

PHOENIX TECHNOLOGIES LTD

Form 10-Q

February 09, 2005

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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

**Washington, D. C. 20549**

**FORM 10-Q**

(Mark One)

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

For the quarterly period ended December 31, 2004

or

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

For the transition period \_\_\_\_\_ to \_\_\_\_\_ .

Commission file number 0-17111

**PHOENIX TECHNOLOGIES LTD.**

(Exact name of Registrant as specified in its charter)

**Delaware**  
(State or other jurisdiction of

incorporation or organization)

**04-2685985**  
(I.R.S. Employer

Identification Number)

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915 Murphy Ranch Road, Milpitas, CA 95035

(Address of principal executive offices, including zip code)

(408) 570-1000

(Registrant's telephone number, including area code)

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

Indicate by check mark whether the Registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act).

YES x NO "

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

| Class                           | Number of Shares Outstanding at |
|---------------------------------|---------------------------------|
|                                 | January 31, 2005                |
| Common Stock, par value \$0.001 | 24,725,510                      |

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**PHOENIX TECHNOLOGIES LTD.**

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**Table of Contents****PART I FINANCIAL INFORMATION****ITEM 1. FINANCIAL STATEMENTS****PHOENIX TECHNOLOGIES LTD.****CONDENSED CONSOLIDATED BALANCE SHEETS***(in thousands, except par value)**(Unaudited)*

|                                                                                                                          | December 31,      | September 30,     |
|--------------------------------------------------------------------------------------------------------------------------|-------------------|-------------------|
|                                                                                                                          | 2004              | 2004              |
|                                                                                                                          | <u>          </u> | <u>          </u> |
| <b>Assets</b>                                                                                                            |                   |                   |
| Current assets:                                                                                                          |                   |                   |
| Cash and cash equivalents                                                                                                | \$ 39,165         | \$ 38,898         |
| Short-term investments                                                                                                   | 23,426            | 20,925            |
| Accounts receivable, net of allowances of \$1,049 and \$ 1,569 at December 31, 2004 and September 30, 2004, respectively | 23,509            | 23,871            |
| Prepaid royalties and maintenance                                                                                        | 2,245             | 2,266             |
| Deferred income taxes                                                                                                    |                   | 370               |
| Other current assets                                                                                                     | 2,823             | 3,632             |
|                                                                                                                          | <u>          </u> | <u>          </u> |
| Total current assets                                                                                                     | 91,168            | 89,962            |
| Property and equipment, net                                                                                              | 4,493             | 4,519             |
| Computer software costs, net                                                                                             | 7,083             | 7,922             |
| Goodwill                                                                                                                 | 13,433            | 13,433            |
| Intangible assets, net                                                                                                   | 420               | 437               |
| Prepaid royalties - non current                                                                                          | 1,668             | 2,221             |
| Other assets                                                                                                             | 2,587             | 2,391             |
|                                                                                                                          | <u>          </u> | <u>          </u> |
| Total assets                                                                                                             | \$ 120,852        | \$ 120,885        |
|                                                                                                                          | <u>          </u> | <u>          </u> |
| <b>Liabilities and stockholders' equity</b>                                                                              |                   |                   |
| Current liabilities:                                                                                                     |                   |                   |
| Accounts payable                                                                                                         | \$ 1,276          | \$ 2,188          |
| Accrued compensation and related liabilities                                                                             | 5,552             | 5,535             |
| Deferred revenue                                                                                                         | 6,724             | 9,642             |
| Income taxes payable                                                                                                     | 2,254             | 3,136             |
| Accrued restructuring charges - current                                                                                  | 464               | 536               |
| Other accrued liabilities                                                                                                | 3,740             | 3,229             |
|                                                                                                                          | <u>          </u> | <u>          </u> |
| Total current liabilities                                                                                                | 20,010            | 24,266            |
| Accrued restructuring charges - noncurrent                                                                               | 1,510             | 1,648             |
| Other liabilities                                                                                                        | 1,870             | 1,942             |
|                                                                                                                          | <u>          </u> | <u>          </u> |

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|                                                                                                                                                                                            |            |            |
|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|------------|------------|
| Total liabilities                                                                                                                                                                          | 23,390     | 27,856     |
| Commitments and Contingencies (Note 7)                                                                                                                                                     |            |            |
| Stockholders' equity:                                                                                                                                                                      |            |            |
| Preferred stock, \$0.100 par value, 500 shares authorized, none issued or outstanding                                                                                                      |            |            |
| Common stock, \$0.001 par value, 60,000 shares authorized, 31,913 and 31,734 shares issued, 24,717 and 24,536 shares outstanding at December 31, 2004 and September 30, 2004, respectively | 32         | 32         |
| Additional paid-in capital                                                                                                                                                                 | 182,250    | 181,302    |
| Deferred compensation                                                                                                                                                                      | (598)      | (777)      |
| Retained earnings                                                                                                                                                                          | 7,036      | 4,793      |
| Accumulated other comprehensive loss                                                                                                                                                       | (815)      | (1,878)    |
| Less: Cost of treasury stock (7,196 shares at December 31, 2004 and September 30, 2004)                                                                                                    | (90,443)   | (90,443)   |
|                                                                                                                                                                                            | <hr/>      | <hr/>      |
| Total stockholders' equity                                                                                                                                                                 | 97,462     | 93,029     |
|                                                                                                                                                                                            | <hr/>      | <hr/>      |
| Total liabilities and stockholders' equity                                                                                                                                                 | \$ 120,852 | \$ 120,885 |
|                                                                                                                                                                                            | <hr/>      | <hr/>      |

*See notes to unaudited consolidated financial statements*

**Table of Contents****PHOENIX TECHNOLOGIES LTD.****CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS***(In thousands, except per share amounts)**(unaudited)*

|                                                       | <b>Three months ended<br/>December 31,</b> |             |
|-------------------------------------------------------|--------------------------------------------|-------------|
|                                                       | <b>2004</b>                                | <b>2003</b> |
| Revenues                                              | \$ 26,176                                  | \$ 18,500   |
| Cost of revenues                                      | 4,236                                      | 3,614       |
| Gross Margin                                          | 21,940                                     | 14,886      |
| Operating expenses:                                   |                                            |             |
| Research and development                              | 4,730                                      | 5,539       |
| Sales and marketing                                   | 9,310                                      | 8,344       |
| General and administrative                            | 3,578                                      | 3,083       |
| Amortization of acquired intangible assets            | 17                                         | 17          |
| Stock-based compensation                              | 72                                         | 52          |
| Total operating expenses                              | 17,707                                     | 17,035      |
| Income (loss) from operations                         | 4,233                                      | (2,149)     |
| Interest and other income, net                        | (697)                                      | 161         |
| Income (loss) before income taxes                     | 3,536                                      | (1,988)     |
| Income tax expense                                    | 1,294                                      | 450         |
| Net income (loss)                                     | \$ 2,242                                   | \$ (2,438)  |
| Earnings (loss) per share:                            |                                            |             |
| Basic                                                 | \$ 0.09                                    | \$ (0.10)   |
| Diluted                                               | \$ 0.09                                    | \$ (0.10)   |
| Shares used in Earnings (loss) per share calculation: |                                            |             |
| Basic                                                 | 24,599                                     | 24,333      |
| Diluted                                               | 25,219                                     | 24,333      |

*See notes to unaudited consolidated financial statements*

**Table of Contents****PHOENIX TECHNOLOGIES LTD.****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS***(in thousands)**(Unaudited)*

|                                                                           | <b>Three Months Ended<br/>December 31,</b> |             |
|---------------------------------------------------------------------------|--------------------------------------------|-------------|
|                                                                           | <b>2004</b>                                | <b>2003</b> |
| Cash flows from operating activities:                                     |                                            |             |
| Net income (loss)                                                         | \$ 2,242                                   | \$ (2,438)  |
| Reconciliation to net cash provided by operating activities:              |                                            |             |
| Depreciation and amortization                                             | 1,714                                      | 1,995       |
| Stock-based compensation                                                  | 72                                         | 52          |
| Loss from disposal of fixed assets                                        |                                            | 268         |
| Deferred income tax                                                       | 370                                        | (7)         |
| Change in operating assets and liabilities:                               |                                            |             |
| Accounts receivable                                                       | 362                                        | (8,154)     |
| Prepaid royalties and maintenance                                         | 574                                        | 619         |
| Other assets                                                              | 613                                        | 151         |
| Accounts payable                                                          | (912)                                      | 161         |
| Accrued compensation and related liabilities                              | 17                                         | (2,272)     |
| Deferred revenue                                                          | (2,918)                                    | 9,120       |
| Income taxes                                                              | (882)                                      | 79          |
| Accrued restructuring charges                                             | (344)                                      | (271)       |
| Other accrued liabilities                                                 | 574                                        | 980         |
| Net cash provided by operating activities                                 | 1,482                                      | 283         |
| Cash flows from investing activities:                                     |                                            |             |
| Proceeds from sale of investments                                         | 42,629                                     | 47,285      |
| Purchases of investments                                                  | (45,130)                                   | (45,024)    |
| Proceeds from the sale of fixed assets                                    |                                            | 38          |
| Purchases of property and equipment                                       | (832)                                      | (365)       |
| Net cash provided by (used in) investing activities                       | (3,333)                                    | 1,934       |
| Cash flows from financing activities:                                     |                                            |             |
| Proceeds from stock purchases under stock option and stock purchase plans | 1,055                                      | 620         |
| Net cash provided by financing activities                                 | 1,055                                      | 620         |
| Effect of exchange rate changes on cash and cash equivalents              | 1,063                                      | (358)       |
| Net increase (decrease) in cash and cash equivalents                      | 267                                        | 2,479       |
| Cash and cash equivalents at beginning of period                          | 38,898                                     | 26,601      |
| Cash and cash equivalents at end of period                                | \$ 39,165                                  | \$ 29,080   |

*See notes to unaudited consolidated financial statements*



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**PHOENIX TECHNOLOGIES LTD.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**(UNAUDITED)**

**Note 1. Summary of Significant Accounting Policies**

*Basis of Presentation.* The consolidated financial statements as of December 31, 2004 and for the three months ended December 31, 2004 and 2003 have been prepared by the Company, without an audit, pursuant to the rules and regulations of the Securities and Exchange Commission (the "SEC") and in accordance with the Company's accounting policies as described in its latest Annual Report on Form 10-K filed with the SEC. Certain information and footnote disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles have been omitted pursuant to such rules and regulations. The consolidated balance sheet as of September 30, 2004 was derived from audited financial statements, but does not include all disclosures required by generally accepted accounting principles. These consolidated financial statements should be read in conjunction with the Company's audited consolidated financial statements and notes thereto included in the Company's Annual Report on Form 10-K for the year ended September 30, 2004.

In the opinion of management, the unaudited consolidated financial statements reflect all adjustments of a normal recurring nature necessary for a fair presentation of the Company's results of operations and cash flows for the interim periods presented, and financial condition of the Company as of December 31, 2004. The results of operations for interim periods are not necessarily indicative of results to be expected for the full fiscal year.

*Reclassifications.* Certain amounts in prior period financial statements have been reclassified to conform to current period presentation as Management reviews expenses for research and development, sales and marketing, general and administrative, and cost of revenues under the different methodology. The Company's results of operations and financial condition were not affected by the reclassification.

*Use of Estimates.* The preparation of the consolidated financial statements in conformity with generally accepted accounting principles ("GAAP") requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses for the reporting period. The Company bases its estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances.

On an on-going basis, the Company evaluates its estimates on, including but not limited to, a) allowance for uncollectible accounts receivable and sales returns; b) accruals for royalty revenues; c) accruals for employee benefits and restructuring and related costs; d) income taxes and realizability of deferred tax assets and the associated valuation allowances and; e) useful lives and/or realizability of carrying values for property and equipment, computer software costs, goodwill and intangibles, and prepaid royalties. Actual results could differ from those estimates.

*Revenue Recognition.* The Company licenses software under non-cancelable license agreements and provides services including non-recurring engineering, maintenance (consisting of product support services and rights to unspecified upgrades on a "when-and-if available" basis), and training.

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Revenues from software license agreements are recognized when persuasive evidence of an arrangement exists, delivery has occurred, the fee is fixed or determinable, and collection is probable. The Company uses the residual method to recognize revenue when an agreement includes one or more elements to be delivered at a future date and vendor specific objective evidence of the fair value of all the undelivered elements exists. Under the residual method, the fair value of the undelivered elements is deferred and the remaining portion of the arrangement fee is recognized as revenues. If evidence of fair value of one or more undelivered elements does not exist, revenues are deferred and recognized when delivery of those elements occurs or when fair value can be established. Revenue from non-refundable up-front fee arrangements including rights to unspecified future products is recognized ratably over the term of the respective agreement.

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**PHOENIX TECHNOLOGIES LTD.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**(UNAUDITED)**

Royalty revenues from OEMs/ODMs are generally recognized in each period based on estimated consumption by the OEMs/ODMs of products containing the Company's software, provided that all other revenue recognition criteria have been met. The Company normally recognizes revenue for all consumption prior to the end of the accounting period. However, for volume purchase agreements (VPAs) the Company also recognizes revenues for units estimated to be consumed by the end of the following accounting quarter, to the extent that the customer has been invoiced for such consumption prior to the end of the quarter and provided all other revenue recognition criteria have been met. Amounts that have been invoiced under VPAs and relate to consumption beyond the following accounting quarter which we have determined to be not fixed and determinable are recorded as deferred revenues. Since the Company generally receives quarterly royalty reports from our OEMs/ODMs approximately 30 to 60 days following the end of a quarter, it has put processes in place to reasonably estimate the royalty revenues, including obtaining estimates of production from our OEM/ODM customers, utilizing historical experience, and other relevant current information. To date the variances between estimated and actual revenues have been immaterial.

In fiscal 2004, the Company began to enter into an increased number of paid-up license arrangements, under which its customers pay a fixed upfront fee for an unlimited number of units. During the first quarter of fiscal 2005, the efforts to enter into such arrangements continued. As a result, the Company's revenues from such paid-up license arrangements increased from \$6.7 million in the fourth quarter of 2004, or 27% of fourth quarter revenues, to \$10.0 million in the first quarter of fiscal 2005, or 38% of first quarter fiscal 2005 revenues. The Company generally enters into such paid-up license arrangements only with respect to PC/Server Core System Software that is approaching the end of its lifecycle or with respect to sales to its Non-PC Device customers where the Company expects that the number of units will be relatively small.

Non-recurring engineering service revenues are recognized on a time and materials basis, on a completed contract basis, or when contractual milestones are met. Contractual milestones involve the use of estimates and approximate the percentage-of-completion method. Software maintenance revenues are recognized ratably over the maintenance period, which is typically one year. Training and other service revenues are recognized as the services are performed. Amounts billed in advance for licenses and services that are in excess of revenues recognized are recorded as deferred revenues.

*Income taxes.* Income taxes are accounted for in accordance with Statement of Financial Accounting Standards No. 109 *Accounting for Income Taxes* (SFAS 109). Under the asset and liability method of SFAS 109, deferred tax assets and liabilities are recognized for future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities, and their respective tax bases. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period of enactment.

After examining the available evidence at December 31, 2004, the Company believes a full valuation allowance was necessary for the U.S. Federal and state net deferred tax assets. The valuation allowance was calculated in accordance with the provisions of SFAS 109, which requires an assessment of both negative and positive evidence when measuring the need for a valuation allowance. In accordance with SFAS 109, evidence such as operating results during recent periods is given more weight than the Company's expectations of future profitability, which are inherently uncertain. The Company's recent financial performance represented sufficient negative evidence to require a full valuation allowance against its U.S. Federal and state deferred tax assets under SFAS 109. The Company intends to maintain a full valuation allowance against its deferred tax assets until sufficient positive evidence exists to support realization of the U.S. Federal and state deferred tax assets.



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*Stock-Based Compensation.* The Company accounts for its stock option plans and employee stock purchase plan in accordance with provisions of the Accounting Principles Board's Opinion No. 25, Accounting for Stock Issued to Employees (APB 25). The Statement of Financial Accounting Standards No. 148, Accounting for Stock-Based Compensation Transition and Disclosure an amendment of FAS 123 (SFAS 148) which amends the disclosure requirements of Statement of Financial Accounting Standards No. 123, Accounting for Stock-Based Compensation (SFAS 123), requires the Company to provide more prominent disclosures in both annual and interim financial statements regarding the method of accounting for stock-based employee compensation and the effect of the method used in the reported results. SFAS 148 also requires the Company to disclose pro forma information regarding option grants made to its employees based on specified valuation techniques that produce estimated compensation charges. The pro forma is as follows (in thousands, except per-share amounts):

|                                                                                                                                                 | <b>Three Months Ended<br/>December 31,</b> |             |
|-------------------------------------------------------------------------------------------------------------------------------------------------|--------------------------------------------|-------------|
|                                                                                                                                                 | <b>2004</b>                                | <b>2003</b> |
| Net income (loss) as reported                                                                                                                   | \$ 2,242                                   | \$ (2,438)  |
| Add: Stock-based employee compensation expense included in reported net income (loss), net of related tax effects                               | 69                                         | 18          |
| Deduct: Total stock-based employee compensation expense determined under the fair value based method for all awards, net of related tax effects | (1,273)                                    | (504)       |
| Pro forma net income (loss)                                                                                                                     | \$ 1,038                                   | \$ (2,924)  |
| Basic and diluted earnings (loss) per share:                                                                                                    |                                            |             |
| As reported                                                                                                                                     | \$ 0.09                                    | \$ (0.10)   |
| Pro forma                                                                                                                                       | \$ 0.04                                    | \$ (0.12)   |

The fair value of options granted in the three months ended December 31, 2004 and 2003 reported above have been estimated as of the date of the grant using a Black-Scholes multiple option pricing model with the following assumptions:

|                                          | <b>Employee Stock Options</b>          |             |
|------------------------------------------|----------------------------------------|-------------|
|                                          | <b>Three months ended December 31,</b> |             |
|                                          | <b>2004</b>                            | <b>2003</b> |
| Expected life from grant date (in years) | 3.38                                   | 3.14        |
| Risk-free interest rate                  | 3.0%                                   | 2.4%        |
| Volatility                               | 0.83                                   | 0.88        |
| Dividend yield                           | None                                   | None        |

| Employee Stock Purchase Plan             |      |      |
|------------------------------------------|------|------|
| Three months ended December 31,          |      |      |
|                                          | 2004 | 2003 |
| Expected life from grant date (in years) | 0.50 | 0.50 |
| Risk-free interest rate                  | 2.5% | 1.3% |
| Volatility                               | 0.51 | 0.63 |
| Dividend yield                           | None | None |

*Computation of Earnings (loss) per Share.* Basic earnings (loss) per share is computed using the weighted-average number of common shares outstanding during the period. Diluted net income per share is computed using the weighted-average number of common and dilutive potential common shares outstanding during the period. Diluted common-equivalent shares primarily consist of employee stock options and warrants, computed using the treasury stock method. In computing diluted earnings per share, the average stock price for the period is used in determining the number of shares assumed to be purchased from the exercise of stock options. For the three months ended December 31, 2003, the Company reported net losses and did not include the outstanding options in the calculation of diluted loss per share, as their inclusion would be anti-dilutive. See Note 6 to Consolidated Financial Statements for more information.

*New Accounting Pronouncements.* On December 16, 2004, the Financial Accounting Standards Board (FASB) issued FASB Statement No. 123 (revised 2004), Share-Based Payment, which is a revision of FASB Statement No. 123, Accounting for Stock-Based Compensation. Statement 123(R) supersedes APB Opinion No. 25, Accounting for Stock Issued to Employees, and amends FASB Statement No. 95, Statement of Cash Flows. Generally, the approach in Statement 123(R) is similar to the approach described in Statement 123.

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However, Statement 123(R) requires all share-based payments to employees, including grants of employee stock options, to be recognized in the income statement based on their fair values. Pro forma disclosure is no longer an alternative. The new standard will be effective for public entities in the first interim or annual reporting period beginning after June 15, 2005. The Company has not yet assessed the impact of adopting this new standard.

**Note 2. Comprehensive Income (loss)**

The following are the components of comprehensive income (loss) (*in thousands*):

|                                             | <b>Three months ended<br/>December 31,</b> |             |
|---------------------------------------------|--------------------------------------------|-------------|
|                                             | <b>2004</b>                                | <b>2003</b> |
| Net income (loss)                           | \$ 2,242                                   | \$ (2,438)  |
| Other comprehensive income (loss)           |                                            |             |
| Unrealized loss from short-term investments |                                            | (39)        |
| Foreign currency translation adjustments    | 1,064                                      | (319)       |
| Comprehensive income (loss)                 | \$ 3,306                                   | \$ (2,796)  |

**Note 3. Restructuring Charges**

The following table summarizes the activity related to the liability for restructuring charges through December 31, 2004 (*in thousands*):

|                                          | <b>Severance<br/>and Benefits</b> | <b>Facilities<br/>Exit Costs</b> | <b>Asset<br/>Write-off</b> | <b>Total</b> |
|------------------------------------------|-----------------------------------|----------------------------------|----------------------------|--------------|
| Balance of accrual at September 30, 2001 | \$ 226                            | \$                               | \$                         | \$ 226       |
| Provision                                | 3,925                             |                                  |                            | 3,925        |
| Cash payments                            | (3,412)                           |                                  |                            | (3,412)      |
| True up adjustments                      | (460)                             |                                  |                            | (460)        |

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|                                          |         |          |       |          |
|------------------------------------------|---------|----------|-------|----------|
| Balance of accrual at September 30, 2002 | 279     |          |       | 279      |
| Provision                                | 4,796   | 2,479    | 118   | 7,393    |
| Cash payments                            | (3,420) | (935)    |       | (4,355)  |
| Non-cash charges                         |         |          | (118) | (118)    |
| True up adjustments                      | (328)   | 1,728    |       | 1,400    |
|                                          | <hr/>   | <hr/>    | <hr/> | <hr/>    |
| Balance of accrual at September 30, 2003 | 1,327   | 3,272    |       | 4,599    |
| Cash payments                            | (1,127) | (1,232)  |       | (2,359)  |
| True up adjustments                      | (200)   | 144      |       | (56)     |
|                                          | <hr/>   | <hr/>    | <hr/> | <hr/>    |
| Balance of accrual at September 30, 2004 |         | 2,184    |       | 2,184    |
| Cash payments                            |         | (210)    |       | (210)    |
|                                          | <hr/>   | <hr/>    | <hr/> | <hr/>    |
| Balance of accrual at December 31, 2004  | \$      | \$ 1,974 | \$    | \$ 1,974 |
|                                          | <hr/>   | <hr/>    | <hr/> | <hr/>    |

## Overview

As of December 31, 2004, the remaining accrual balance of \$1.9 million is related to a facility exit plan implemented in the first quarter of fiscal 2003 and is expected to be paid through the third quarter of fiscal 2009. The unpaid portion of facilities exit costs is included in the consolidated balance sheets under the captions "Accrued restructuring charges - current" and "Accrued restructuring charges - non current".



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In the first quarter of fiscal 2003, the Company announced a restructuring program that impacted approximately 100 positions across all business functions and closed its facilities in Irvine, California and Louisville, Colorado. This restructuring resulted in employee termination benefits of \$2.9 million, estimated facilities exit expenses of \$2.5 million, and asset write-offs in the amount of \$0.1 million. All charges were recorded in the three months ended December 31, 2002 in accordance with Emerging Issues Task Force 94-3 *Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity* ( EITF 94-3 ). As of September 30, 2003, payments relating to the employee termination benefits were completed. Actual payments for employee termination benefits were lower than the original provision as of September 30, 2003. As a result, \$0.1 million of excess accrual was reversed in the fourth quarter of fiscal 2003. In addition, the Company increased the restructuring liability related to the Irvine, California facility by \$1.7 million and \$0.1 million in fiscal 2003 and 2004, respectively, to reflect changes in the assumptions made previously for both the length of time the space would remain vacant and the sublease rate when the Company finds subtenants. As of December 31, 2004, approximately \$2.4 million of the facilities exit expenses had been paid.

**Note 4. Other Current and Non-Current Accrued Liabilities**

The following table provides details of other current accrued liabilities (*in thousands*):

|                                         | December 31,<br>2004 | September 30,<br>2004 |
|-----------------------------------------|----------------------|-----------------------|
| Other current accrued liabilities:      |                      |                       |
| Royalties and commissions               | \$ 694               | \$ 430                |
| Accounting and legal fees               | 638                  | 763                   |
| Co-op advertising                       | 660                  | 658                   |
| Other accrued expenses                  | 1,748                | 1,378                 |
| Total other current accrued liabilities | <u>\$ 3,740</u>      | <u>\$ 3,229</u>       |

The following table provides details of other non-current accrued liabilities (*in thousands*):

|                                        | December 31,<br>2004 | September 30,<br>2004 |
|----------------------------------------|----------------------|-----------------------|
| Other non-current accrued liabilities: |                      |                       |
| Deferred tax liabilities               | \$ 1,041             | \$ 975                |
| Accrued rent                           | 456                  | 577                   |
| Other liabilities                      | 373                  | 390                   |

|                                             |          |          |
|---------------------------------------------|----------|----------|
| Total other non-current accrued liabilities | \$ 1,870 | \$ 1,942 |
|---------------------------------------------|----------|----------|

#### Note 5. Segment Reporting and Significant Customers

The Chief Operating Decision Maker assesses the Company's performance by regularly reviewing the operating results as a single segment: Phoenix. The reportable segment is established based on the criteria set forth in the Statement of Financial Accounting Standards No. 131, *Disclosures about Segments of an Enterprise and Related Information* (SFAS 131), including evaluating the Company's internal reporting structure by the chief operating decision maker and disclosure of revenues and operating expenses. The Chief Operating Decision Maker reviews financial information presented on a consolidated basis, accompanied by disaggregated information about revenues by geographic region for purposes of making operating decisions and assessing financial performance. The Company does not assess the performance of its geographic regions on other measures of income or expense, such as depreciation and amortization, gross margin or net income. In addition, as Phoenix's assets are primarily located in its corporate office in the

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United States and not allocated to any specific region, it does not produce reports for, or measure the performance of its geographic regions based on any asset-based metrics. Therefore, geographic information is presented only for revenues.

The Company reports revenues by geographic area, which is categorized into five major countries/regions: North America, Japan, Taiwan, other Asian countries, and Europe (*in thousands*):

|                       | <b>Three months ended<br/>December 31,</b> |                  |
|-----------------------|--------------------------------------------|------------------|
|                       | <b>2004</b>                                | <b>2003</b>      |
| Revenues:             |                                            |                  |
| North America         | \$ 4,133                                   | \$ 4,559         |
| Japan                 | 8,036                                      | 5,149            |
| Taiwan                | 11,204                                     | 6,876            |
| Other Asian Countries | 1,583                                      | 1,011            |
| Europe                | 1,220                                      | 905              |
| Total                 | <b>\$ 26,176</b>                           | <b>\$ 18,500</b> |

For the three months ended December 31, 2004, three customers accounted for 28%, 12% and 11% of total revenues, respectively. For the three months ended December 31, 2003, three customers accounted for 13%, 13%, and 10% of total revenues, respectively. No other customers accounted for more than 10% of total revenues during these periods.

**Note 6. Earnings (Loss) per Share**

The following table presents the calculation of basic and diluted earnings (loss) per share required under Statement of Financial Accounting Standards No. 128, *Earnings per Share* ( SFAS 128 ) (*in thousands, except per share amounts*):

| <b>Three months ended<br/>December 31,</b> |             |
|--------------------------------------------|-------------|
| <b>2004</b>                                | <b>2003</b> |

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|                                                                   |          |            |
|-------------------------------------------------------------------|----------|------------|
| Net income (loss)                                                 | \$ 2,242 | \$ (2,438) |
| Weighted average common shares outstanding                        | 24,599   | 24,333     |
| Effect of dilutive securities (using the treasury stock method):  |          |            |
| Stock options                                                     | 620      |            |
| Weighted average diluted common and equivalent shares outstanding | 25,219   | 24,333     |
| Earnings (loss) per share:                                        |          |            |
| Basic                                                             | \$ 0.09  | \$ (0.10)  |
| Diluted                                                           | \$ 0.09  | \$ (0.10)  |

Basic earnings (loss) per share is computed using the weighted-average number of common shares outstanding during the period. Diluted net income per share is computed using the weighted-average number of common and dilutive potential common shares outstanding during the period. Diluted common-equivalent shares primarily consist of employee stock options and warrants, computed using the treasury stock method.

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**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**(UNAUDITED)**

In computing diluted earnings per share, the average stock price for the period is used in determining the number of shares assumed to be purchased from the exercise of stock options. For the three months ended December 31, 2003, the Company reported net losses and did not include the outstanding options in the calculation of diluted loss per share, as their inclusion would be anti-dilutive. The dilutive potential common shares that were anti-dilutive for that period amounted to 430,000 shares.

**Note 7. Commitments and Contingencies**

**Litigation**

The Company is subject to certain routine legal proceedings that arise in the normal course of its business. The Company believes that the ultimate amount of liability, if any, for any pending claims of any type (either alone or combined), including the legal proceedings described below, will not materially affect the Company's results of operations, liquidity, or financial position taken as a whole. However, the ultimate outcome of any litigation is uncertain, and unfavorable outcomes could have a material adverse impact. Regardless of outcome, litigation can have an adverse impact on the Company due to defense costs, diversion of management resources, and other factors.

*Korean Electronic Certification Authority, Inc. v. Phoenix Technologies Ltd. and Phoenix Technologies (Hungary) Software Licensing, LLC.* On April 21, 2003, the Korean Electronic Certification Authority, Inc., doing business as CrossCert, Inc. ( CrossCert ), filed a motion (the Preliminary Attachment Motion ) in the Suwon District Court in Seoul, Korea, without notice to Phoenix, for a preliminary attachment under Korean law on Phoenix's expected payments from another Phoenix customer, Samsung Electronics Co., Ltd. ( Samsung ). CrossCert obtained the preliminary attachment on April 21, 2003 in the amount of KRW 496,608,750, or approximately USD \$412,000, which effectively enjoined a payment owing to the Company by Samsung. CrossCert's claim relates to a March 30, 2001 license agreement (the CrossCert Agreement ) between CrossCert and Phoenix, under which Phoenix licensed certain software to CrossCert. Phoenix subsequently assigned its rights in the CrossCert Agreement to an affiliate, Phoenix Technologies (Hungary) Software Licensing, LLC ( Phoenix-Hungary ).

On June 14, 2003, CrossCert filed a complaint in the Suwon District Court in Seoul, Korea against both Phoenix and Phoenix-Hungary for breach of contract, seeking a return of the payments made under the CrossCert Agreement in the amount of approximately USD \$825,000, plus interest under Korean law. Phoenix subsequently filed an objection to the Korean's court's jurisdiction over the dispute based on a choice of forum clause in the CrossCert Agreement in which the parties agreed to the exclusive jurisdiction of the courts in Santa Clara County, California for any disputes arising out of the CrossCert Agreement. In October 2003, the Korean court dismissed CrossCert's suit against Phoenix for lack of jurisdiction. Phoenix then filed a motion for cancellation of the preliminary attachment. On November 24, 2004, the Korean court denied Phoenix's motion to cancel the preliminary attachment, and ruled that the preliminary attachment can remain in place because of the pendency of the U.S.-based lawsuit involving the parties (described below). On January 21, 2005, Phoenix deposited KRW 496,608,750, or approximately USD \$412,000, into escrow with the court pending the outcome of the U.S.-based lawsuit, and requested that the court cancel and release the preliminary attachment. The court is expected to cancel and release the preliminary attachment within a few weeks of receipt of Phoenix's deposit. No other deadlines are presently set.

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*Phoenix Technologies Ltd. and Phoenix Technologies (Hungary) Software Licensing, LLC v. Korean Electronic Certification Authority, Inc.* On May 7, 2003, Phoenix and Phoenix-Hungary filed suit against CrossCert in Santa Clara County Superior Court in the United States of America for breach of contract, interference with contract, interference with prospective economic advantage and unfair competition under California Business and Professions Code Sections 17200 et seq. The claims in this case relate to the CrossCert

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**PHOENIX TECHNOLOGIES LTD.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**(UNAUDITED)**

Agreement and CrossCert's wrongful filing of the Preliminary Attachment Motion in Korea and its interference with Phoenix's contractual relationship with Samsung. Phoenix seeks damages in the amount of \$150,000 for CrossCert's failure to pay software maintenance fees, as well as all damages caused by CrossCert's wrongful conduct with respect to its filing of the Preliminary Attachment Motion in Korea and interference with prospective economic advantage, including lost goodwill, the extent of which is presently unknown. CrossCert filed a cross-complaint against Phoenix on October 24, 2003 for breach of contract, fraud and unfair competition under California Business and Professions Code Sections 17200 et seq. The parties attempted to mediate the dispute, and conducted a mediation of the case on August 6, 2004. The parties did not reach a settlement in that mediation conference. The court continued the Trial Setting Conference until January 25, 2005 to allow discovery to be conducted. The Court again continued the Trial Setting Conference to March 1, 2005. Phoenix anticipates additional discovery in February and there may be motion practice relating to Phoenix's amended complaint, which may necessitate an additional continuance of the Trial Setting Conference. Once the case is at-issue, it will be set for trial no earlier than June 2005.

*USA & Regal Groups, Inc. d.b.a. Sterling Pacific v. Phoenix Technologies Ltd. d.b.a. Phoenix Technologies Asia Pacific, Ltd., Phoenix Technologies Asia Pacific, Ltd., Al Sisto, David Gibbs, George Man and Does 1 through 100, inclusive.* On June 10, 2004, Sterling Pacific filed a complaint against Phoenix in Orange County Superior Court for fraud, negligent misrepresentation, breach of contract, rescission, violation of California Business and Professions Code Sections 17200 et seq., economic duress and common count. The claim arises from a March 31, 2004 Manufacturing License and Distribution Agreement between a subsidiary of Phoenix and Sterling Pacific, under which the Phoenix subsidiary licensed certain technology to Sterling Pacific for the purpose of manufacturing and distributing a Sterling Pacific hardware product. Sterling Pacific seeks return of the amounts paid (USD \$350,000) as well as exemplary damages for the alleged fraud.

The parties agreed to dismiss the suit in Orange County and re-file in Santa Clara County. The complaint was filed in Santa Clara County on September 21, 2004. Phoenix filed a demurrer to the complaint on December 1, 2004, claiming that Sterling Pacific lacked the standing and capacity to sue. In response to the demurrer, Sterling Pacific filed a first amended complaint on January 14, 2005, and the demurrer was taken off the calendar. An initial case management conference was held on January 25, 2005. Another case management conference has been scheduled for February 22, 2005. No other deadlines have been set in this case.

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

This report on Form 10-Q, including without limitation the Management's Discussion and Analysis of Financial Condition and Results of Operations, contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. These statements may include, but are not limited to, statements concerning future liquidity and financing requirements, potential price erosion, plans to make acquisitions, dispositions or strategic investments, expectations of sales volume to customers and future revenue growth, and plans to improve and enhance existing products and develop new products. Words such as "could," "expects," "may," "anticipates," "believes," "estimates," "plans," and other similar expressions are intended to indicate forward-looking statements. All forward looking statements included in this document are based upon information available to the Company as of the date hereof, and the Company assumes no obligation to update any such forward looking statement to reflect events or circumstances occurring after the date hereof. Actual results could differ materially from the Company's current expectations. Some of the factors that could cause future results to materially differ from the recent results or those projected in the forward-looking statements include, but are not limited to, significant increases or decreases in demand for our products, increased competition, lower prices and margins, changes in customer buying patterns, failure to successfully develop and market new products and technologies, competitor introductions of superior products, continued industry consolidation, instability and currency fluctuations in international markets, product defects, failure to secure intellectual property rights, results of litigation, failure to retain and recruit key employees, acts of war or global terrorism, power shortages and unexpected natural disasters. For a more detailed discussion of these and other risks associated with our business, see the "Risk Factors" section below and the "Management's Discussion and Analysis of Financial Condition and Results of Operations" "Risk Factors" section of our Annual Report on Form 10-K for the year ended September 30, 2004.

The following discussion should be read in conjunction with our consolidated financial statements and the related notes and other financial information appearing in our Form 10K for the fiscal year ended September 30, 2004 filed December 27, 2004.

### **Available Information**

Our Web site is [www.phoenix.com](http://www.phoenix.com). Through a link on the Investor Relations section of our Web site, the Company makes available the following filings as soon as reasonably practical after they are electronically filed with or furnished to the SEC: the Annual Report on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K, and any amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934. All such filings are available free of charge. Information contained on the Company's Web site is not part of this report.

### **Company Overview**

We are a global leader in the development, deployment, and support of Core System Software (CSS). CSS, the evolution of BIOS (Basic Input Output System), is used to enable, activate, protect, connect, and recover personal computers (PCs), industrial computers (IPCs), point of sale computers (POS), printers, copiers, medical devices, automotive controls, gaming systems, and other X86 based digital consumer devices. We provide our products primarily to worldwide platform and peripheral manufacturers that range from large branded PC and information products original equipment manufacturers (OEMs) and original design manufacturers (ODMs), to system integrators and value-added resellers. We also develop and provide software applications that enable independent software vendors (ISVs), OEMs, system builders and integrators, and IT departments to authenticate, asset-manage, enable, protect and recover their computer systems and data. In addition to key products, we also provide support services, such as training, maintenance and engineering services, to our customers as required.



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

We believe that our products and services enable our customers to bring secure, leading-edge products to market faster, while reducing their manufacturing and support costs and providing essential features and capabilities to enable product differentiation.

#### **Fiscal 2005 First Quarter Overview**

Phoenix analyzes revenue along two dimensions: (a) platform, with PCs and servers representing one category and non-PC devices, including consumer and industrial devices, representing a second category; and (b) products, with Core System Software representing one category and applications representing the second category. We disclose revenue breakdowns in three resulting sectors (1) PC/Server Core System Software, (2) PC/Server Applications, and (3) total Non-PC Devices (including both CSS and applications) which will be discussed in more detail under Results of Operations and Revenues.

The PC/Server Core System Software sector is currently our largest, representing 72% of our total revenue of \$26.2 million during the first quarter of fiscal 2005. Revenue in this sector increased by \$0.2 million, or 1%, as compared to the fourth quarter of fiscal 2004. Revenue in the PC/Server Applications sector increased from \$2.2 million in the fourth quarter of fiscal 2004, or 9% of fourth quarter revenue, to \$3.0 million in the first quarter of fiscal 2005, or 12% of revenue. Revenues in the Non-PC Device sector increased from \$3.6 million in the fourth quarter of fiscal 2004, or 15% of fourth quarter 2004 revenue to \$4.2 million in the first quarter of 2005, or 16% of first quarter revenue.

During the first quarter of fiscal 2005, we continued to enter into volume purchase agreements (or VPAs) with our larger ODM and OEM customers. Under VPA, customers commit to a fixed payment schedule for an agreed-upon number of units, typically over the next several quarters. Amounts that have been invoiced under VPAs and relate to consumption beyond the following quarter are recorded as deferred revenues. The decline in deferred revenue from \$9.6 million as of September 30, 2004 to \$6.7 million as of December 31, 2004 was attributable to several factors including 1) some customers who signed VPA deals with us in the first quarter of fiscal 2004, have yet to consume their full amount of purchased product, and thus have not yet signed new VPA deals and 2) we structured a deal with one of our ODM customers in Taiwan in which we recognized the entire amount of the transaction of \$6.9 million in this quarter. Management expects deferred revenues to increase in the second quarter of fiscal 2005 as 1) we expect to sign additional VPA agreements with strategic customers in Japan as these customers approach their fiscal year-end and 2) we enter into negotiations to renew VPA deals with customers who have consumed products covered under previous VPA deals signed in fiscal 2004.

In fiscal 2004, we began to enter into an increased number of paid-up license arrangements, under which our customers pay a fixed upfront fee for an unlimited number of units. During the first quarter of fiscal 2005, the efforts to enter into such arrangement continued. As a result, our revenues from such paid-up license arrangements increased from \$6.7 million in the fourth quarter of 2004, or 27% of fourth quarter revenues, to \$10.0 million in the first quarter of fiscal 2005, or 38% of first quarter fiscal 2005 revenues.

Operating expenses remained constant in the first quarter of fiscal 2005 at \$17.7 million compared to \$17.6 million for the fourth quarter in fiscal 2004.

As we enter the current fiscal year, the Company continues to execute its strategic plan to improve its business outlook and profitability. We continue to enter into long-term VPA transaction agreements with our key customers; we believe that these deals stabilize our product pricing and block out our competitors, while offering our customers the pricing flexibility that they require for their business needs. We also continue to

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develop and strengthen our partnerships with key system builders and channel distributors, allowing us to establish greater brand awareness of Phoenix and create a strong end-user demand pull for our core system and applications software products. Finally, the Company continues to invest in operational improvements, such as deploying and re-aligning engineering and sales resources to geographically better serve our customers, and improving internal processes and controls to enhance our ability to execute our strategies. There can be no assurance that our efforts will be successful.

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

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

We believe the following critical accounting policies, among others, are affected by our more significant judgments and estimates used in the preparation of our consolidated financial statements. The Company has discussed the critical accounting policies and estimates with the Audit Committee of the Board of Directors.

*Revenue Recognition.* We license software under non-cancelable license agreements and provide services including non-recurring engineering efforts, maintenance (consisting of product support services and rights to unspecified upgrades on a when-and-if available basis), and training. In many cases our products are incorporated into the products of our OEM/ODM customers.

Revenues from software license agreements are recognized when persuasive evidence of an arrangement exists, delivery has occurred, the fee is fixed and determinable, and collection is probable. Royalty revenues from OEMs/ODMs are generally recognized in each period based on estimated consumption by the OEMs/ODMs of products containing our software, provided that all other revenue recognition criteria have been met. We normally recognize revenue for all consumption prior to the end of the accounting period. However, for volume purchase agreements ( VPAs ) we also recognize revenues for units estimated to be consumed by the end of the following accounting quarter, to the extent that the customer has been billed for such consumption prior to the end of the quarter and provided all other revenue recognition criteria have been met. Since we generally receive quarterly royalty reports from our OEMs/ODMs approximately 30 to 60 days following the end of the quarter, we have put processes in place to reasonably estimate the royalty revenues, including obtaining estimates of production from our OEM/ODM customers, utilizing historical experience, and other relevant current information. We accrued \$4.8 million and \$6.3 million of royalty revenues from our OEM/ODM customers as of December 31, 2004 and September 30, 2004, respectively. To date, the variances between estimated and actual revenues have been immaterial. Although management believes that it has a reliable basis for making reasonable estimates, the actual results could differ depending on customer or market factors.

Amounts that have been invoiced under VPAs and relate to consumption beyond the following accounting quarter which we have determined to be not fixed and determinable are recorded as deferred revenues. During an accounting period, deferred revenues increase (or decrease) primarily to the extent that the dollar amount of new VPAs entered into during the period is greater (or less) than the revenue that is recognized during the period from the outstanding deferred revenue balance at the beginning of the period. We believe virtually all deferred revenue will be recognized as revenue within the next 12 months. Actual results could differ from the estimates used and have a material adverse effect on our business, operating results and financial condition.

In addition, we may execute multiple contracts/amendments with the same customer several times throughout a year. These contracts are reviewed to determine if they are linked and should be evaluated as one deal. The review includes consideration of Statement of Position 97-2, *Software Revenue Recognition* ( SOP 97-2 ) and Technical Practice Aid, *Software Revenue recognition for multiple-element arrangements* ( TPA 5100.39 ) guidelines and the standard historical business practice of our company.

*Allowance for Sales and Doubtful Accounts.* We record provisions for estimated sales allowances against revenues in the same period as the related revenues are recorded. Provisions for doubtful accounts are recorded in general and administrative expenses. At December 31, 2004 and September 30, 2004, the allowance for sales and doubtful accounts was \$1.0 million and \$1.6 million, respectively. These estimates are based on our assessment of the probable collection from specific customer accounts, the aging of the accounts receivable, historical sales returns, analysis of credit memo data, bad debt write-offs, and other known factors. If economic or specific industry trends worsen beyond our estimates, or if there is a deterioration of our major customers' credit worthiness, or actual defaults are higher than our estimates based on historical experience,

we would increase the allowances for sales and doubtful accounts which would impact revenue and expense, respectively, as appropriate.

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

*Intangible Assets.* Intangible assets include prepaid royalties, purchased technologies, goodwill and other intangibles. At December 31, 2004 and September 30, 2004, these assets, net of accumulated amortization, totaled \$24.9 million and \$26.4 million, respectively.

Prepaid royalties represent payments to several third party technology partners for their software that is incorporated into certain of our products. All other intangible assets were derived from our acquisitions. The cost of the acquisitions is allocated to the assets and liabilities acquired, including intangible assets based on their respective estimated fair value at the date of acquisition, with the remaining amount being classified as goodwill. The useful life of the intangible assets was estimated based on the period over which the assets were expected to contribute directly and indirectly to the future cash flows. If assumptions regarding the estimated future cash flows and other factors to determine the fair value of the respective assets change in the future, we may be required to record impairment charges.

Accordingly, the allocation of the acquisition cost to intangible assets and goodwill has a significant impact on our future operating results. The original recorded values of intangible assets and goodwill are based on third-party appraisals. The allocation process requires the extensive use of estimates and assumptions, including estimates of future cash flows expected to be generated by the acquired assets. In accordance with the terms of the purchase agreement for the acquisition of Integrity Science, Inc. ( ISI ) in February 2001, contingent consideration of \$1.5 million is to be paid out in equal annual increments beginning in fiscal 2004 providing that the developed technology purchased as part of the original business combination is still utilized within products at the annual milestone dates. In June 2004, the Company made the first payment of \$0.5 million in accordance with the earn-out terms noted above, and recorded the payment as additional purchase price resulting in incremental goodwill. The Company is currently assessing whether the second payment of the same dollar amount is due in the second quarter of fiscal 2005.

*Income Taxes - Estimates of Effective Tax Rates, Deferred Taxes Assets and Valuation Allowance:* When preparing our financial statements, we estimate our income taxes based on the various jurisdictions where we conduct business. This requires us to (1) estimate our current tax exposure and (2) assess temporary differences due to different treatment of certain items for tax and accounting purposes thereby resulting in deferred tax assets and liabilities. In addition, on a quarterly basis, we perform an assessment of the recoverability of the deferred income tax assets, which is principally dependent upon our ability to achieve taxable income in specific geographies.

After examining the available evidence at December 31, 2004, we believe a full valuation allowance was necessary for the U.S. Federal and state net deferred tax assets. The valuation allowance was calculated in accordance with the provisions of SFAS 109, which requires an assessment of both negative and positive evidence when measuring the need for a valuation allowance. In accordance with SFAS 109, evidence such as operating results during recent periods is given more weight than our expectations of future profitability, which are inherently uncertain. Our recent financial performance represented sufficient negative evidence to require a full valuation allowance against our U.S. Federal and state deferred tax assets under SFAS 109. We intend to maintain a full valuation allowance against our deferred tax assets until sufficient positive evidence exists to support realization of the U.S. Federal and state deferred tax assets.

**Table of Contents****ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS****Results of Operations*****Revenues***

Revenues by geographic region for the three and nine months ended December 31, 2004 and 2003 were as follows (*in thousands, except percentages*):

|                       | Amount                             |           |             | % of Consolidated Revenue          |        |
|-----------------------|------------------------------------|-----------|-------------|------------------------------------|--------|
|                       | Three months ended<br>December 31, |           |             | Three months ended<br>December 31, |        |
|                       | 2004                               | 2003      | %<br>Change | 2004                               | 2003   |
| North America         | \$ 4,133                           | \$ 4,559  | -9.3%       | 15.8%                              | 24.6%  |
| Japan                 | 8,036                              | 5,149     | 56.1%       | 30.7%                              | 27.8%  |
| Taiwan                | 11,204                             | 6,876     | 62.9%       | 42.8%                              | 37.2%  |
| Other Asian Countries | 1,583                              | 1,011     | 56.6%       | 6.0%                               | 5.5%   |
| Europe                | 1,220                              | 905       | 34.8%       | 4.7%                               | 4.9%   |
| Total revenues        | \$ 26,176                          | \$ 18,500 | 41.5%       | 100.0%                             | 100.0% |

Total revenues for the three months ended December 31, 2004 increased by 41.5% compared to the three months ended December 31, 2003. Revenue for the three months ended December 31, 2004 from Japan, Taiwan, other Asian countries and Europe increased by 56%, 63%, 57 and 35%, respectively. The increase was primarily attributable to 1) a large paid up license arrangement in Taiwan where all revenues were recognized up-front and 2) increased unit shipments as a result of a strengthening economy in each of these regions compared to the same period a year ago. Revenues in North America decreased by 9%. The decrease in North America was related to a slower sales cycle for applications products.

PC/server Core System Software revenues were \$18.9 million for the three months ended December 31, 2004 compared to \$14.3 million for the three months ended December 31, 2003. This increase was primarily due to increased unit shipments and a large paid-up license arrangement in Taiwan. We experienced strong growth across the desktop and notebook businesses in the first quarter of fiscal 2005, as key customers began shipping products with our Core System Software installed, and we closed additional VPA agreements with key customers in Asia Pacific and Japan.

PC/Server Applications revenues were \$3.0 million for the three months ended December 31, 2004 as compared to \$1.8 million for the three months ended December 31, 2003. The increase was related to the strong growth in our recovery applications business, as design wins secured in prior quarters led to greater unit shipments. We expect this trend to continue as we expand our base of active resellers and the market adoption of these products continue to grow.

The last revenue category is non-PC devices, which includes both the Core System Software and applications. The non-PC device sector recorded a significant increase in revenue to \$4.2 million in the first quarter of fiscal 2005 from \$2.4 million in the first quarter of fiscal 2004. We believe there is less quarter-to-quarter revenue stability here because there are a high proportion of non-standard contracts for which revenue is recognized upon contract execution. While the results for this period are not necessarily indicative of results to be expected in future periods, we expect continued long-term growth in this category as more digital device vendors adopt x86-based technology for their non-PC devices.

***Cost of Revenues and Gross Margin***

Cost of revenues consists of third-party license fees, post-sales engineering support costs and amortization of purchased technology. Gross margin as a percentage of revenues was 84% and 81% for the three months ended December 31, 2004 and 2003, respectively. Gross margin was \$21.9 million for the three

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

months ended December 31, 2004 as compared to \$14.9 million for the same period in fiscal 2003. The increases in percentage and in dollar amount during this period were mostly attributable to higher growth in overall revenue versus growth in post-sales customer support and third-party license fees. Amortization of purchased technologies from business combinations for the three months ended December 31, 2004 and 2003 were \$0.8 million for both periods.

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

Research and development expenses were \$4.7 million and \$5.5 million for the three months ended December 31, 2004 and 2003, respectively. As a percentage of revenues, these expenses represented 18% and 30%, respectively. The decrease was primarily due a re-allocation of customer engineering resources to enhance sales and marketing functions to be more customer-focused.

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

Sales and marketing expenses were \$9.3 million and \$8.3 million for the three months ended December 31, 2004 and 2003, respectively. As a percentage of revenues, these expenses represented 36% and 45%, respectively. The increase in sales and marketing expenses was primarily due to additional customer engineering resources to enhance sales and marketing functions.

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

General and administrative expenses were \$3.6 million and \$3.1 million for the three months ended December 31, 2004 and 2003, respectively. As a percentage of revenues, these expenses represented 14% and 17%, respectively. The increase in general and administrative expenses was due primarily to increased payroll and related compensation expenses, consulting-related expenses, and increased costs relating to compliance with the Sarbanes-Oxley Act.

#### ***Interest and Other Income, Net***

Interest and other income, net, was (\$0.7) million and \$0.2 million for the three months ended December 31, 2004 and 2003, respectively. The decrease during the three months ended December 31, 2004 was due primarily to higher unrealized foreign exchange losses, partially offset by higher interest income. The unrealized foreign exchange losses were the result of the the way GAAP requires the Company to account for intercompany obligations where the subsidiaries' functional currencies were different from the Company's reporting currency. The foreign exchange fluctuations were especially noticeable this quarter due the dramatic drop in the value of the US dollar against these functional currencies. Most of the transactions involved in this accounting were denominated in US dollars for the entire quarter, thus the foreign exchange losses had no real economic or cash impact on our assets. Interest income was \$0.2 million and \$0.1 million for the three months ended December 31, 2004 and 2003, respectively. The increase was due to the higher cash and short-term investment balance at December 31, 2004.





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

#### ***Provision for Income Taxes***

The Company recorded an income tax provision of \$1.3 million and \$0.5 million for the three months ended December 31, 2004 and 2003, respectively. At the close of our most recent fiscal year end, management determined that based upon its assessment of both positive and negative evidence available it was appropriate to continue to provide a full valuation allowance against any U.S. Federal and state net deferred tax assets. As of December 31, 2004 it continues to be the assessment of management that a full valuation against the U.S. Federal and state net deferred tax assets is appropriate.

The income tax provision for the three months ended December 31, 2004 of \$1.3 million is comprised primarily of taxes on foreign income and foreign withholding taxes, but also includes a provision for state income taxes and Federal alternative minimum taxes. The effective tax rate for the three months ended December 31, 2004 was 36% compared with (23%) for the comparable period ended December 31, 2003. This change in the effective tax rate was primarily due to the effect of overall pretax profitability during the three months ended December 31, 2004 in certain geographic jurisdictions that the Company operates in as contrasted with a pretax loss during the comparable period ended December 31, 2003.

#### **Financial Condition**

At December 31, 2004, our principal source of liquidity consisted of cash and cash equivalents, and short-term investments totaling \$62.6 million. The primary source of cash during the three months ended December 31, 2004 was \$1.5 million from operating activities and proceeds from stock purchases under stock option and stock purchase plans of \$1.1 million. At December 31, 2003, our principal source of liquidity consisted of cash and cash equivalents, and short-term investments totaling \$47.5 million. The primary source of cash during the three months ended December 31, 2003 was \$0.3 million from operating activities and proceeds from stock purchases under stock option and stock purchase plans of \$0.6 million. There were no outstanding borrowings with banks in either period.

The Company's deferred revenue balance decreased to \$6.7 million at December 31, 2004, compared to \$9.6 million at September 30, 2004. See Fiscal 2005 First Quarter Overview for more information on deferred revenue. Management expects deferred revenues to increase in the second quarter of fiscal 2005 as 1) we expect to sign additional VPA agreements with strategic customers in Japan as these customers approach their fiscal year-end and 2) we enter into negotiations to renew VPA deals with customers who have consumed products covered under previous VPA deals signed in fiscal 2004.

#### **Commitments**

We have commitments under non-cancelable operating leases ranging from one to ten years for \$20.2 million. The operating lease obligations include a net lease commitment for the Irvine location of \$2.1 million, after sublease income of \$1.1 million. The Irvine net lease commitment was included in the Company's fiscal 2003 first quarter restructuring plan. See Note 3 to the consolidated financial statements for further information on the Company's restructuring plans.

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In addition, we may have commitments pursuant to the original purchase agreement with ISI to make anniversary payments of \$0.5 million per year for 3 years, from fiscal 2004, for the use of certain technology in our future products. In June 2004, we made the first payment in accordance with the earn-out terms in the agreement noted above. Company is currently assessing whether the second payment is due in the second quarter of fiscal 2005.

We did not enter into any additional material commitments for capital expenditures or non-cancelable purchase commitments during the quarter ended December 31, 2004.

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

#### **Overview**

Based on past performance and current expectations, we believe that current cash and cash equivalent, short-term investments, and cash generated from operations will satisfy our working capital needs, capital expenditures, commitments and other liquidity requirements associated with our existing operations through at least the next twelve months. There are no transactions and arrangements that are reasonably likely to materially affect liquidity or the availability of our requirements for capital.

#### **Risk Factors**

The additional following factors should be considered carefully when evaluating our business.

#### ***Fluctuations in Operating Results***

Our future operating results may vary substantially from period to period. The timing and amount of our license fees are subject to a number of factors that make estimating revenues and operating results prior to the end of a quarter uncertain. While we receive recurring revenues from royalty-based license agreements and some agreements contain minimum quarterly royalty commitments, a significant amount of license fees in any quarter is dependent on signing agreements and delivering the licensed software in that quarter. Generally, we experience a pattern of recording 50% or more of our quarterly revenues in the third month of the quarter. We have historically monitored our revenue bookings through regular, periodic worldwide forecast reviews within the quarter. There can be no assurances that this process will result in our meeting revenue expectations. Operating expenses for any year are normally based on the attainment of planned revenue levels for that year and are generally incurred ratably throughout the year. As a result, if revenues were less than planned in any period while expense levels remain relatively fixed; our operating results would be adversely affected for that period. In addition, unplanned expenses could adversely affect operating results for the period in which such expenses were incurred.

#### ***Product Development***

Our long-term success will depend on our ability to enhance existing products and to introduce new products timely and cost-effectively that meet the needs of customers in existing and emerging markets. There can be no assurance that we will be successful in developing new products or in enhancing existing products or that those new and/or enhanced products will be introduced before our competitors make their introductions, or that those products will meet market requirements. Delays in introducing new products can adversely impact acceptance and revenues generated from the sale of such products. We have, from time to time, experienced such delays. Our software products and their enhancements contain complex code that may contain undetected errors and/or bugs when first introduced. There can be no assurance that new products or enhancements will not contain errors or bugs that will adversely affect commercial acceptance of such new products or enhancements. The introduction of new products in the short term will also depend on adoption of our Phoenix cME and applications as well as the overall market demand for PCs and other digital devices.

#### ***Uncertain Geopolitical Environment and Unfavorable Economic and Market Conditions***

Adverse economic conditions in certain geographic regions have contributed to recent slowdowns in the PC and information appliance industries and could continue to impact our business, resulting in:

Reduced demand for our products as a result of a decrease in capital spending by our customers;

Changes in customer production strategies;

Increased price competition for our products, partially as a consequence of price pressure in the PC markets; and

Higher operating expenses as a percentage of revenues.

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

Recent political turmoil in many parts of the world, including terrorist and military actions, may continue to put pressure on global economic conditions. If the global economic and market conditions do not improve, or if they deteriorate further, we may continue to experience material adverse impacts on our business, operating results and financial condition as a consequence of the above factors or otherwise.

#### ***Changes in Industry and Market Conditions***

In response to changes in industry and market conditions, we may be required to strategically realign our resources and consider restructuring, disposing of, or otherwise exiting businesses. Any decision to limit investment in, or dispose of or otherwise exit businesses may result in the recording of special charges, such as technology related write-offs, workforce reduction costs, or changes relating to consolidation of excess facilities. Our estimates with respect to the useful life or ultimate recoverability of our carrying basis of assets, including purchased intangible assets, could change as a result of such assessments and decisions. Further, our estimates relating to the liabilities for excess facilities are affected by changes in real estate market conditions. Additionally, we are required to perform goodwill impairment tests on an annual basis and between annual tests in certain circumstances. There can be no assurance that future goodwill impairment tests will not result in a charge to earnings.

#### ***Dependence on New Product Releases by Our Customers***

Successful introduction of new products is key to our success in both our CSS and new applications businesses. Frequently our new products are used in our customers' new products, making each of us dependent on the other for product introduction schedules. It can happen that a customer may not be able to introduce one of his new products for reasons unrelated to our new product. In these cases, we would not be able to ship our new product until the customer had resolved his other problems.

Due to continued economic downturn and market uncertainties in certain geographic regions, many customers have delayed their product introductions, specifically in the notebook and non-PC segments. If our customers continue to delay their product introductions, our ability to generate revenue from our new application products could be adversely affected.

#### ***Risks in Acquisitions***

Our growth is dependent upon market growth, our ability to enhance our existing products and introduction of new products on a timely basis. We have and will continue to address the need to develop new products through acquisitions of other companies and technologies. Acquisitions involve numerous risks, including the following:

Difficulties in integrating the operations, technologies, products and personnel of the acquired companies;

Diversion of management's attention from normal daily operations of the business;

Potential difficulties in completing projects associated with in-process research and development;

Difficulties in entering markets in which we have no or limited direct prior experience and where competitors in such markets have stronger market positions;

Insufficient revenues to offset increased expenses associated with acquisitions; and

Potential loss of key employees of the acquired companies.

Acquisitions may also cause us to:

Issue common stock that would dilute our current shareholders' percentage ownership;

Assume liabilities;

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

Record goodwill and non-amortizable intangible assets that will be subject to impairment testing and potential periodic impairment charges;

Incur amortization expenses related to certain intangible assets;

Incur large and immediate write-offs of in-process research and development costs; or

Become subject to litigation.

Mergers and acquisitions of high-technology companies are inherently risky, and no assurance can be given that our previous or future acquisitions will be successful or will not adversely affect our business, operating results, or financial condition. Failure to manage and successfully integrate acquisitions we make could harm our business and operating results in a material way. Even when an acquired company has already developed and marketed products, there can be no assurance that product enhancements will be made in a timely fashion or that all pre-acquisition due diligence will have identified all possible issues that might arise with respect to such products.

We have not made acquisitions that result in in-process research and development expenses being charged in an individual quarter. These charges may occur in future acquisitions in any particular quarter resulting in variability in our quarterly earnings.

#### ***Litigation Risks***

From time to time, we become involved in litigation claims and disputes in the ordinary course of business. We are currently involved in several lawsuits. Litigation can be expensive, lengthy and disruptive to normal business operations. Moreover, the results of complex legal proceedings are difficult to predict. An unfavorable resolution of a particular lawsuit could have a material adverse effect on our business, operating results, or financial condition.

#### ***Protection of Intellectual Property***

We rely on a combination of patent, trade secret, copyright, trademark, and contractual provisions to protect our proprietary rights in our software products. There can be no assurance that these protections will be adequate or that competitors will not independently develop technologies that are substantially equivalent or superior to our technology. In addition, copyright and trade secret protection for our products may be unavailable or unreliable in certain foreign countries. As of December 31, 2004, we have been issued 69 patents in the U.S. and had 44 patent applications in process in the United States Patent and Trademark Office. On a worldwide basis, we have been issued 130 patents with respect to our product offerings and have 151 patent applications pending with respect to certain of the products we market. We maintain an active internal program designed to identify employee inventions worthy of being patented. There can be no assurance that any of the pending applications will be approved and patents issued or that our engineers will be able to develop technologies capable of being patented. Also, as the number of software patents increases, we believe that companies that develop software products may become increasingly subject to infringement claims.



There can be no assurance that a third party will not assert that their patents or other proprietary rights are violated by products offered by us. Any such claims, whether or not meritorious, may be time consuming and expensive to defend, can trigger indemnity obligations owed by us to third parties and may have an adverse effect on our business, results of operations and financial condition. Infringement of valid patents or copyrights or misappropriation of valid trade secrets, whether alleged against us, or our customers, and regardless of whether such claims have merit, could also have an adverse effect on our business, results of operations and financial condition.

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

#### ***Effective Tax Rates***

Our future effective tax rates could be adversely affected by earnings being lower than anticipated in jurisdictions where we have varying statutory rates or by changes in tax laws or interpretations thereof.

#### ***Entrance into New or Developing Markets***

As we focus on new market opportunities, we will increasingly compete with large, established suppliers as well as start-up companies. Some of our current and potential competitors may have greater resources, including technical and engineering resources, than we do. Additionally, as customers in these markets mature and expand, they may require greater levels of service and support than we have provided in the past. We expect that demand for these types of service and support may increase in the future. There can be no assurance that we can provide products, service, and support to effectively compete for these market opportunities. Further, provision of greater levels of services may result in a delay in the timing of revenue recognition.

#### ***Changes in Financial Accounting Standards***

We prepare our financial statements in conformity with accounting principles generally accepted in the United States of America ( GAAP ). GAAP are subject to interpretation by the Financial Accounting Standard Board, the American Institute of Certified Public Accountants (AICPA), the SEC and various bodies appointed by these organizations to interpret existing rules and create new accounting policies. Accounting policies affecting software revenue recognition, in particular, have been the subject of frequent interpretations, which have had a profound effect on the way we license our products. As a result of the recent enactment of the Sarbanes-Oxley Act in 2002 and the related scrutiny of accounting policies by the SEC and the various national and international accounting industry bodies, we expect the frequency of accounting policy changes to accelerate. Future changes in financial accounting standards, including pronouncements relating to revenue recognition, may have a significant effect on our reported results.

#### ***Importance of Microsoft and Intel***

For a number of years, we have worked closely with leading software and semiconductor companies in developing standards for the PC industry. Although we remain optimistic regarding relationships with these industry leaders, there can be no assurance that leading software and semiconductor companies will not develop alternative product strategies that could conflict with our product plans and marketing strategies. Action by such companies may adversely impact our business and results of operations. Presently, there is little overlap or conflict in our product offerings, although these companies may incorporate some functionality that has traditionally resided in CSS. We must continuously create new features and functions to sustain, as well as increase, our software's added value to our Customers. There can be no assurances that we will be successful in these efforts.

#### ***Attraction and Retention of Key Personnel***

Our ability to achieve our revenue and operating performance objectives will depend in part on our ability to attract and retain top-tier engineering, sales, marketing, and administrative personnel. Our newer products are based in part on technologies and industry standards that are different from CSS technologies. As such, we need to attract and retain key personnel with expertise in new areas. Accordingly, failure to attract and retain employees with the necessary skills could adversely affect our business and operating results. All of our employees, including executive officers and key personnel, are employees-at-will.

***Dependence on Key Customers; Concentration of Credit***

The loss of any key customer and our inability to replace revenues provided by a key customer may have a material adverse effect on our business and financial condition. Our customer base includes large OEMs in the PC, semiconductor and Internet markets, system integrator value-added resellers, and

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

motherboard manufacturers. As a result, we maintain individually significant receivable balances due from some of them. If these customers fail to meet guaranteed minimum royalty payments and other payment obligations, our operating results and financial condition could be adversely affected. As of December 31, 2004, two customers, accounted for 32% and 10% of our total accounts receivable. There are no other customers with more than 10% of our total accounts receivable.

#### ***Competition***

The markets for our products are intensely competitive and we expect both product and pricing competition to increase. Increased competition could result in pricing pressures, reduced margins, or the failure of one or more of our products to achieve or maintain market acceptance, any of which could adversely affect our business.

The Company competes for CSS sales primarily with in-house research and development ( R&D ) departments of PC manufacturers that may have significantly greater financial and technical resources, as well as closer engineering ties and experience with specific hardware platforms, than those of the Company. Major OEM companies which may use their own internal BIOS R&D personnel include Dell Computer Corporation, Hewlett Packard Company, IBM Corporation (workstation and server only), Toshiba Corporation, and Intel Corporation. In addition, some of these competitors are also our customers. Any inability to effectively manage these complicated relationships with customers and suppliers could have a material adverse effect on our business, operating results, and financial condition and accordingly affect our chances of success.

The Company also competes for system software business with other independent suppliers, including American Megatrends Inc., a privately held company, and other small BIOS companies such as General Software, Inc. and Insyde Software, Inc.

In the applications software area, as with CSS, the Company competes with in-house and third party company solutions to access the protected area of hard drives. Large enterprise solution competitors such as Altiris Incorporated and Symantec Corporation, as well as smaller third party companies such as XPoint Technologies Incorporated and SoftThinks Incorporated are the primary players. The Company's applications that reside in the protected area compete with individual component software and diagnostic and repair software from other companies, as well as with PC manufacturer-developed solutions.

The principal competitive factors in the markets in which we presently compete and may compete in the future include:

The ability to provide a broad range of products and services;

Product performance;

Price;

The ability to introduce new products timely; and

Market share.

***International Sales and Activities***

Revenues derived from the international sales of our CSS product families comprise a majority of total revenues. There can be no assurances that we will not experience significant fluctuations in international revenues. While the major portion of our license fee or royalty contracts are U.S. dollar denominated, we are entering into a number of contracts denominated in local currencies. We have international sales and engineering offices in Germany, the Netherlands, Japan, Korea, Taiwan, Hong Kong, and China. Our operations and financial results may be adversely affected by factors associated with international operations, such as changes in foreign currency exchange rates, uncertainties related to regional economic circumstances, political instability in emerging markets, difficulties in attracting qualified employees, and language, cultural and other difficulties managing foreign operations.

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

***Volatile Market for Phoenix Stock***

The market for our stock is highly volatile. The trading price of our common stock has been, and will continue to be, subject to fluctuations in response to operating and financial results, changes in demand for our products and services, announcements of technological innovations, the introduction and market acceptance of new technologies by us or our competitors, changes in our product mix or product direction or the product mix or direction of our competitors, pricing pressure from our customers and competitors, changes in our revenue mix and revenue growth rates, changes in expectations of growth for the PC industry, the overall trend toward industry consolidation both among our competitors and customers, the timing and size of orders from customers, our ability to achieve targeted cost reductions, as well as other events or factors which we may not be able to influence or control. Statements or changes in opinions, ratings or earnings estimates made by brokerage firms and industry analysts relating to the markets in which we do business, companies with which we compete or relating to us specifically could have an immediate and adverse effect on the market price of our stock. In addition, the stock market has from time to time experienced extreme price and volume fluctuations that have particularly affected the market price for many small capitalization, high-technology companies and have often included factors other than the operating performance of these companies. If our market value decreases below our net book value, we may have to record a charge for impairment of goodwill.

***Certain Anti-Takeover Effects***

Our Certificate of Incorporation, Bylaws and Stockholder Rights Plan and the Delaware General Corporation Law include provisions that may be deemed to have anti-takeover effects and may delay, defer or prevent a takeover attempt that stockholders might consider in their best interests. These include provisions under which members of the Board of Directors are divided into three classes and are elected to serve staggered three-year terms.

***Business Disruptions***

While we have not been the target of software viruses specifically designed to impede the performance of our products, such viruses could be created and deployed against our products in the future. Similarly, experienced computer programmers or hackers may attempt to penetrate our network security or the security of our Web sites from time to time. A hacker who penetrates our network or Web sites could misappropriate proprietary information or cause interruptions of our services. We might be required to expend significant capital and resources to protect against, or to alleviate, problems caused by virus creators and/or hackers. In addition, acts of war, power shortage, natural disasters, acts of terror, and regional and global health risks could impact our ability to conduct business in certain regions. Any of these events could have an adverse effect on our business, results of operations, and financial condition.

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**ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

There have been no material changes to the Company's financial market risks related to changes in interest rates and foreign currency exchange rates from September 30, 2004. Refer to the Company's Annual Report on Form 10-K for the year ended September 30, 2004 for more details.

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### **ITEM 4. CONTROLS AND PROCEDURES**

#### *(a) Evaluation Of Disclosure Controls And Procedures.*

Our Chief Executive Officer and Chief Financial Officer have reviewed, as of the end of the period covered by this report, the effectiveness of the company's disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the Exchange Act)), which are designed to ensure that information relating to the company that is 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 Exchange Act and related regulations. Based on this review, our chief executive officer and our chief financial officer have concluded that, except as discussed below, our disclosure controls and procedures are effective and include adequate controls and procedures to ensure that information relating to the company that is required to be disclosed by us in the reports that we file or submit under the Exchange Act is communicated to the company's management, including our chief executive officer and our chief financial officer, as appropriate to allow timely decisions regarding required disclosure.

In connection with the audit of our consolidated financial statements for the fiscal year ended September 30, 2004, Ernst & Young LLP, our independent registered public accounting firm, identified and reported to management and our audit committee on December 27, 2004 certain matters that it considered to be reportable conditions under standards established by the American Institute of Certified Public Accountants. Specifically, Ernst & Young reported that internal control deficiencies relating to management's proposed solutions to tax related issues and documentation of management's tax conclusions were deficiencies that constituted material weaknesses. In addition, Ernst & Young reported that inadequate management review of the financial statement close process and the lack of technical accounting resources to adequately perform certain significant non-routine financial reporting processes were deficiencies, but were not considered material weaknesses.

We intend to correct the specifically identified internal control deficiencies by taking the following steps, among others:

initiating a search for an in-house accountant with significant corporate tax experience;

reviewing our documentation and review procedures relating to our tax accounts;

and reviewing our financial statement close process.

We believe that the steps we are taking to strengthen to our system of internal controls and our disclosure controls and procedures will be adequate to provide reasonable assurance that the objectives of these control systems will be met. However, because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues, if any, within the Company have been detected. These inherent limitations include the realities that judgments in decision-making can be faulty, and that breakdowns can occur because of simple error or mistake.

#### *(b) Changes in Internal Controls.*



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Except as described above, there were no changes in our internal control over financial reporting that occurred during our last fiscal quarter that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

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### **PART II OTHER INFORMATION**

#### **ITEM 1. LEGAL PROCEEDINGS**

The Company is subject to certain routine legal proceedings that arise in the normal course of its business. The Company believes that the ultimate amount of liability, if any, for any pending claims of any type (either alone or combined), including the legal proceedings described below, will not materially affect the Company's results of operations, liquidity, or financial position taken as a whole. However, the ultimate outcome of any litigation is uncertain, and unfavorable outcomes could have a material adverse impact. Regardless of outcome, litigation can have an adverse impact on the Company due to defense costs, diversion of management resources, and other factors.

*Korean Electronic Certification Authority, Inc. v. Phoenix Technologies Ltd. and Phoenix Technologies (Hungary) Software Licensing, LLC.* On April 21, 2003, the Korean Electronic Certification Authority, Inc., doing business as CrossCert, Inc. ( CrossCert ), filed a motion (the Preliminary Attachment Motion ) in the Suwon District Court in Seoul, Korea, without notice to Phoenix, for a preliminary attachment under Korean law on Phoenix's expected payments from another Phoenix customer, Samsung Electronics Co., Ltd. ( Samsung ). CrossCert obtained the preliminary attachment on April 21, 2003 in the amount of KRW 496,608,750, or approximately USD \$412,000, which effectively enjoined a payment owing to the Company by Samsung. CrossCert's claim relates to a March 30, 2001 license agreement (the CrossCert Agreement ) between CrossCert and Phoenix, under which Phoenix licensed certain software to CrossCert. Phoenix subsequently assigned its rights in the CrossCert Agreement to an affiliate, Phoenix Technologies (Hungary) Software Licensing, LLC ( Phoenix-Hungary ).

On June 14, 2003, CrossCert filed a complaint in the Suwon District Court in Seoul, Korea against both Phoenix and Phoenix-Hungary for breach of contract, seeking a return of the payments made under the CrossCert Agreement in the amount of approximately USD \$825,000, plus interest under Korean law. Phoenix subsequently filed an objection to the Korean's court's jurisdiction over the dispute based on a choice of forum clause in the CrossCert Agreement in which the parties agreed to the exclusive jurisdiction of the courts in Santa Clara County, California for any disputes arising out of the CrossCert Agreement. In October 2003, the Korean court dismissed CrossCert's suit against Phoenix for lack of jurisdiction. Phoenix then filed a motion for cancellation of the preliminary attachment. On November 24, 2004, the Korean court denied Phoenix's motion to cancel the preliminary attachment, and ruled that the preliminary attachment can remain in place because of the pendency of the U.S.-based lawsuit involving the parties (described below). On January 21, 2005, Phoenix deposited KRW 496,608,750, or approximately USD \$412,000, into escrow with the court pending the outcome of the U.S.-based lawsuit, and requested that the court cancel and release the preliminary attachment. The court is expected to cancel and release the preliminary attachment within a few weeks of receipt of Phoenix's deposit. No other deadlines are presently set.

*Phoenix Technologies Ltd. and Phoenix Technologies (Hungary) Software Licensing, LLC v. Korean Electronic Certification Authority, Inc.* On May 7, 2003, Phoenix and Phoenix-Hungary filed suit against CrossCert in Santa Clara County Superior Court in the United States of America for breach of contract, interference with contract, interference with prospective economic advantage and unfair competition under California Business and Professions Code Sections 17200 et seq. The claims in this case relate to the CrossCert Agreement and CrossCert's wrongful filing of the Preliminary Attachment Motion in Korea and its interference with Phoenix's contractual relationship with Samsung. Phoenix seeks damages in the amount of \$150,000 for CrossCert's failure to pay software maintenance fees, as well as all damages caused by CrossCert's wrongful conduct with respect to its filing of the Preliminary Attachment Motion in Korea and interference with prospective economic advantage, including lost goodwill, the extent of which is presently unknown. CrossCert filed a cross-complaint against Phoenix on October 24, 2003 for breach of contract, fraud and unfair competition under California Business and Professions Code Sections 17200 et seq. The parties attempted to mediate the dispute, and conducted a mediation of the case on August 6, 2004. The parties did not reach a settlement in that mediation conference. The court continued the Trial Setting Conference until January 25, 2005 to allow discovery to be conducted. The Court again

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continued the Trial Setting Conference to March 1, 2005. Phoenix anticipates additional discovery in February and there may be motion practice relating to Phoenix's amended complaint, which may necessitate an additional continuance of the Trial Setting Conference. Once the case is at-issue, it will be set for trial no earlier than June 2005.

*USA & Regal Groups, Inc. d.b.a. Sterling Pacific v. Phoenix Technologies Ltd. d.b.a. Phoenix Technologies Asia Pacific, Ltd., Phoenix Technologies Asia Pacific, Ltd., Al Sisto, David Gibbs, George Man and Does 1 through 100, inclusive.* On June 10, 2004, Sterling Pacific filed a complaint against Phoenix in Orange County Superior Court for fraud, negligent misrepresentation, breach of contract, rescission, violation of California Business and Professions Code Sections 17200 et seq., economic duress and common count. The claim arises from a March 31, 2004 Manufacturing License and Distribution Agreement between a subsidiary of Phoenix and Sterling Pacific, under which the Phoenix subsidiary licensed certain technology to Sterling Pacific for the purpose of manufacturing and distributing a Sterling Pacific hardware product. Sterling Pacific seeks return of the amounts paid (USD \$350,000) as well as exemplary damages for the alleged fraud.

The parties agreed to dismiss the suit in Orange County and re-file in Santa Clara County. The complaint was filed in Santa Clara County on September 21, 2004. Phoenix filed a demurrer to the complaint on December 1, 2004, claiming that Sterling Pacific lacked the standing and capacity to sue. In response to the demurrer, Sterling Pacific filed a first amended complaint on January 14, 2005, and the demurrer was taken off the calendar. An initial case management conference was held on January 25, 2005. Another case management conference has been scheduled for February 22, 2005. No other deadlines have been set in this case.

## **ITEM 6. EXHIBITS**

- 31.1 Certification of Principal Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 31.2 Certification of Principal Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 32.1 Certification of Principal Executive Officer Pursuant to 18 U.S.C. Section 1350.
- 32.2 Certification of Principal Financial Officer Pursuant to 18 U.S.C. Section 1350.

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**SIGNATURE**

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.

**PHOENIX TECHNOLOGIES LTD.**

By: /s/ ALBERT E. SISTO

Albert E. Sisto

Chairman, President and Chief Executive Officer

Date: February 9, 2005

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**EXHIBIT INDEX**

| <b>Exhibit<br/>Number</b> | <b>Description</b>                                                                                      |
|---------------------------|---------------------------------------------------------------------------------------------------------|
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