore adversely affect our revenues as well. Because we operate in a rapidly evolving industry, we have difficulty predicting our future operating results and we cannot be certain that our revenues will grow or our expenses will decrease at rates that will allow us to achieve profitability on a quarterly or annual basis. Additionally, in recent years the slowdown in the software industry and the decrease in spending by companies in our target markets have reduced the rate of growth of the Internet as a channel for consumer branded retail and financial services companies. If current economic conditions continue for an extended period of time or worsen, we may experience additional adverse effects on our revenue, net income and cash flows, which could result in a decline in the price of our common stock.

*We expect our revenues and operating results to continue to fluctuate for the foreseeable future, and the price of our common stock is likely to fall if quarterly results are lower than the expectations of securities analysts.*

Our revenues and operating results have varied from quarter to quarter in the past, and are likely to vary significantly from quarter to quarter in the foreseeable future. If our quarterly results fall below our expectations and those of securities analysts, the price of our common stock is likely to fall. A number of factors are likely to cause variations in our operating results, including:

fluctuating economic conditions, particularly as they affect our customers' willingness to implement new e-commerce solutions;

the timing of sales of our products and services;

the timing of customer orders and product implementations;

delays in introducing new products and services;

increased expenses, whether related to sales and marketing, product development or administration;

the mix of revenues derived from products and services;

timing of hiring and utilization of services personnel;

cost overruns related to fixed-price services projects;

the mix of domestic and international sales; and

costs related to possible acquisitions of technologies or businesses.

Accordingly, we believe that quarter-to-quarter comparisons of our operating results are not necessarily meaningful. The results of one quarter or a series of quarters should not be relied upon as an indication of our future performance.

***Turnover in our management, sales and engineering personnel may impair our ability to develop and implement a business strategy, which could have a material adverse effect on our operating results and common stock price.***

Members of our senior management team, including our two founders, our former Chief Executive Officer and President, and several senior managers, have left us during the past three years for a variety of reasons, and we cannot assure you that there will not be additional departures. As a result of this management turnover, our current management team has had limited experience working together and may be unsuccessful in developing or executing a business strategy for us. These changes in management, and any future similar changes, may be disruptive to our operations. In addition, equity incentives such as stock options constitute an important part of our total compensation program for management, and the volatility or lack of positive performance of our stock price may from time to time adversely affect our ability to retain our management team.

We rely heavily on our direct sales force. We have recently restructured and reduced the size of our sales force. Changes in the structure of the sales force have generally resulted in temporary lack of focus and reduced productivity.

In addition, we recently restructured our research and development group, which could result in interruptions in product development and reduced productivity.

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***Our lengthy sales cycle makes it difficult to predict our quarterly results and causes variability in our operating results.***

Our long sales cycle, which can range from several weeks to several months or more, makes it difficult to predict the quarter in which sales may occur. We have a long sales cycle because we generally need to educate potential customers regarding the use and benefits of our products and services. Our sales cycle varies depending on the size and type of customer contemplating a purchase and whether we have conducted business with a potential customer in the past. In addition, we believe the recent economic downturn in the United States has contributed to an increase in the average length of our sales cycle as customers deferred implementing new e-commerce solutions.

We may incur significant sales and marketing expenses in anticipation of licensing our products, and if we do not achieve the level of revenues we expected, our operating results will suffer and our stock price may decline. These potential customers frequently need to obtain approvals from multiple decision makers prior to making purchase decisions. Delays in sales could cause significant variability in our revenues and operating results for any particular period.

Competition could materially and adversely affect our ability to obtain revenues from license fees from new or existing customers and professional services revenues from existing customers. While the list price for our software generally has been maintained over the past three years, in the first quarter of 2004, we reduced our list prices on purchases exceeding certain volumes. Additional volume based reductions in our list price could adversely affect our business, operating results and financial condition.

***We face intense competition in the market for Internet online marketing, sales and service applications, and we expect competition to intensify in the future. This competition could cause our revenues to fall short of expectations, which could adversely affect our future operating results and our ability to grow our business.***

The market for online marketing, sales and services applications is intensely competitive, and we expect competition to intensify in the future. This level of competition could reduce our revenues and result in increased losses or reduced profits. Our primary competition currently comes from in-house development efforts by potential customers or partners, as well as from other vendors of Web-based application software. We currently compete with Internet application software vendors such as BroadVision and commerce, marketing and self-service vendors such as Chordiant, E.piphany and Kana. We also compete with platform application server products and vendors such as BEA Systems, IBM, and Microsoft, among others. In addition, we compete indirectly with portal software vendors such as Vignette (through its acquisition of Epicentric), SAP Portals, a subsidiary of SAP, and Plumtree and customer relationship management vendors such as Siebel and PeopleSoft.

Many of our competitors have longer operating histories and significantly greater financial, technical, marketing and other resources than we do and may be able to respond more quickly to new or changing opportunities, technologies and customer requirements. Also, many current and potential competitors have greater name recognition and more extensive customer bases that they can use to gain market share. These competitors may be able to undertake more extensive promotional activities, adopt more aggressive pricing policies and offer more attractive terms to purchasers than we can. Moreover, our current and potential competitors, such as Microsoft, may bundle their products in a manner that may discourage users from purchasing our products. In addition, current and potential competitors have established or may establish cooperative relationships among themselves or with third parties to enhance their products and expand their markets. Accordingly, new competitors or alliances among competitors may emerge and rapidly acquire significant market share.

Competition could materially and adversely affect our ability to obtain revenues from license fees from new or existing customers and professional services revenue from existing customers. Further, competitive pressures could require us to reduce the price of our software products. In either case, our business, operating results and financial condition would be materially and adversely affected.

***If we fail to maintain our existing customer base, our ability to generate revenues will be harmed.***

Historically, we have derived a significant portion of our revenues from existing customers that purchase our support and maintenance services and enhanced versions of our products. Retention of our existing customer base requires that we provide high levels of customer service and product support to help our customers maximize the benefits that they derive from our products. To compete, we must introduce enhancements and new versions of our products that provide additional functionality. Further, we must manage the transition from our older products so as to minimize the disruption to our customers caused by such migration and integration with the customers' information technology platform. If we are unable to continue to obtain significant revenues from our existing customer base, our ability to grow our business would be harmed and our competitors could achieve greater market share.

***If systems integrators reduce their support and implementation of our products, our revenues may fail to meet expectations and our operating results would suffer.***

Since our potential customers often rely on third-party systems integrators to develop, deploy and manage Web sites for conducting commerce on the Internet, we cultivate relationships with systems integrators to encourage them to support our products. We do not, however, have written agreements with our systems integrators, and they are not required to implement solutions that include our products or to maintain minimum sales levels of our products. Our revenues would be reduced if we fail to train a sufficient number of systems integrators adequately or if systems integrators devote their efforts to integrating or co-selling products of other companies. Any such reduction in revenue would not be accompanied by a significant offset in our expenses. As a result, our operating results would suffer and the price of our common stock probably would fall.

***If value added resellers are unwilling to service and support our products, our revenues may fail to meet expectations and our operating results would suffer.***

We license products through value added resellers and encourage them to service and support our products. If we are unable to find qualified resellers, are unable to convince qualified resellers to license our products to end users, fail to adequately train a sufficient number of resellers or if resellers choose to devote their efforts to reselling our competitor's products, our revenues could be reduced and our operating results could be harmed.

***Competition with our resellers could limit our sales opportunities and jeopardize these relationships.***

We sell products through resellers and original equipment manufacturers. In some instances, we target our direct selling efforts toward markets that are also served by some of these resellers. This competition may limit our ability to sell our products and services directly in these markets and may jeopardize, or result in the termination of, these relationships.

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***We could incur substantial costs protecting our intellectual property from infringement or defending against a claim of infringement.***

Our professional services often involve the development of custom software applications for specific customers. In some cases, customers retain ownership or impose restrictions on our ability to use the technologies developed from these projects. Issues relating to the ownership of software can be complicated, and disputes could arise that affect our ability to resell or reuse applications we develop for customers.

We seek to protect the source code for our proprietary software both as a trade secret and as a copyrighted work. However, because we make the source code available to some customers, third parties may be more likely to misappropriate it. Our policy is to enter into confidentiality agreements with our employees, consultants, vendors and customers and to control access to our software, documentation and other proprietary information. Despite these precautions, it may be possible for someone to copy our software or other proprietary information without authorization or to develop similar software independently.

In recent years, there has been significant litigation in the United States involving patents and other intellectual property rights. We could incur substantial costs in prosecuting or defending any intellectual property litigation. If we sue to enforce our rights or are sued by a third party that claims that our technology infringes its rights, the litigation could be expensive and could divert our management resources.

Despite our efforts to protect our proprietary rights, unauthorized parties may attempt to copy aspects of our products or to obtain and use information that we regard as proprietary. Policing unauthorized use of our products is difficult and while we are unable to determine the extent to which piracy of our software exists, software piracy can be expected to be a persistent problem. Litigation may be necessary in the future to enforce our intellectual property rights, to protect our trade secrets, to determine the validity and scope of the proprietary rights of others or to defend against claims of infringement or invalidity. However, the laws of many countries do not protect proprietary rights to as great an extent as the laws of the United States. Any such resulting litigation could result in substantial costs and diversion of resources and could have a material adverse effect on our business, operating results and financial condition. There can be no assurance that our means of protecting our proprietary rights will be adequate or that our competitors will not independently develop similar technology. Any failure by us to meaningfully protect our intellectual property could have a material adverse effect on our business, operating results and financial condition.

In addition, we have agreed to indemnify customers against claims that our products infringe the intellectual property rights of third parties. The results of any intellectual property litigation to which we might become a party may force us to do one or more of the following:

- cease selling or using products or services that incorporate the challenged intellectual property;
- obtain a license, which may not be available on reasonable terms, to sell or use the relevant technology; or
- redesign those products or services to avoid infringement.

***If we fail to adapt to rapid changes in the market for Internet online marketing, sales, and service applications, our existing products could become obsolete.***

The market for our products is marked by rapid technological change, frequent new product introductions and Internet-related technology enhancements, uncertain product life cycles, changes in customer demands, coalescence of product differentiators, product commoditization and evolving industry standards. We may not be able to develop and market or acquire new products or product enhancements that comply with present or emerging Internet technology standards and to differentiate our products based on functionality and performance. In particular, there can be no assurance that our current or potential clients will adopt the e-commerce and self-service applications that we began



focusing on in 2003. In addition, we may not be able to establish strategic alliances with operating system and infrastructure vendors that will permit migration opportunities for our current user base. New products based on new technologies or new industry standards could render our existing products obsolete and unmarketable. For example, functionality that once differentiated our products over time has been incorporated into products offered by the major operating system and infrastructure providers.

To succeed, we will need to enhance our current products, develop new products on a timely basis to keep pace with developments related to Internet technology and to satisfy the increasingly sophisticated requirements of customers and leverage strategic alliances with third parties in the e-commerce field who have complementary or competing products. E-commerce technology is complex and new products and product enhancements can require long development and testing periods. Any delays in developing and releasing new or enhanced products could cause us to lose revenue opportunities and customers.

***If we fail to address the challenges associated with international operations, revenues from our products and services may decline or the costs of providing our products or services may increase.***

As of March 31, 2004 we had offices in the United Kingdom, France, Germany and Italy, and additionally had sales personnel in Spain. We derived 39% of our total revenues in quarter ended March 31, 2004 from customers outside the United States. In December 2002, we initiated a restructuring plan, which included the closing of our offices in Australia, Canada, and the Netherlands at varying times during the first quarter of 2003. Our operations outside North America are subject to additional risks, including:

changes in regulatory requirements, exchange rates, tariffs and other barriers;

longer payment cycles and problems in collecting accounts receivable in Western Europe and the Far East;

difficulties in managing systems integrators and technology partners;

difficulties in staffing and managing foreign subsidiary operations;

differing technology standards;

difficulties and delays in translating products and product documentation into foreign languages to the extent that our products are sold in countries that do not have English as their primary language;

reduced protection for intellectual property rights in some of the countries in which we operate or plan to operate;

potentially adverse tax consequences; and

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political and economic instability.

The impact of future exchange rate fluctuations on our operating results cannot be accurately predicted. We may increase the extent to which we denominate arrangements with international customers in the currencies of the countries in which the software or services are provided. From time to time we may engage in hedges of a significant portion of contracts denominated in foreign currencies. Any hedging policies implemented by us may not be successful, and the cost of these hedging techniques may have a significant negative impact on our operating results. Our software products may contain errors or defects that could result in lost revenues, delayed or limited market acceptance or product liability claims with substantial litigation costs.

Complex software products such as ours often contain errors or defects, particularly when first introduced or when new versions or enhancements are released. We began shipping the latest version of the ATG 6.3 suite of products in the first quarter of 2004. Despite internal testing and testing by customers, our current and future products may contain serious defects. Serious defects or errors could result in lost revenues or a delay in market acceptance.

Since our customers use our products for critical business applications such as e-commerce, errors, defects or other performance problems could result in damage to our customers. They could seek significant compensation from us for the losses they suffer. Although our license agreements typically contain provisions designed to limit our exposure to product liability claims, existing or future laws or unfavorable judicial decisions could negate these limitations. Even if not successful, a product liability claim brought against us would likely be time consuming and costly.

### ***Our software offerings under our recent agreement with IBM may not achieve market acceptance, which may harm our business and operating results.***

On June 27, 2003, we entered into an original equipment manufacturer, or OEM, agreement with IBM under which we agreed to offer IBM's WebSphere Internet infrastructure software as part of our packaged software offerings. Market acceptance of our relationship with IBM is important to our future success and is subject to a number of significant risks, many of which are outside our control. These risks include:

Our packaged software offerings must meet the requirements of our current and prospective clients. We are working with IBM to further integrate our applications to optimize their performance while running on IBM WebSphere, but we cannot assure you that our integration efforts will satisfy the needs of current and prospective customers.

IBM may determine not to devote significant resources to the arrangements contemplated by our OEM agreement or may disagree with us as to how to proceed with the integration of our products. The amount and timing of resources dedicated by IBM under the OEM agreement are not under our direct control.

Our arrangement with IBM may cause confusion among current and prospective customers as to our product focus and direction.

If our relationship with IBM does not achieve market acceptance, our business and operating results may be harmed.

### ***If we acquire other companies or businesses, we will be subject to risks that could hurt our business.***

In the future, we may pursue acquisitions to obtain complementary businesses, products, services or technologies. An acquisition may not produce the revenues, earnings or business synergies that we anticipated, and an acquired business, product, service or technology might not perform as we expected. If we pursue an acquisition, our management could spend a significant amount of time and effort in identifying and completing the acquisition. If we complete an acquisition, we may encounter significant difficulties and incur substantial expenses in integrating the operations and personnel of the acquired company into our operations while preserving the goodwill of the acquired

company. In particular, we may lose the services of key employees of the acquired company and we may make changes in management that impair the acquired company's relationships with employees and customers.

Any of these outcomes could prevent us from realizing the anticipated benefits of our acquisitions. To pay for an acquisition, we might use stock or cash. Alternatively, we might borrow money from a bank or other lender. If we use our stock, our stockholders would experience dilution of their ownership interests. If we use cash or debt financing, our financial liquidity would be reduced. We may be required to capitalize a significant amount of intangibles, including goodwill, which may lead to significant amortization charges. In addition, we may incur significant, one-time write-offs and amortization charges. These amortization charges and write-offs could decrease our future earnings or increase our future losses.

***Our announced restructurings may not result in the reduced cost structure we anticipate and may have other adverse impacts on productivity.***

During 2003, we had corporate restructurings involving workforce reductions and closures of excess facilities. In addition, there were changes in assumptions and estimates connected to prior restructuring charges and the leases that were settled during the period. These actions resulted in recording a net restructuring benefit of \$5.4 million. In January 2003, we publicly announced a corporate restructuring involving a workforce reduction and the closing and consolidation of office facilities in selected locations. These actions resulted in recording a restructuring charge of \$19.1 million in the fourth quarter of 2002. In addition, we recorded a restructuring charge of \$75.6 million in 2001. These restructuring activities require that we close facilities, maintain sales efforts and provide continuing customer support and service in regions where the sales and support staff has been reduced or eliminated, reallocate workload among continuing employees, and seek to reduce liability for idle lease space. The outcomes of such restructuring activities are difficult to predict. While we believe our restructuring and consolidation activities will reduce our cost structure, we may not achieve the cost reductions that we are expecting. In addition, our restructuring activities may result in lower revenues as a result of the decreased staff in our sales and marketing and professional services groups or other adverse impacts on productivity that we did not anticipate.

***We may need additional financing in the future, and any additional financing may result in restrictions on our operations or substantial dilution to our stockholders.***

We may need to raise additional funds in the future, for example, to develop new technologies, support an expansion, respond to competitive pressures, acquire complementary businesses or respond to unanticipated situations. We may try to raise additional funds through public or private financings, strategic relationships or other arrangements. Our ability to obtain debt or equity funding will depend on a number of factors, including market conditions, our operating performance and investor interest. Additional funding may not be available to us on acceptable terms or at all. If adequate funds are not available, we may be required to revise our business plan to reduce expenditures, including curtailing our growth strategies, foregoing acquisitions or reducing our product development efforts. If we succeed in raising additional funds through the issuance of equity or convertible securities, the issuance could result in substantial dilution to existing stockholders. If we raise additional funds through the issuance of debt securities or preferred stock, these new securities would have rights, preferences and privileges senior to those of the holders of our common stock. The terms of these securities, as well as any borrowings under our credit agreement, could impose restrictions on our operations.

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***We use the Java programming language to develop our products, and our business could be harmed if Java loses market acceptance or if we are not able to continue using Java or Java-related technologies.***

We write our software in the Java computer programming language developed by Sun Microsystems and we incorporate J2EE, Java Runtime Environment, Java Naming and Directory Interface, Java Servlet Development Kit, Java Foundation Classes, JavaMail and JavaBeans Activation Framework into our products under licenses granted to us by Sun. Our ATG 6.3 Relationship Management Platform has been designed to support Sun's J2EE standards. If Sun were to decline to continue to allow us to use these technologies for any reason, we would be required to (a) license the equivalent technology from another source, (b) rewrite the technology ourselves or (c) rewrite portions of our software to accommodate the change or no longer use the technology.

While a number of companies have introduced Web applications based on Java, Java could fall out of favor, and support by Sun Microsystems or other companies could decline. Moreover, our new ATG 6.3 Relationship Management Platform is designed to support Sun's Java 2 Platform, Enterprise Edition, or J2EE, standards for developing modular Java programs that can be accessed over a network. We have licensed the J2EE brand and certification tests from Sun. There can be no assurance that these standards will be widely adopted, that we can continue to support J2EE standards established by Sun from time to time or that the J2EE brand will continue to be made available to us on commercially reasonable terms. If Java or J2EE support decreased or we could not continue to use Java or related Java technologies or to support J2EE, we might have to rewrite the source code for our entire product line to enable our products to run on other computer platforms. Also, changes to Java or J2EE standards or the loss of our license to the J2EE brand could require us to change our products and adversely affect the perception of our products by our customers. If we were unable to develop or implement appropriate modifications to our products on a timely basis, we could lose revenue opportunities and our business could be harmed.

## **Risks Related To the Internet Industry**

***Our performance will depend on the growth of e-commerce and self-service.***

Our success will depend heavily on the continued use of the Internet for e-commerce. The recent United States economic downturn reduced demand for our products as customers and potential customers delayed or cancelled the implementation of online marketing, sales and service applications. If the market for our products and services fails to mature, we will be unable to execute our business plan. Adoption of electronic commerce and online marketing, sales and service applications, particularly by those companies that have historically relied upon traditional means of commerce, will require a broad acceptance of different methods of conducting business. Our future revenues and profits will substantially depend on the Internet being accepted and widely used for commerce and communication. If Internet commerce does not continue to grow or grows more slowly than expected, our future revenues and profits may not meet our expectations or those of analysts. Similarly, purchasers with established patterns of commerce may be reluctant to alter those patterns or may otherwise resist providing the personal data necessary to support our consumer profiling capability.

***Regulations could be enacted that either directly restrict our business or indirectly impact our business by limiting the growth of e-commerce.***

As e-commerce evolves, federal, state and foreign agencies could adopt regulations covering issues such as user privacy, content and taxation of products and services. If enacted, government regulations could limit the market for our products and services or could impose burdensome requirements that render our business unprofitable. Although many regulations might not apply to our business directly, we expect that laws regulating the solicitation, collection or processing of personal and consumer information could indirectly affect our business. The Telecommunications Act of 1996 prohibits certain types of information and content from being transmitted over the Internet. The prohibition's scope and the liability associated with a violation are currently unsettled. In addition, although substantial portions of the Communications Decency Act were held to be unconstitutional, we cannot be certain that similar legislation will not be enacted and upheld in the future. It is possible that legislation could expose companies involved in e-commerce

to liability, which could limit the growth of e-commerce generally. Legislation like the Telecommunications Act and the Communications Decency Act could dampen the growth in Web usage and decrease its acceptance as a medium of communications and commerce.

***The Internet is generating privacy concerns that could result in legislation or market perceptions that could harm our business or result in reduced sales of our products, or both.***

Businesses use our ATG Adaptive Scenario Engine product to develop and maintain profiles to tailor the content to be provided to Web site visitors. When a visitor first arrives at a Web site, our software creates a profile for that visitor. If the visitor registers or logs in, the visitor's identity is added to the profile, preserving any profile information that was gathered up to that point. ATG Adaptive Scenario Engine product tracks both explicit user profile data supplied by the user as well as implicit profile attributes derived from the user's behavior on the Web site. Privacy concerns may cause visitors to resist providing the personal data or to avoid Web sites that track the Web behavioral information necessary to support our profiling capability. More importantly, even the perception of security and privacy concerns, whether or not valid, may indirectly inhibit market acceptance of our products. In addition, legislative or regulatory requirements may heighten these concerns if businesses must notify Web site users that the data captured after visiting Web sites may be used to direct product promotion and advertising to that user. Other countries and political entities, such as the European Economic Community, have adopted such legislation or regulatory requirements. The United States may adopt similar legislation or regulatory requirements. If privacy legislation is enacted or consumer privacy concerns are not adequately addressed, our business, financial condition and operating results could be harmed.

Our products use cookies to track demographic information and user preferences. A cookie is information keyed to a specific user that is stored on a computer's hard drive, typically without the user's knowledge. Cookies are generally removable by the user, although removal could affect the content available on a particular site. Germany has imposed laws limiting the use of cookies, and a number of Internet commentators and governmental bodies in the United States and other countries have urged passage of laws limiting or abolishing the use of cookies. If such laws are passed or if users begin to delete or refuse cookies as a common practice, demand for our personalization products could be reduced.

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**Risks Related To The Securities Markets And Our Stock**

***Our stock price may continue to be volatile.***

The market price of our common stock has fluctuated in the past and is likely to continue to be highly volatile. For example, the market price of our common stock has ranged from \$.58 per share to \$126.88 per share since our initial public offering in July 1999. Fluctuations in market price and volume are particularly common among securities of Internet and software companies. The market price of our common stock may fluctuate significantly in response to the following factors, some of which are beyond our control:

variations in our quarterly operating results;

changes in market valuations of Internet and software companies;

our announcements of significant contracts, acquisitions, strategic partnerships, joint ventures or capital commitments;

our failure to complete significant sales;

additions or departures of our key personnel;

future sales of our common stock; or

changes in financial estimates by securities analysts.

***We may incur significant costs from class action litigation.***

We currently are the subject of securities class action litigation. If a court awards damages to the plaintiffs, the total amount could exceed the limit of our existing insurance. This litigation also may divert management's attention and resources. For a further description of the pending litigation, see Part II, Item 1. Legal Proceedings. We may be the target of similar litigation in the future if the market for our stock becomes volatile. While we believe that we have an appropriate amount of insurance for class action lawsuits, we cannot be certain that the insurance coverage will be available or, if available, sufficient to cover our liability with respect to a specific future action that may be brought.

***Anti-takeover provisions in our charter documents and Delaware law could prevent or delay a change in control of our company.***

Certain provisions of our charter and by-laws may discourage, delay or prevent a merger or acquisition that a stockholder may consider favorable, which could reduce the market price of our common stock. These provisions include:

authorizing the issuance of blank check preferred stock;

providing for a classified board of directors with staggered, three-year terms;

providing that directors may only be removed for cause by a two-thirds vote of stockholders;

limiting the persons who may call special meetings of stockholders prohibiting stockholder action by written consent;

establishing advance notice requirements for nominations for election to the board of directors or for proposing matters that can be acted on by stockholders at stockholder meetings; and

authorizing anti-takeover provisions.

In addition, we adopted a shareholder rights plan in 2001 and Delaware law may further discourage, delay or prevent someone from acquiring or merging with us.

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

We maintain an investment portfolio consisting mainly of investment grade money market funds, corporate obligations and government obligations with a weighted average maturity of less than one year. These held-to-maturity securities are subject to interest rate risk. However, a 10% change in interest rates would not have a material impact to the fair values of these securities primarily due to their short maturity and our intent to hold the securities to maturity. There have been no significant changes since March 31, 2004.

The majority of our operations are based in the U.S., and accordingly, the majority of our transactions are denominated in U.S. dollars. However, we have foreign-based operations where transactions are denominated in foreign currencies and are subject to market risk with respect to fluctuations in the relative value of currencies. Relative to foreign currency exposures existing at March 31, 2004, a 10% movement in foreign exchange rates would not expose us to significant gains or losses in earnings or cash flows. We may use derivative instruments to manage the risk of exchange rate fluctuations, however, at March 31, 2004, there were no outstanding derivative instruments. We do not use derivative instruments for trading or speculative purposes.

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

Our management, with the participation of our chief executive officer and chief financial officer, evaluated the effectiveness of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act) as of March 31, 2004. Based on this evaluation, our chief executive officer and chief financial officer concluded that, as of March 31, 2004, our disclosure controls and procedures were (1) designed to ensure that material information relating to our company, including our consolidated subsidiaries, is made known to our chief executive officer and chief financial officer by others within those entities, particularly during the period in which this report was being prepared and (2) effective, in that they provide reasonable assurance that information required to be disclosed by us in the reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms.

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No change in our internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) occurred during the fiscal quarter ended March 31, 2004 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

**PART II. OTHER INFORMATION**

**Item 1. Legal Proceedings**

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 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 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. While management believes the remaining claim against the Company is without merit, and intends to defend the action vigorously, the litigation is still in the preliminary stage.

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.

**Item 2. Changes in Securities and Use of Proceeds**

None.

**Item 3. Defaults Upon Senior Securities**

None.

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

None.

**Item 5. Other Information**



None.

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

**(a) Exhibits**

31.1 Certifications of Principal Executive Officer Pursuant to Exchange Act Rules 13a-14 and 15d-14, as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

31.2 Certifications of Principal Financial and Accounting Officer Pursuant to Exchange Act Rules 13a-14 and 15d-14, as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

32.1 Certifications of Principal Executive Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

32.2 Certifications of Principal Financial and Accounting Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

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

None

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**SIGNATURES**

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

ART TECHNOLOGY GROUP, INC.  
(Registrant)

By: /s/ ROBERT D. BURKE

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Robert D. Burke  
President and Chief Executive Officer  
(principal executive officer)

By: /s/ EDWARD TERINO

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Edward Terino  
Senior Vice President, Finance and Chief  
Financial Officer  
(principal financial and accounting  
officer)

Date: May 10, 2004