

ART TECHNOLOGY GROUP INC

Form 10-Q

November 08, 2005

Table of Contents

**SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549**

FORM 10-Q

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

**For the Quarterly Period Ended September 30, 2005
OR**

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

**For the Transition Period from to
Commission file number 000-26679**

ART TECHNOLOGY GROUP, INC.

(Exact name of registrant as specified in its charter)

Delaware

(State or other jurisdiction of incorporation or
organization)

04-3141918

(I.R.S. Employer Identification Number)

25 First Street, Cambridge, Massachusetts

(Address of principal executive offices)

02141

(Zip Code)

(617) 386-1000

(Registrant's telephone number, including area code)

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

Yes No

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

Yes No

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

Yes No

As of November 3, 2005 there were 110,136,576 shares of the Registrant's common stock outstanding.

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

**Page
Number**

PART I. FINANCIAL INFORMATION

<u>Item 1. Financial Statements</u>	3
<u> Unaudited Condensed Consolidated Balance Sheets at September 30, 2005 and December 31, 2004</u>	3
<u> Unaudited Condensed Consolidated Statements of Operations for the three and nine months ended September 30, 2005 and 2004</u>	4
<u> Unaudited Condensed Consolidated Statements of Cash Flows for the nine months ended September 30, 2005 and 2004</u>	5
<u> Notes to Unaudited Condensed Consolidated Financial Statements</u>	6
<u>Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	22
<u>Item 3. Quantitative and Qualitative Disclosures About Market Risk</u>	51
<u>Item 4. Controls and Procedures</u>	51

PART II. OTHER INFORMATION

<u>Item 1. Legal Proceedings</u>	53
<u>Item 2. Unregistered Sales of Equity Securities and Use of Proceeds</u>	54
<u>Item 3. Defaults Upon Senior Securities</u>	54
<u>Item 4. Submission of Matters to a Vote of Security Holders</u>	54
<u>Item 5. Other Information</u>	54
<u>Item 6. Exhibits</u>	54

<u>Signature</u>	55
------------------	----

EX-10.1 Offer letter with Julie M.B. Bradley dated July 6, 2005

EX-10.2 Non-Employee Director Compensation Plan

EX-10.3 1999 Outside Direct Stock Option Plan

EX-10.4 1996 Stock Option Plan

EX-31.1 Certification of CEO

EX-31.2 Certification of CFO

EX-32.1 Certification of CEO

EX-32.2 Certification of CFO

Table of Contents**PART I. FINANCIAL INFORMATION****Item 1. Financial Statements**

ART TECHNOLOGY GROUP, INC.
CONDENSED CONSOLIDATED BALANCE SHEETS
(In thousands, except share and per share data)
(UNAUDITED)

	September 30, 2005	December 31, 2004
ASSETS		
Current Assets:		
Cash and cash equivalents	\$ 20,972	\$ 21,310
Marketable securities	8,944	5,197
Accounts receivable, net of reserves of \$658 (\$680 in 2004)	19,814	24,430
Prepaid expenses and other current assets	1,909	1,694
Total current assets	51,639	52,631
Property and equipment, net	2,495	3,120
Long term marketable securities		4,001
Goodwill	27,458	27,458
Intangible assets, net	5,439	7,177
Other assets	1,576	3,416
	\$ 88,607	\$ 97,803

LIABILITIES AND STOCKHOLDERS EQUITY

Current Liabilities:		
Accounts payable	\$ 2,705	\$ 5,186
Accrued expenses	12,469	13,156
Deferred revenue	20,623	25,355
Accrued restructuring, short-term	3,685	6,095
Capital lease obligations, current portion	56	56
Notes payable	208	595
Total current liabilities	39,746	50,443
Capital lease obligations, less current portion	70	112
Accrued restructuring, less current portion	2,339	5,063

Commitments and contingencies (Notes 11 and 13)

Stockholders Equity:

Edgar Filing: ART TECHNOLOGY GROUP INC - Form 10-Q

Preferred stock, \$0.01 par value: authorized 10,000,000 shares; issued and outstanding no shares		
Common stock, \$0.01 par value: authorized 200,000,000 shares; issued and outstanding 110,091,113 shares and 108,141,966 shares at September 30, 2005 and December 31, 2004, respectively	1,101	1,081
Additional paid-in capital	251,010	249,465
Accumulated deficit	(202,644)	(205,235)
Accumulated other comprehensive loss	(3,015)	(3,126)
Total stockholders' equity	46,452	42,185
	\$ 88,607	\$ 97,803

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

Table of Contents

ART TECHNOLOGY GROUP, INC.
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(In thousands, except per share data)
(UNAUDITED)

	Three months ended		Nine months ended	
	September 30,		September 30,	
	2005	2004	2005	2004
Revenues:				
Product licenses	\$ 7,068	\$ 6,376	\$ 19,770	\$ 15,884
Services	15,637	11,105	45,190	32,739
Total revenues	22,705	17,481	64,960	48,623
Cost of Revenues:				
Product licenses	471	447	1,413	1,177
Services	5,911	4,916	16,718	14,826
Total cost of revenues	6,382	5,363	18,131	16,003
Gross Profit	16,323	12,118	46,829	32,620
Operating Expenses:				
Research and development	4,333	3,676	13,470	11,956
Sales and marketing	7,935	6,624	21,730	21,196
General and administrative	2,747	1,946	8,439	5,615
Restructuring charges (benefits)	(52)		823	
Total operating expenses	14,963	12,246	44,462	38,767
Income (loss) from operations	1,360	(128)	2,367	(6,147)
Interest and other income, net	172	175	272	192
Income (loss) before provision for income taxes	1,532	47	2,639	(5,955)
Provision (benefit) for income taxes	22	(4)	48	28
Net income (loss)	\$ 1,510	\$ 51	\$ 2,591	\$ (5,983)
Basic net income (loss) per share	\$ 0.01	\$ 0.00	\$ 0.02	\$ (0.08)

Edgar Filing: ART TECHNOLOGY GROUP INC - Form 10-Q

Diluted net income (loss) per share	\$ 0.01	\$ 0.00	\$ 0.02	\$ (0.08)
Basic weighted average common shares outstanding	109,625	73,882	109,177	73,486
Diluted weighted average common shares outstanding	110,987	74,151	110,823	73,486

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

4

Table of Contents

ART TECHNOLOGY GROUP, INC.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(In thousands)
(UNAUDITED)

	Nine months ended September	
	2005	30, 2004
Cash Flows from Operating Activities:		
Net income (loss)	\$ 2,591	\$ (5,983)
Adjustments to reconcile net income (loss) to net cash used in operating activities:		
Stock-based compensation		11
Depreciation and amortization	3,106	1,451
Non-cash restructuring charge	1,167	
Loss on disposal of fixed assets, net		125
Changes in current assets and liabilities:		
Accounts receivable, net	4,616	1,487
Prepaid expenses and other current assets	(215)	83
Deferred rent	523	707
Accounts payable	(1,471)	660
Accrued expenses	(687)	(2,513)
Deferred revenues	(4,732)	(907)
Accrued restructuring	(5,134)	(7,579)
Net cash used in operating activities	(236)	(12,458)
Cash Flows from Investing Activities:		
Purchases of marketable securities	(6,119)	(8,640)
Maturities of marketable securities	6,373	10,454
Purchases of property and equipment	(931)	(451)
Payment of acquisition costs	(1,010)	
Decrease in other assets	268	25
Net cash provided by (used) in investing activities	(1,419)	1,388
Cash Flows from Financing Activities:		
Proceeds from exercise of stock options	1,045	384
Proceeds from employee stock purchase plan	520	730
Principal payments on notes payable	(387)	
Payments on capital leases	(42)	
Net cash provided by financing activities	1,136	1,114
Effect of Foreign Exchange Rate Changes on Cash and Cash Equivalents	181	(67)
Net Decrease in Cash and Cash Equivalents	(338)	(10,023)

Cash and Cash Equivalents, Beginning of Period	21,310	31,934
Cash and Cash Equivalents, End of Period	\$ 20,972	\$ 21,911

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

5

Table of Contents

ART TECHNOLOGY GROUP, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(1) OPERATIONS AND BASIS OF PRESENTATION

Art Technology Group, Inc. (ATG or the Company) offers an integrated suite of Internet online marketing, commerce and service applications, as well as related application development, integration and support services. The Company was incorporated in 1991 in the State of Delaware and has been a publicly traded corporation since 1999.

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

The accompanying unaudited condensed consolidated financial statements of the Company have been prepared pursuant to the rules of the Securities and Exchange Commission for quarterly reports on Form 10-Q. The disclosures do not include all of the information and footnotes required by accounting principles generally accepted in the United States, and while the Company believes that the disclosures presented are adequate to make the information presented not misleading, these financial statements should be read in conjunction with the audited financial statements and related notes included in the Company's 2004 Annual Report on Form 10-K. In the opinion of management, the accompanying unaudited condensed consolidated financial statements and notes contain all adjustments, consisting of normal recurring accruals, considered necessary for a fair presentation of the Company's financial position, results of operations and cash flows at the dates and for the periods indicated. The operating results for the three and nine months ended September 30, 2005 are not necessarily indicative of the results to be expected for the full year ending December 31, 2005.

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

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

(2) STOCKHOLDERS' EQUITY*Stock-Based Compensation*

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

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

	Three months ended September 30,		Nine months ended September 30,	
	2005	2004	2005	2004
Net income (loss) as reported	\$ 1,510	\$ 51	\$ 2,591	\$ (5,983)
Add: Stock-based compensation expense included in reported net income (loss)				11
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards	(287)	(3,245)	(2,214)	(14,203)
Pro forma net income (loss)	\$ 1,223	\$ (3,194)	\$ 377	\$ (20,175)

Basic and diluted net income (loss) per share

As reported	\$	0.01	\$	0.00	\$	0.02	\$	(0.08)
Pro forma	\$	0.01	\$	(0.04)	\$	0.00	\$	(0.27)

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

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

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

	Three months ended		Nine months ended	
	September 30,		September 30,	
	2005	2004	2005	2004
Net income (loss)	\$ 1,510	\$ 51	\$ 2,591	\$ (5,983)
Weighted average common shares outstanding	109,625	73,882	109,177	73,486
Weighted average common stock equivalents outstanding:				
Employee stock options	1,362	269	1,646	
Total weighted average common stock and common stock equivalents	110,987	74,151	110,823	73,486
Basic net income (loss) per share	\$ 0.01	\$ 0.00	\$ 0.02	\$ (0.08)
Diluted net income (loss) per share	\$ 0.01	\$ 0.00	\$ 0.02	\$ (0.08)

(4) REVENUE RECOGNITION

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

ATG recognizes revenue in accordance with SOP 97-2 and SOP 98-9. Revenues from software license agreements are recognized upon execution of a license agreement and delivery of the software, provided that the fee is fixed or determinable and deemed collectible by management. If conditions for acceptance are required subsequent to delivery, revenues are recognized upon customer acceptance if such acceptance is not deemed to be perfunctory. In multiple element arrangements, ATG uses the residual value method in accordance with SOP 97-2 and SOP 98-9. Revenue earned on software arrangements involving multiple elements that qualify for separate element accounting treatment is allocated to each undelivered element using the relative fair values of those elements based on vendor-specific objective evidence with the remaining value assigned to the delivered element, the software license. Typically, the Company's software licenses do not include significant post-delivery obligations to be fulfilled by the Company and payments are due within a three-month period from the date of delivery. Consequently, license revenue is generally recognized when the software is shipped. Revenues from software support and maintenance or application hosting agreements are recognized ratably over the term of the support and maintenance or application hosting period, which

for application hosting and support and maintenance is typically one year. Customers who have both purchased ATG's software licenses and entered into an application hosting agreement typically have a contractual right to cancel the application hosting agreement with a minimum notice period. ATG enters into reseller arrangements that typically provide for sublicense fees payable to ATG based upon a percentage of ATG's list price. Revenues are recognized under reseller agreements as earned for guaranteed minimum royalties, or based upon actual sales to the resellers. ATG does not grant its resellers the right of return or price protection.

Revenues from professional service arrangements are recognized on either a time-and-materials, proportional performance method or percentage-of-completion basis as the services are performed, provided that amounts due from customers are fixed or determinable and deemed collectible by management. From time to time the Company enters into fixed price service arrangements. In those circumstances in which services are essential to the functionality of the software, the Company applies the percentage-of-completion method, and in those situations when only professional services are provided, the Company applies the proportional performance

Table of Contents

method. Both of these methods require that the Company track the effort expended and the effort expected to complete a project. Amounts collected or billed prior to satisfying the above revenue recognition criteria are reflected as deferred revenue. Deferred revenue primarily consists of advance payments related to support and maintenance agreements and deferred product license revenues.

(5) INCOME TAXES

ATG expects to have no Federal and minimal foreign income taxes in 2005 due to the use of net operating loss carryforwards and the projection of a taxable loss in domestic and foreign locations in 2005. The tax provision recorded in 2005 relates to state and foreign taxes. As a result of net operating losses incurred, and after evaluating its anticipated performance over its normal planning horizon, the Company has provided a full valuation allowance for its net operating loss carryforwards, research credit carryforwards and other net deferred tax assets. For the nine months ended September 30, 2005 and 2004, the Company reversed previously accrued taxes of \$0 and \$105,000, respectively, due to the closure of statutes of limitations in foreign locations. For the three months ended September 30, 2005 and 2004, the Company had no such reversals.

(6) CASH, CASH EQUIVALENTS AND MARKETABLE SECURITIES

ATG accounts for investments in marketable securities under SFAS No. 115, *Accounting for Certain Investments in Debt and Equity Securities*. Under SFAS 115, investments which ATG has the intent and ability to hold to maturity, consisting of cash equivalents and marketable securities, are reported at amortized cost, which approximates fair market value. Cash equivalents are highly liquid investments with maturities at the date of acquisition of less than 90 days. Marketable securities are investment grade debt securities with maturities at the date of acquisition of greater than ninety days. At September 30, 2005 and December 31, 2004, all of ATG's marketable securities were classified as held-to-maturity. The remaining average maturity of ATG's marketable securities was approximately 3.5 months and 9.6 months at September 30, 2005 and December 31, 2004, respectively. At September 30, 2005 all marketable securities were classified as short-term. At December 31, 2004, the average maturity of the marketable securities classified as long-term was 13.6 months. At September 30, 2005 and December 31, 2004, the difference between the amortized cost and market value of ATG's marketable securities resulted in unrealized losses of approximately \$39,000 and \$77,000, respectively. At September 30, 2005 and December 31, 2004, ATG's cash, cash equivalents and marketable securities consisted of the following (in thousands):

	September 30, 2004	December 31, 2004
Cash and cash equivalents:		
Cash	\$ 6,171	\$ 4,360
Money market accounts	10,687	13,529
Commercial paper	794	799
U.S. Treasury and Government Agency securities	3,320	2,622
Total cash and cash equivalents	\$ 20,972	\$ 21,310
Marketable securities		
Corporate debt securities	\$ 7,010	\$ 7,754
U.S. Treasury and Government Agency securities	350	648
Commercial paper	1,584	796
Total marketable securities	\$ 8,944	\$ 9,198

(7) GOODWILL

In accordance with SFAS No. 141, *Business Combinations*, the Company accounts for its business combinations using the purchase method. In accordance with SFAS No. 142, *Goodwill and Other Intangible Assets*, the Company

does not amortize goodwill but instead tests goodwill for impairment at least annually or more frequently upon the occurrence of certain events that may indicate that an impairment has occurred. Intangible assets acquired in conjunction with a business combination are required to be separately recognized if the benefit of the intangible asset obtained is through contractual or other legal rights, or if the intangible asset can be sold, transferred, licensed, rented or exchanged, regardless of the acquirer's intent to do so.

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

Table of Contents

value of the reporting entity's goodwill. If the carrying value of a reporting entity's goodwill exceeds its implied fair value, then the Company records an impairment loss equal to the difference.

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

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

(8) LONG-LIVED ASSETS, INCLUDING INTANGIBLE ASSETS

In accordance with SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, the Company reviews the carrying value of its long-lived assets, including intangible assets subject to amortization, for impairment whenever events and circumstances indicate that their carrying value may not be recoverable. Recoverability of these assets is measured by comparison of their carrying value to the undiscounted cash flows estimated to be generated by those assets over their remaining economic life. If the undiscounted cash flows are not sufficient to recover the assets carrying value, the assets are considered impaired, and the impairment loss is measured by comparing the fair value of the assets to their carrying values. Fair value is determined by either a quoted market price or a value determined by a discounted cash flow technique, whichever is more appropriate under the circumstances involved. Intangible assets with determinable lives are amortized over their estimated useful lives based upon the pattern in which the expected benefits will be realized. The Company has recorded impairment charges as discussed in Note 14.

(9) COMPREHENSIVE INCOME (LOSS)

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

	Three months ended		Nine months ended	
	September 30,		September 30,	
	2005	2004	2005	2004
Net income (loss)	\$ 1,510	\$ 51	\$ 2,591	\$ (5,983)
Foreign currency translation adjustment	24	(29)	111	1
Comprehensive income (loss)	\$ 1,534	\$ 22	\$ 2,702	\$ (5,982)

The accumulated other comprehensive loss at September 30, 2005 and December 31, 2004 of \$3.0 and \$3.1 million, respectively, consisted entirely of the cumulative foreign currency translation adjustment.

(10) DISCLOSURES ABOUT SEGMENTS OF AN ENTERPRISE

SFAS No. 131, *Disclosures About Segments of an Enterprise and Related Information*, establishes standards for reporting information regarding operating segments in annual financial statements and requires selected information for those segments to be presented in interim financial reports. SFAS 131 also establishes standards for related disclosures about products and services and geographic areas. Operating segments are identified as components of an enterprise for which separate discrete financial information is available for evaluation by the chief operating decision-maker or decision-making group in making decisions on how to allocate resources and assess performance. The Company's chief operating decision-maker, as defined under SFAS 131, is its executive management team. To date, the Company has viewed its operations and manages its business as principally one segment with two product offerings: software licenses and services. The Company evaluates these product offerings based on their respective gross margins. As a result, the financial information disclosed in the consolidated financial statements represents all of

the material financial information related to the Company's principal operating segment. Revenues from sources outside of the United States were approximately \$5.4 million and \$3.6 million for the three months ended September 30, 2005 and 2004, respectively, and \$15.6 million and \$14.4 million for the nine months ended September 30, 2005 and 2004, respectively. ATG's revenues from international sources were primarily generated from customers located in Europe and the

Table of Contents

Asia/Pacific region. All of ATG's product license sales for the three and nine months ended September 30, 2005 and 2004 were delivered from its headquarters located in the United States.

The following table represents the percentage of total revenues by geographic region for the three and nine months ended September 30, 2005 and 2004:

	Three months ended		Nine months ended	
	September 30,		September 30,	
	2005	2004	2005	2004
United States	76%	80%	76%	70%
United Kingdom (UK)	11	4	11	10
Europe, Middle East and Africa (excluding UK)	12	15	12	17
Asia Pacific	1		1	
Other		1		3
	100%	100%	100%	100%

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

On June 13, 2002, ATG entered into a \$15 million revolving line of credit with Silicon Valley Bank (the Bank) which provided for borrowings of up to the lesser of \$15 million or 80% of eligible accounts receivable. Effective December 24, 2002 the revolving line of credit increased to \$20 million. The line of credit bears interest at the Bank's prime rate (6.75% at September 30, 2005). The line of credit is secured by all of the Company's tangible and intangible intellectual and personal property and is subject to financial covenants including liquidity coverage and profitability. On December 24, 2004, the Company entered into the Seventh Loan Modification Agreement (the Seventh Amendment) with the Bank, which amended the Amended and Restated Loan and Security Agreement dated as of June 13, 2002. Under the Seventh Amendment, the profitability covenant was revised to allow for a quarterly net loss not to exceed \$1.5 million for the third quarter of 2005, and to require net profitability of at least \$1.00 for the fourth quarter of 2005 and for each quarter thereafter. The Company is required to maintain unrestricted and unencumbered cash, which includes cash equivalents and marketable securities, of \$20 million at the end of each month.

To avoid additional bank fees and expenses, the Company is required to maintain unrestricted cash, which includes cash equivalents and marketable securities, at the Bank in an amount equal to two times the amount of obligations outstanding, which includes letters of credit (LCs) that have been issued but not drawn upon, under the loan agreement. In the event the Company's cash balance at the Bank falls below this amount, the Company will be required to pay fees and expenses to compensate the Bank for lost income. At September 30, 2005, ATG was in compliance with all financial covenants under the credit facility. In the event that ATG does not comply with any of the financial covenants within the line of credit or defaults on any of its provisions, the Bank's significant remedies include: (1) declaring all obligations immediately due and payable, which could include requiring ATG to cash collateralize its outstanding LCs; (2) ceasing to advance money or extend credit for the Company's benefit; (3) applying to the obligations any balances and deposits held by the Company or any amount held by the Bank owing to or for the credit or the account of ATG; and (4) putting a hold on any deposit account held as collateral. If the agreement expires, or is not extended, the Bank will require outstanding LCs at that time to be cash secured on terms acceptable to the Bank. The revolving line of credit expires on December 24, 2005. While there were no outstanding borrowings under the facility at September 30, 2005, the Bank has issued LCs totaling \$7.1 million, which are supported by this facility. The LCs have been issued in favor of various landlords and equipment leasing companies to secure obligations under ATG's facility leases pursuant to leases expiring from August 2006 through March 2009. As of September 30, 2005, approximately \$12.9 million was available under the facility.

Notes Payable

In connection with the November 2004 acquisition of Primus, the Company assumed Primus' outstanding obligation of \$297,000 under a credit facility with a bank. The facility is payable in monthly installments of \$11,000,

including interest at the bank's prime rate plus 2% (6.5% at September 30, 2005 and 6.75% at December 31, 2004), due June 2008. The facility is callable on demand. The loan is denominated in British pounds. At September 30, 2005 and December 31, 2004, the balance on the note was \$208,000 and \$295,000, respectively.

On November 1, 2004, the Company entered into a settlement agreement with ServiceWare Technologies, Inc. (ServiceWare) related to ServiceWare allegation that Primus had infringed certain patents owned by ServiceWare. As part of the settlement, the

Table of Contents

Company was required to make cash payments totaling \$800,000, of which \$500,000 was paid during 2004 and \$300,000 was included in notes payable at December 31, 2004 and was subsequently paid in January 2005.

(12) ACQUISITION OF PRIMUS

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

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

The consolidated financial statements include the results of Primus from the date of acquisition. The purchase price has been allocated based on estimated fair values as of the acquisition date. After allocating the purchase price to the acquired net tangible and intangible assets, the Company recorded \$27.5 million of goodwill. The allocation of the purchase price is preliminary and could be adjusted due to settlement of litigation (see Note 15) or other matters that were not identified at the acquisition date. As of September 30, 2005 the Company has made no adjustments to the goodwill.

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

	September 30, 2005			December 31, 2004		
	Gross Carrying Amount	Accumulated Amortization	Net Book Value	Gross Carrying Amount	Accumulated Amortization	Net Book Value
Purchased technology	\$ 3,600	\$ (1,054)	\$ 2,546	\$ 3,600	\$ (441)	\$ 3,159
Customer relationships	4,200	(1,585)	2,615	4,200	(559)	3,641
Non-compete agreements	400	(122)	278	400	(23)	377
Total intangible assets, excluding goodwill	\$ 8,200	\$ (2,761)	\$ 5,439	\$ 8,200	\$ (1,023)	\$ 7,177

Amortization expense from intangible assets was \$580,000 and \$1.7 million for the three and nine months ended September 30, 2005, respectively. As of September 30, 2005, amortization expense on existing intangibles for the next five years is as follows (in thousands):

Remainder of 2005	\$ 580
2006	2,055
2007	1,740
2008	848
2009	216
Total	\$ 5,439

In connection with the Primus acquisition, integration activities resulted in involuntary terminations of employment and lease and contract terminations. As part of the purchase price of the acquisition, the Company recorded restructuring costs of \$2.1 million for these activities comprised of \$1.7 million for involuntary termination benefits

and \$400,000 for facilities-related costs. The liability for involuntary termination benefits was for 49 employees, primarily in general and administrative and research and development functions.

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

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

Category	Balance at December 31, 2004	Payments	Balance at September 30, 2005
Involuntary termination benefits	\$ 1,218	\$ (1,110)	\$ 108
Facilities-related costs	279	(251)	28
Total	\$ 1,497	\$ (1,361)	\$ 136

Table of Contents

The balance of \$136,000 in costs associated with the integration activities at September 30, 2005 is included in accrued expenses.

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

ATG has offices, primarily for sales and support personnel, in six domestic locations as well as four foreign countries. At September 30, 2005, ATG's bank had issued \$7.1 million of LCs under ATG's line of credit in favor of various landlords and equipment leasing companies to secure obligations under its leases, which expire from 2005 through 2009.

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

The future minimum payments of ATG's facility leases and operating and capital lease obligations as of September 30, 2005, were as follows (in thousands):

	Leases
Remainder of 2005	\$ 2,030
2006	5,926
2007	2,997
2008	2,488
2009	704
 Total future minimum lease payments	 \$ 14,145

Of the \$14.1 million in future minimum lease payments, \$9.7 million is included in the Company's accrued restructuring charges. The \$9.7 million is reduced to a \$5.8 million restructuring accrual after taking into consideration estimated sublease income, contracted sublease income, vacancy periods and operating costs of the various subleased properties (see Note 14).

Rent expense included in the accompanying statements of operations was approximately \$1.0 million and \$1.2 million for the three months ended September 30, 2005 and 2004, and \$3.2 million and \$3.6 million for the nine months ended September 30, 2005 and 2004, respectively.

Indemnification

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

With respect to software license agreements, these indemnifications generally include provisions indemnifying the customer against losses, expenses, and liabilities from damages that may be awarded against the customer in the event the Company's software is found to infringe upon the intellectual property of others. The software license agreements generally limit the scope of and remedies for such indemnification obligations in a variety of industry-standard respects. The Company relies on a combination of patent, copyright, trademark and trade secret laws and restrictions on disclosure to protect its intellectual property rights. The Company believes such laws and practices, along with its internal development processes and other policies and practices limit its exposure related to the indemnification provisions of the software license agreements. However, in recent years there has been significant litigation in the United States involving patents and other intellectual property rights. Companies providing Internet-related products and services are increasingly bringing and becoming subject to suits alleging infringement of proprietary rights, particularly patent rights. From time to time, the Company's customers have been subject to third party patent claims and the Company has agreed to indemnify such customers from claims to the extent the claims relate to the Company's products.

With respect to real estate lease agreements or settlement agreements with landlords, these indemnifications typically apply to claims asserted against the landlord relating to personal injury and property damage at the leased premises or to certain breaches of the Company's contractual obligations or representations and warranties included in

the settlement agreements. These indemnification provisions generally survive the termination of the respective agreements, although the provision generally has the most relevance during the contract term and for a short period of time thereafter. The maximum potential amount of future payments that the

Table of Contents

Company could be required to make under these indemnification provisions is unlimited. The Company has purchased insurance that reduces its monetary exposure for landlord indemnifications.

(14) RESTRUCTURING

During the quarter ended September 30, 2005, the Company recorded a net restructuring benefit of \$52,000 for adjustments in estimates relative to sublease costs included in the accruals related to the 2001 and 2002 actions as well as adjustments in estimates relative to severance costs included in the accruals related to the 2004 action. During the quarter ended June 30, 2005, the Company recorded a net restructuring charge of \$671,000, primarily due to a \$1.8 million charge related to the relocation of its San Francisco office and other facility charges; offset by \$1.1 million for adjustments in estimates related to sublease costs included in the accruals relative to the 2001, 2002 and 2004 actions. During the quarter ended March 31, 2005, the Company recorded a net restructuring charge of approximately \$204,000 due to adjustments in estimates related to the 2004 restructuring charge for employee severance benefits payable in international geographies. During the years ended 2004, 2003, 2002 and 2001, the Company recorded net restructuring charges/(benefits) of \$3.6 million, \$(10.5) million, \$19.0 million and \$75.6 million, respectively, as a result of the global slowdown in information technology spending. The significant drop in demand in 2001 for technology oriented products, particularly internet related technologies, caused management to significantly scale back the Company's prior growth plans, resulting in a significant reduction in the Company's workforce and consolidation of the Company's facilities in 2001. Throughout 2002, the continued softness of demand for technology products, as well as near term revenue projections, caused management to further evaluate the Company's marketing, sales and service resource capabilities as well as its overall general and administrative cost structure, which resulted in additional restructuring actions being taken in 2002. These actions resulted in a further reduction in headcount and consolidation of additional facilities. In 2003, as the Company continued to refine its business strategy and to consider future revenue opportunities, the Company took further restructuring actions to reduce costs, including product development costs, in order to help move the Company towards profitability. In 2004, the Company's restructuring activities were undertaken to align the Company's headcount more closely with management's revenue projections and changing staff requirements as a result of strategic product realignments and the Company's acquisition of Primus, and to eliminate facilities that were not needed in order to efficiently run the Company's operations. The charges referred to above primarily pertain to the closure and consolidation of excess facilities, impairment of assets, employee severance benefits, and the settlement of certain contractual obligations. The 2005, 2004 and 2003 charges were recorded in accordance with SFAS No. 146, *Accounting for Costs Associated with Exit or Disposal Activities*, SFAS No. 88, *Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits* and Staff Accounting Bulletin (SAB) No. 100, *Restructuring and Impairment Charges*. The 2002 and 2001 charges were recorded in accordance with Emerging Issues Task Force Issue No. 94-3, *Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (Including Certain Costs Incurred in a Restructuring)*, SFAS 88 and SAB 100.

2001 Actions

Actions taken by the Company in 2001 included the consolidation and closure of excess facilities, a worldwide workforce reduction, the write-off of certain unrealizable assets and settling certain obligations that had no future benefit. In the second quarter of 2001, the Company recorded a restructuring charge of \$44.2 million, and in the fourth quarter of 2001, the Company recorded a restructuring charge of \$31.4 million. In connection with these actions, the Company also recorded in cost of product licenses an impairment charge for purchased software of \$1.4 million. Total restructuring charges for 2001 totaled \$75.6 million.

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

Accrued Restructuring Balance as of December 31, 2004	2005 Adjustments in Estimates Resulting in Reduced Charges	Payments	Accrued Restructuring Balance as of September 30, 2005
--	---	-----------------	---

Edgar Filing: ART TECHNOLOGY GROUP INC - Form 10-Q

Facilities-related costs and impairments	\$	6,254	\$	(792)	\$	(1,941)	\$	3,521
Employee severance, benefits and related costs		57				(57)		
Total	\$	6,311	\$	(792)	\$	(1,998)	\$	3,521

Facilities-Related Costs and Impairments

During 2001, the Company recorded facilities-related charges of \$59.4 million of which \$38.1 million was recorded in the second quarter and \$21.3 million was recorded in the fourth quarter. The facilities-related charges comprise excess rental space for offices worldwide, net of estimates for vacancy periods and sublease income based on the then-current real estate market data, and related

Table of Contents

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

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

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

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

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

During 2005, the Company recorded an adjustment to its estimates of sublease costs related to the 2001 actions, resulting in a credit to the restructuring charge of \$792,000. The change in estimate was primarily due to the Company's continued evaluation of the financial condition of its subtenants and their ability to meet their financial obligations to the Company.

Employee Severance, Benefits and Related Costs and Exchangeable Shares

As part of the 2001 restructuring actions, the Company recorded charges of \$7.9 million for employee severance. The Company terminated the employment of 530 employees, or 46% of the Company's workforce, of which 249 were from sales and marketing, 117 from services, 101 from general and administrative and 63 from research and development. None of these employees remained employed as of September 30, 2002. In addition, the Company settled 11,762 exchangeable shares with an employee, who was terminated in connection with the restructuring action, and recorded \$1.3 million as a charge to restructuring for this settlement.

During 2003, the Company recorded additional charges of \$229,000 for severance related to an employee terminated as part of the 2001 restructuring action.

During 2004, the Company reached a final settlement with this employee, resulting in a reduction to the restructuring charge of \$172,000.

Asset Impairments

The asset impairment charges included the write-off of approximately \$4.0 million of the remaining unamortized goodwill related to the two professional service organizations acquired in 2000. The Company had closed these

operations and terminated the employees as part of the 2001 restructuring action, and as a result, the unamortized goodwill was impaired and had no future value. In addition, the Company recorded an impairment charge of approximately \$1.4 million in cost of product license revenues related to

Table of Contents

purchased software to record the software at its net realizable value of zero due to the Company abandoning a certain product development strategy. The purchased software had no future use to the Company.

Marketing Costs and Legal and Accounting

The Company recorded charges of \$851,000 to write off certain prepaid costs for future marketing services to their fair value of zero due to changes in the Company's product development strategy, as a result of which, the prepaid marketing cost had no future utility to the Company.

During 2002, the Company unexpectedly was able to recoup \$536,000 and recorded a credit for the amount received.

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

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

2002 Actions

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

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

	Accrued Restructuring Balance as of December 31, 2004	2005 Adjustments in Estimates Resulting in Reduced Charges	Payments	Accrued Restructuring Balance as of September 30, 2005
Facilities-related costs and impairments	\$ 1,155	\$ (48)	\$ (429)	\$ 678

Facilities-Related Costs and Impairments

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

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

During 2003, the Company recorded an adjustment of \$1.9 million primarily to increase its lease obligation accrual at two locations because of changes in assumptions as to the vacancy period and sublease income. The sublease income was adjusted by decreasing anticipated sublease rates from \$23 to \$18 per square foot for one location and from \$35 to \$30 per square foot at the other location. The Company also extended the initial vacancy periods from 12

to 21 months to 24 to 42 months. These changes resulted in an estimated reduction of sublease income of \$1.8 million. In addition, principally due to a favorable lease settlement relating to its 2002 restructuring activities, the Company reduced its lease obligations by \$7.2 million. The settlement resulted in the Company

Table of Contents

terminating a future lease obligation for an aggregate payment of \$3.3 million, which was paid in January 2004. As a result of this transaction, the Company recorded prepaid rent of \$2.2 million, increasing the accrual adjustments in 2003 to \$4.1 million.

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

The Company executed a sub-lease agreement during the three months ended June 30, 2005. As a result, the Company recorded an adjustment to its estimates of sublease costs related to the 2002 actions, resulting in a credit to the restructuring charge of \$36,000. During the three months ended September 30, 2005 the Company made an adjustment in estimate resulting in a \$12,000 credit.

Employee Severance, Benefits and Related Costs

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

2003 Actions

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

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

	Accrued Restructuring Balance as of December 31, 2004	2005 Adjustments in Estimates Resulting in Reduced Charges	Payments	Accrued Restructuring Balance as of September 30, 2005
Facilities-related costs and impairments	\$ 1,373	\$ (24)	\$ (309)	\$ 1,040

Second Quarter 2003 Actions

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

Facilities-Related Costs and Impairments

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

accordance with SFAS 146, the Company recorded the present value of the net lease obligation.

As a result of a reduction of employees and closure of an office location, the Company wrote off computer and office equipment to their fair value based on the expected discounted cash flows they would generate over their remaining economic life. Due to the short remaining economic life and current market conditions for such assets, the fair value of these assets was estimated to be zero. These

Table of Contents

assets ceased being used by June 30, 2003 and were disposed of by September 30, 2003. In addition, the Company wrote off leasehold improvements, which continue to be in use and are related to the facility it is attempting to sublease, to their fair value of zero because the estimated cash flows to be generated from that location will not be sufficient to recover the carrying value of the assets.

Employee Severance, Benefits and Related Costs

As part of the second quarter 2003 restructuring action, the Company recorded a charge of \$927,000 for severance and benefit costs related to cost reduction actions taken across the worldwide employee base. The severance and benefit costs were for 32 employees, or 7.4% of the Company's workforce, consisting of 11 employees from sales and marketing, 3 from services, 3 from general and administrative and 15 from research and development. The Company accrued employee benefits pursuant to its ongoing benefit plans for domestic locations and under statutory minimum requirements in foreign locations. All employees were notified of their termination as of June 30, 2003. The termination process was completed during the fourth quarter of 2003. During the third quarter of 2003, the Company accrued an additional \$69,000 for employees at its foreign locations based on management's best estimate of the final payments for severance. During the fourth quarter of 2003, the Company reduced certain severance accruals by \$84,000 at its international locations as a result of final settlements.

Asset Impairments

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

Third Quarter 2003 Actions

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

Facilities-Related Costs and Impairments

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

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

Employee Severance, Benefits and Related Costs

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

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

Table of Contents

During 2005, the Company recorded an adjustment to its cost estimates related to the 2003 actions, resulting in a credit to the restructuring charge of \$24,000.

2004 Actions

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

Facilities-Related Costs and Impairments

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

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

Employee Severance, Benefits and Related Costs

As part of the fourth quarter 2004 restructuring action, the Company recorded a charge of \$2.5 million for severance and benefit costs related to cost reduction actions taken across the worldwide employee base. The severance and benefit costs were for 56 employees, or 14% of the Company's workforce, consisting of 27 employees from sales and marketing, 8 from services, 6 from general and administrative and 15 from research and development. The Company accrued employee benefits pursuant to its ongoing benefit plans for domestic locations and under statutory minimum requirements in foreign locations. All employees were notified of their termination as of December 31, 2004. As of December 31, 2004, 13 employees had been terminated. As of June 30, 2005 the termination process was completed.

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

	Accrued Restructuring Balance as of December 31, 2004	2005 Adjustments in Estimates Resulting in Additional (Decreased) Charges	Payments	Accrued Restructuring Balance as of September 30, 2005
Facilities-related costs and impairments	\$ 750	\$ (267)	\$ (303)	\$ 180
Employee severance, benefits and related costs	1,569	137	(1,508)	198
Total	\$ 2,319	\$ (130)	\$ (1,811)	\$ 378

During the first quarter of 2005, the Company recorded a restructuring charge of \$200,000, resulting from adjustments to estimates made in 2004 for employee severance benefits payable in international geographies, and a \$4,000 charge to facilities related cost due to adjusting its estimates.

During the second and third quarter of 2005, the Company recorded credits of \$32,000 and \$31,000, respectively, to the employee severance costs due to adjusting its estimates. During the second quarter of 2005, the Company recorded a credit of \$271,000 to the facilities related cost charge, due to adjusting its estimates of net sublease obligations as a result of executing a sub lease agreement for which the term began in the second quarter of 2005.

2005 Actions

During 2005, the Company recorded net restructuring charges of \$823,000, comprised of costs related to new actions of \$1.8 million and net credits resulting from changes in estimates related to prior actions of \$1.0 million.

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

During the second quarter of 2005, the Company relocated its San Francisco office and reduced the amount of space it occupies in San Francisco. As a result of this action and other minor facilities charges, the Company recorded facilities-related charges of \$1.8 million primarily comprised of \$1.0 million of deferred rent related to the abandoned space, \$118,000 of leasehold improvements written down to their fair value, and \$557,000 for an operating lease related to idle office space vacated during the second quarter of 2005, net of assumptions for sublease income based on an executed sublease agreement. In accordance with SFAS 146, the Company recorded the net present value of the net lease obligation.

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

	2005	Write-Offs and	Balance as of
	Charges	Payments	September 30, 2005
Facilities-related costs and impairments	\$ 1,817	\$ (1,410)	\$ 407

Abandoned Facilities Obligations

At September 30, 2005, the Company had lease arrangements related to seven abandoned facilities. The lease arrangements with respect to six of these facilities are ongoing, and one is the subject of a lease settlement arrangement under which the Company is obligated to make payments through 2006. All locations for which the Company has recorded restructuring charges have been exited, and thus management's plans with respect to these leases have been completed. A summary of the remaining facility locations and the timing of the remaining cash payments are as follows (in thousands):

Lease locations	2005	2006	2007	2008	2009	Total
Cambridge, MA*	\$ 517	\$ 1,035				\$ 1,552
Cambridge, MA	34	91				125
Cambridge, MA	100	400				500
Waltham, MA	362	1,452	\$ 1,452	\$ 1,452	\$ 363	5,081
Chicago, IL	160	427				587
San Francisco, CA	128	513	512			1,153
Reading, UK	142	570	570	570	142	1,994
Facility obligations, gross	1,443	4,488	2,534	2,022	505	10,992
Contracted and assumed sub-lease income	(513)	(1,718)	(1,467)	(1,215)	(304)	(5,217)
Net cash obligations	\$ 930	\$ 2,770	\$ 1,067	\$ 807	\$ 201	\$ 5,775
Assumed sub-lease income	\$	\$ 135	\$ 270	\$ 270	\$ 67	\$ 742

* represents a location for which the Company executed a lease settlement agreement

(15) LITIGATION

The Company and certain former officers have been named as defendants in seven purported class action suits that have been consolidated into one action currently pending in the United States District Court for the District of Massachusetts under the caption *In re Art Technology Group, Inc. Securities Litigation* (Master File No. 01-CV-11731-NG). This case alleges that the Company and certain former officers have violated Sections 10(b) and 20(a) of the Securities Exchange Act of 1934 and SEC Rule 10b-5 promulgated thereunder, which generally may subject issuers of securities and persons controlling those issuers to civil liability for fraudulent actions in connection with the purchase and sale of securities. The case was originally filed in 2001, and a consolidated amended complaint was filed in March 2002. In April, 2002, the Company filed a motion to dismiss the case. On September 4, 2003 the court issued a ruling dismissing all but one of the plaintiffs' allegations. The remaining allegation was based on the veracity of a public statement made by a former officer of the Company. In August 2004, the Company filed a renewed motion to dismiss and motion for summary judgment as to the remaining allegation, which the court granted in September 2005. The plaintiffs have moved for leave to file a second consolidated amended complaint, which, if allowed, would revive some of the claims previously dismissed by the court. The court has deferred a final order of dismissal of plaintiffs' case to allow it time to consider plaintiffs' motion for leave to file a second consolidated amended complaint. The Company has opposed that motion. Management believes that none of the claims that plaintiffs seek to assert in their second amended complaint has merit, and intends to continue to defend the action vigorously. While management cannot predict with certainty the outcome of the litigation, management does not expect any material adverse impact to the Company's business, or the results of its operations, from this matter.

Table of Contents

The Company's wholly owned subsidiary Primus Knowledge Solutions, Inc. (Primus), two former officers of Primus, and FleetBoston Robertson Stephens, Inc., J.P. Morgan Securities Inc., U.S. Bancorp Piper Jaffray Inc., CIBC World Markets, Dain Rauscher, Inc. and Salomon Smith Barney Holdings Inc., the underwriters of Primus' initial public offering, have been named as defendants in an action filed in December 2001 in the United States District Court for the Southern District of New York under the caption *In re Primus Knowledge Solutions, Inc. Securities Litigation*, Civil Action 01-Civ.-11201 (SAS) on behalf of a purported class of purchasers of Primus common stock during the period from June 30, 1999 through December 6, 2000, which was issued pursuant to the June 30, 1999 registration statement and prospectus for Primus' initial public offering. The consolidated and amended complaint asserts claims under Sections 11 and 15 of the Securities Act of 1933 and Sections 10(b) (and SEC Rule 10b-5 promulgated thereunder) and 20(a) of the Securities Exchange Act of 1934. This action is one of more than 300 similar actions coordinated for pretrial purposes under the caption *In re Initial Public Offering Securities Litigation*, Civil Action No. 21-MC-92. Plaintiffs in these coordinated proceedings have brought claims under the federal securities laws against underwriters, companies, and individuals, alleging generally that defendant underwriters engaged in improper and undisclosed activities concerning the allocation of shares in the IPOs of more than 300 companies during the period from late 1998 through 2000. Among other things, the plaintiffs allege that the prospectus pursuant to which shares of Primus common stock were sold in the IPO contained certain false and misleading statements regarding the practices of Primus' underwriters with respect to their allocation of shares of common stock in Primus' IPO to their customers and their receipt of commissions from those customers related to such allocations, and that such statements and omissions caused Primus' post-IPO stock price to be artificially inflated. On February 19, 2003, the Court denied in part and granted in part the motion to dismiss filed on behalf of defendants, including Primus. The Court's order did not dismiss any claims against Primus. The individual defendants have been dismissed from the action without prejudice pursuant to a tolling agreement. By action of a special committee of disinterested directors (who were neither defendants in the litigation nor members of Primus' Board of Directors at the time of the actions challenged in the litigation), Primus decided to accept a settlement proposal presented to all issuer defendants. In the settlement plaintiffs will dismiss and release all claims against Primus and the individual defendants in exchange for a contingent payment by the insurance companies collectively responsible for insuring the issuers in all of the consolidated IPO cases, and for the assignment or release of certain potential claims that Primus may have against the underwriters. Primus will not be required to make any cash payments in the settlement, unless the pro rata amount paid by the insurers in the settlement on Primus' behalf exceeds the amount of the insurance coverage, a circumstance that management believes is not likely to occur. A stipulation of settlement of claims against the issuer defendants, including Primus, was submitted to the Court for preliminary approval in June 2004. On August 31, 2005, the Court granted preliminary approval of the settlement. The settlement is subject to a number of conditions, including final Court approval after proposed settlement class members have an opportunity to object or opt out. If the settlement does not occur, and litigation against Primus continues, management believes the Company has meritorious defenses and intends to defend the case vigorously. While management cannot predict with certainty the outcome of the litigation or whether the settlement will be approved, management does not expect any material adverse impact to the Company's business, or the results of its operations, from this matter.

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

(16) CONCENTRATION OF CREDIT RISK

ATG provides credit to customers in the normal course of business. Credit is extended to new customers based upon industry reputation and demonstrated financial stability. Credit is extended to existing customers based upon prior payment history and demonstrated financial stability. Credit risk associated with accounts receivable is limited due to the large number of customers and their dispersion over multiple industries and geographic areas. ATG maintains an allowance for potential credit losses but historically has not experienced any significant losses related to individual customers or groups of customers in any particular industry or geographic area. There were no customers at September 30, 2005 that accounted for greater than 10% of accounts receivable. At December 31, 2004 one customer accounted for 11% of accounts receivable.

(17) RECENT ACCOUNTING PRONOUNCEMENTS

In December 2004, the Financial Accounting Standards Board issued SFAS No. 123R, *Share-Based Payment*, which replaces SFAS 123 and supersedes APB Opinion 25. SFAS 123R requires all share-based payments to employees, including grants of employee stock options, to be recognized in the financial statements based on their fair values. The pro forma disclosures previously permitted under SFAS 123 no longer will be an alternative to financial statement recognition. The Company is required to adopt SFAS 123R on January 1, 2006.

Table of Contents

Public companies are required to adopt the new Standard using a modified prospective method or may elect to restate prior periods using the modified retrospective method. Under the modified prospective method, companies are required to record compensation cost for new and modified awards over the related vesting period of such awards prospectively and record compensation cost prospectively for the unvested portion, at the date of adoption, of previously issued and outstanding awards over the remaining vesting period of such awards. No change to prior periods presented is permitted under the modified prospective method. Under the modified retrospective method, companies record compensation costs for prior periods retroactively through restatement of such periods using the exact pro forma amounts disclosed in the companies' footnotes. Also, in the period of adoption and after, companies record compensation cost utilizing the modified prospective method. The Company has not yet determined the method of adoption it will use and the Company has not completed its evaluation of the effects of adopting SFAS 123R.

Table of Contents

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

Overview

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

Between December 1991, when we were founded, and 1995, we devoted our efforts principally to building, marketing and selling our professional services capabilities and to research and development activities related to our software products. Beginning in 1996, we began to focus on selling our software products. To date, we have enhanced and released several versions of our products.

We derive our revenues from the sale of software licenses and related services that help consumer-facing organizations create an interactive experience for their customers and partners via the Internet and other channels. Our software licenses are priced based on either the size of the customer implementation or site license terms. Services revenues are derived from fees for professional services, training, support and maintenance, and application hosting. Professional services include implementation, custom application development and project and technical consulting. We bill professional service fees primarily on a time and materials basis or in some cases, on a fixed-price schedule defined in our contracts. Support and maintenance arrangements are priced based on the level of services provided. Generally, customers are entitled to receive software updates, maintenance releases as well as on-line and telephone technical support for an annual maintenance fee. Training is billed as services are provided. Revenue from application hosting services are recognized monthly as the services are provided. We market and sell our products worldwide through our direct sales force, systems integrators, technology alliances and original equipment manufacturers.

On November 1, 2004, we acquired all of the outstanding shares of common stock of Primus Knowledge Solutions, Inc., a provider of software solutions that enabled companies to deliver a superior customer experience via contact centers, information technology help desks, web (intranet and internet) self-service and electronic communication channels. The consolidated financial statements include Primus' financial results from the date of acquisition.

As of September 30, 2005 we had offices in the United States, United Kingdom, France, Spain and Northern Ireland with sales personnel in United States, United Kingdom, France, and Spain. Revenues from customers outside the United States accounted for 24% and 20% of our total revenues for the three months ended September 30, 2005 and 2004, and 24% and 30% of our total revenues for the nine months ended September 30, 2005 and 2004, respectively.

Critical Accounting Policies and Estimates

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

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

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

Table of Contents*Revenue Recognition*

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

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

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

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

Accounts Receivable and Bad Debt

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

Research and Development Costs

We account for research and development costs in accordance with SFAS No. 2, *Accounting for Research and Development Costs*, and SFAS No. 86, *Accounting for the Costs of Computer Software to be Sold, Leased, or Otherwise Marketed*, which specifies that costs incurred internally to develop computer software products should be charged to expense as incurred until technological feasibility is reached for the product. Once technological feasibility is reached, all software costs should be capitalized until the

Table of Contents

product is made available for general release to customers. Judgment is required in determining when technological feasibility is established. We believe that the time period from reaching technological feasibility until the time of general product release is very short. Costs incurred after technological feasibility is reached are not material, and accordingly, all such costs are charged to research and development expense as incurred.

Restructuring Expenses

During the three months ended September 30, 2005, the Company recorded a net restructuring credit of approximately \$52,000. During the nine months ended September 30, 2005, the Company recorded a net restructuring charge of \$823,000. During the years ended 2004, 2003, 2002 and 2001, the Company recorded net restructuring charges/ (benefits) of \$3.6 million, \$(10.5) million, \$19.0 million and \$75.6 million, respectively, pertaining to the closure and consolidation of excess facilities, impairment of assets as discussed below, employee severance benefits and settlement of certain contractual obligations. These charges and benefits were recorded in accordance with SFAS No. 146, *Accounting for Costs Associated with Exit or Disposal Activities*, SFAS No. 88, *Employers Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits* and Staff Accounting Bulletin (SAB) No. 100, *Restructuring and Impairment Charges*. The 2002 and 2001 charges were recorded in accordance with Emerging Issues Task Force Issue No. 94-3, *Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring)*, SFAS 88, and SAB 100. In determining the charges to record, we made certain estimates and judgments surrounding the amounts ultimately to be paid for the actions we have taken. At September 30, 2005, we had recorded accruals for the costs to terminate employees and exit certain facilities and lease obligations. These accruals may be adjusted periodically for resolution of contractual commitments or changes in estimates of severance payments, sublease income or the period of time the facilities will be vacant and subleased. Although we do not anticipate additional significant changes to our restructuring accruals, the actual costs may differ from those recorded in the event that the subleasing assumptions require adjustment due to changes in economic conditions in the real estate market or if we terminate our lease obligations prior to the scheduled termination dates. Such changes had a material impact to our operating results in the past and could have a material impact on our operating results in the future.

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

Included in our accrued restructuring balance at September 30, 2005 was estimated sublease income of \$742,000, net of adjustments. We based our estimates of sublease income on, among other things, (a) opinions of independent real estate experts, (b) current market conditions and rental rates, (c) an assessment of the time period over which reasonable estimates could be made, (d) the status of negotiations with potential subtenants and (e) the locations of the facilities. These estimates, together with other estimates made by us in connection with the restructuring actions, may vary significantly from the actual results, depending in part on factors beyond our control. For example, the actual results will depend on our success in negotiating with lessors, the time periods required for us to locate and contract suitable subleases and the market rental rates at the time of such subleases. Adjustments to the facilities reserve may be required if actual lease settlement costs or sublease income differ from the amounts previously estimated. We review the status of our restructuring activities on a quarterly basis and, if appropriate, record adjustments to our restructuring obligations in our financial statements for such quarter based on management's then-current estimates. Additionally, we estimate the required severance accrual at foreign locations based on the minimum statutory requirements of each country. The amount of severance that ultimately is paid may differ from the amount we have accrued. To date, we have not experienced significant variations between the amounts initially accrued for severance at foreign locations and the amounts ultimately paid out.

Impairment or Disposal of Long Lived Assets, including Intangible Assets

We review our long-lived assets, including intangible assets subject to amortization, whenever events or changes in circumstances indicate that the carrying amount of such an asset may not be recoverable. Recoverability of these assets is measured by comparison of their carrying amount to the future undiscounted cash flows the assets are

expected to generate. If such assets are considered impaired, the impairment to be recognized is equal to the amount by which the carrying value of the assets exceeds their fair market value

Table of Contents

determined by either a quoted market price, if any, or a value determined by utilizing a discounted cash flow technique. In assessing recoverability, we must make assumptions regarding estimated future cash flows and discount factors. If these estimates or related assumptions change in the future, we may be required to record impairment charges. Intangible assets with determinable lives are amortized over their estimated useful lives, based upon the pattern in which the expected benefits will be realized, or on a straight-line basis, whichever is greater.

As a result of our restructuring activities in 2005, 2004, 2003 and 2002, we evaluated the realizability of our long-lived assets, including fixed assets and leasehold improvements related to our restructured facility leases and intangible assets, consisting primarily of unamortized goodwill. In 2005, 2004, 2003 and 2002, we determined that \$0, \$0, \$78,000 and \$1.7 million, respectively, of furniture and fixtures, computer equipment and software were impaired as a result of our decision to abandon the assets because of the termination of employees and related closures of offices in our 2005, 2004, 2003 and 2002 restructuring plans. These assets are no longer being used or will not be used in the future upon completion of the restructuring activities. In addition, in 2005, 2004, 2003 and 2002 we deemed \$118,000, \$147,000, \$232,000 and \$909,000, respectively, of leasehold improvements to be impaired due to the fact that we had exited certain office locations, and that the estimated sublease income was not sufficient to recover the assets carrying value. In addition we determined that approximately \$169,000 in 2003 of purchased software was impaired due to our revised product development strategy.

Goodwill

We account for goodwill in accordance with SFAS No. 142, *Goodwill and Other Intangible Assets*. SFAS 142 requires that goodwill not be amortized but instead tested for impairment annually and more frequently upon the occurrence of certain events which may indicate that impairment has occurred.

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

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

We perform the annual impairment assessment as of December 1 of each year.

Accounting for Income Taxes

We account for income taxes in accordance with SFAS No. 109, *Accounting for Income Taxes*, which requires that deferred tax assets and liabilities be recognized using enacted tax rates for the effect of temporary differences between the book and tax bases of recorded assets and liabilities. SFAS 109 also requires that deferred tax assets be reduced by a valuation allowance if it is more likely than not that some portion or all of the deferred tax assets will not be realized. We evaluate quarterly the realizability of our deferred tax assets and adjust the amount of such allowance, if necessary. At September 30, 2005 and December 31, 2004, we had provided a full valuation allowance against our net deferred tax assets due to the uncertainty of their realizability. If substantial changes in our ownership have occurred or should occur, as defined by Section 382 of the Internal Revenue Code, there could be annual limitations on the amount of net operating loss carryforwards that can be realized in future periods.

In addition, we have provided for potential amounts due in various foreign tax jurisdictions. Judgment is required in determining our worldwide income tax expense provision. In the ordinary course of global business, there are many

transactions and calculations where the ultimate tax outcome is uncertain. Some of these uncertainties arise as a consequence of cost reimbursement arrangements

Table of Contents

among related entities. Although we believe our estimates are reasonable, no assurance can be given that the final tax outcome of these matters will not be different from that which is reflected in our historical income tax provisions and accruals. Such differences could have a material impact on our income tax provision and operating results in the period in which such determination is made.

Results of Operations

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

	Three months ended September 30,		Nine months ended September 30,	
	2005	2004	2005	2004
Revenues:				
Product license	31%	36%	30%	33%
Services	69	64	70	67
Total revenues	100	100	100	100
Cost of revenues:				
Product license	2	3	2	2
Services	26	28	26	31
Total cost of revenues	28	31	28	33
Gross margin	72	69	72	67
Operating expenses:				
Research and development	19	21	21	25
Sales and marketing	35	38	33	44
General and administrative	12	11	13	12
Restructuring charge			1	
Total operating expenses	66	70	68	80
Income (loss) from operations	6	(1)	4	(13)
Interest and other income (expense), net	1	1	0	1
Income (loss) before provision for income taxes	7	0	4	(12)
Provision (benefit) for income taxes	0	0	0	0
Net income (loss)	7%	0%	4%	(12)%

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

	Three months ended		Nine months ended	
	September 30,		September 30,	
	2005	2004	2005	2004
Cost of product license revenues	7%	7%	7%	7%
Gross margin on product license revenues	93%	93%	93%	93%
Cost of services revenues	38%	44%	37%	45%
Gross margin on services revenues	62%	56%	63%	55%

Three and nine months ended September 30, 2005 and 2004*Revenues*

Total revenues increased 30% to \$22.7 million for the three months ended September 30, 2005 from \$17.5 million for the three months ended September 30, 2004 and increased 34% to \$65.0 million for the nine months ended September 30, 2005 from \$48.6 million for the nine months ended September 30, 2004. The increase was primarily attributable to our acquisition of Primus in

Table of Contents

November 2004 and the shift in the focus of our marketing and sales efforts from infrastructure products to application products. Since 2004 our focus has been on e-commerce and service applications, and through our Primus acquisition, solutions that enable our customers to deliver a superior customer experience via contact centers, information technology help desks, web (intranet and internet) self-service and electronic communication channels. The increase in revenues compared to the first three quarters of 2004 was also partly attributable to our new application hosting service, which generated revenues of approximately \$1.3 million for the three months ended September 30, 2005 and \$3.7 million during the nine months ended September 30, 2005.

Revenues generated from international customers increased to \$5.4 million, or 24% of total revenues, for the three months ended September 30, 2005, from \$3.6 million, or 20% of total revenues, for the three months ended September 30, 2004, and increased to \$15.6 million, or 24% of total revenues for the nine months ended September 30, 2005, from \$14.4 million, or 30% of total revenues, for the nine months ended September 30, 2004.

We expect total revenues in 2005 in the range of \$87 million to \$93 million as we launch new products and continue to realize the benefits of our Primus acquisition.

No customer accounted for more than 10% of our total revenues for the three or nine months ended September 30, 2005 or September 30, 2004.

Product License Revenues

Product license revenues increased 11% to \$7.1 million for the three months ended September 30, 2005 from \$6.4 million for the three months ended September 30, 2004 and increased 24% to \$19.8 million for the nine months ended September 30, 2005 from \$15.9 million for the nine months ended September 30, 2004. The increase was primarily attributable to our acquisition of Primus in November 2004 and the shift in the focus of our marketing and sales efforts from infrastructure products to application products.

Product license revenues generated from international customers increased to \$1.6 million for the three months ended September 30, 2005 from \$632,000 for the three months ended September 30, 2004. The increase in international revenues was due primarily to timing of certain deals and the addition of the Primus product line. Product license revenues generated from international customers decreased to \$4.9 million for the nine months ended September 30, 2005 from \$5.0 million for the nine months ended September 30, 2004. The decrease in international revenues was due primarily to the size and timing of certain deals.

Product license revenues as a percentage of total revenues for the three months ended September 30, 2005 and 2004 were 31% and 36%, respectively, and for the nine months ended September 30, 2005 and 2004 were 30% and 33% respectively. We expect this percentage to be in the range of 30% to 35% for 2005.

Our resellers generally receive a discount from our list prices. The extent of any discount is based on negotiated contractual agreements between us and the reseller. We do not grant our resellers the right of return or price protection. We rely upon resellers to market and sell our products to governmental entities and to customers in geographic regions where it is not cost effective for us to reach out to end users directly. We have approximately 18 active resellers. Reseller revenues and the percentage of revenues from resellers can vary significantly from period to period depending on the revenues from large deals, if any, closed through this channel during any period. No resellers accounted for more than 10% of our revenues for the quarter ended September 30, 2005 and one reseller accounted for greater than 10% of our revenues for the three months ended September 30, 2004. No resellers accounted for more than 10% of our revenues for the nine months ended September 30, 2005 and 2004.

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

	Three months ended		Nine months ended	
	September 30,		September 30,	
	2005	2004	2005	2004
Reseller revenues	\$ 27	\$ 3,877	\$ 454	\$ 4,895
Percentage of product revenues	0%	61%	2%	31%

Services Revenues

Services revenues increased 41% to \$15.6 million for the three months ended September 30, 2005 from \$11.1 million for the three months ended September 30, 2004 and increased 38% to \$45.2 million for the nine months ended September 30, 2005 from \$32.7

Table of Contents

million for the nine months ended September 30, 2004. The increase was primarily attributable to new services revenues from the acquisition of Primus, including application hosting services. As a result, we expect services revenues to be higher in 2005 as compared to 2004.

Support and maintenance revenues were 63% of total service revenues for the three months ended September 30, 2005, as compared to 61% for the three months ended September 30, 2004, and were 64% of total service revenues for the nine months ended September 30, 2005 as compared to 63% for the nine months ended September 30, 2004. Support and maintenance revenues, on a dollar value basis, were higher for the three and nine months ended September 30, 2005 due primarily to the addition of Primus active support and maintenance customer base and support and maintenance on contracts related to license sales entered into during 2005, offset by a portion of existing customers electing not to renew their support coverage.

Cost of Product License Revenues

Cost of product license revenues includes salary and related benefits costs of fulfillment and engineering staff dedicated to maintenance of products that are in general release, the amortization of licenses purchased in support of and used in our products, royalties paid to vendors whose technology is incorporated into our products and amortization expense related to acquired developed technology.

Cost of product license revenues increased 5% to \$471,000 for the three months ended September 30, 2005 from \$447,000 for the three months ended September 30, 2004 and increased 20% to \$1.4 million for the nine months ended September 30, 2005 from \$1.2 million for the nine months ended September 30, 2004. These increases were primarily related to amortization expense of \$204,000 and \$613,000 for the three and nine months ended September 30, 2005 related to developed technology, an intangible asset recorded as part of the Primus acquisition, offset by a reduction in salaries of \$86,000 and \$341,000 for the three and nine months ended September 30, 2005 compared to the same periods for 2004.

For the three months ended September 30, 2005 and 2004, cost of product license revenues as a percentage of total revenues were 2% and 3%, respectively. For the nine months ended September 30, 2005 and 2004, cost of product license revenues as a percentage of total revenues was 2%. We anticipate the cost of product license revenues, as a percentage of total revenues, to be between 1% and 3% for 2005.

Gross Margin on Product License Revenues

For the three months ended September 30, 2005 and 2004, gross margin on product license revenues was 93%, or \$6.6 million, and 93%, or \$5.9 million, respectively, and for the nine months ended September 30, 2005 and 2004, gross margin on product license revenues was 93%, or \$18.4 million, and 93%, or \$14.7 million, respectively. The increase in dollar amount was primarily related to increased product license revenues primarily attributable to the acquisition of Primus.

Cost of Services Revenues

Cost of services revenues includes salary and other related costs for our professional services and technical support staff, as well as third-party contractor expenses. Additionally cost of services revenues includes fees for hosting facilities, as well as equipment and related depreciation costs. Cost of services revenues varies significantly from period to period depending on the level of professional services staffing, the effective utilization rates of our professional services staff, the mix of services performed, including product license technical support services, the extent to which these services are performed by us or by third-party contractors, the level of third-party contractors fees, and the amount of equipment and hosting space required.

Cost of services revenues increased 20% to \$5.9 million for the three months ended September 30, 2005 from \$4.9 million for the three months ended September 30, 2004, and increased 13% to \$16.7 million for the nine months ended September 30, 2005 from \$14.8 million for the nine months ended September 30, 2004. The increase was primarily attributable to an increase in salaries and benefits attributable to higher headcount and increased use of third party contractors. Our usage of outside professional services increased by \$362,000 and \$783,000 for the three and nine months ended September 30, 2005 compared to the same period in 2004.

For the three months ended September 30, 2005 and 2004, cost of services revenues as a percentage of total revenues was 26% and 28%, respectively, and for the nine months ended September 30, 2005 and 2004, cost of services revenues as a percentage of total

Table of Contents

revenues was 26% and 30%, respectively. We anticipate the cost of services revenues, as a percentage of total revenues, to be between 23% and 27% for 2005.

Gross Margin on Services Revenues

For the three months ended September 30, 2005 and 2004, gross margin on services revenues were 62%, or \$9.8 million, and 56%, or \$6.2 million, respectively, and for the nine months ended September 30, 2005 and 2004, gross margin on services revenues were 63%, or \$28.5 million, and 55%, or \$17.9 million, respectively. The increase in gross margin and gross margin as a percentage of service revenues was primarily attributable to increased services revenues, including our new application hosting offering, which generated \$1.3 million and \$3.7 million in revenue during the three and nine months ended September 30, 2005, respectively.

We expect gross margin on services revenues for 2005 to be approximately 60% to 65% for 2005.

Research and Development Expenses

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

Research and development expenses increased 18% to \$4.3 million for the three months ended September 30, 2005 from \$3.7 million for the three months ended September 30, 2004, and increased 13% to \$13.5 million for the nine months ended September 30, 2005 from \$12.0 million for the nine months ended September 30, 2004. The increase in spending was primarily attributable to an increase in our use of third party offshore contractors and to higher professional fees, which increased by \$260,000 and \$1.1 million during the three and nine months ended September 30, 2005 respectively.

Research and development expenses as a percentage of total revenues were 19% and 21% for the three months ended September 30, 2005 and 2004 respectively and were 21% and 25% for the nine months ended September 30, 2005 and 2004, respectively. We anticipate that research and development expenses as a percentage of total revenues will be in the range of 20% to 22% for 2005.

Sales and Marketing Expenses

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

Sales and marketing expenses increased 20% to \$7.9 million for the three months ended September 30, 2005 from \$6.6 million for the three months ended September 30, 2004 and increased 3% to \$21.7 million for the nine months ended September 30, 2005 from \$21.2 million for the nine months ended September 30, 2004. The increase is primarily attributable to amortization of an intangible asset related to customer relationships from the Primus acquisition of \$341,000 and \$1.0 million for the three and nine months ended September 30, 2005, respectively, offset by cost saving initiatives that resulted in a reduction in the workforce of our sales and marketing groups, reduced recruitment fees and training costs, and a reduction in our spending on marketing programs, along with a decrease in operating expenses resulting from our restructuring efforts.

For three months ended September 30, 2005 and 2004, sales and marketing expenses as a percentage of total revenues were 35% and 38%, respectively and for nine months ended September 30, 2005 and 2004, sales and marketing expenses as a percentage of total revenues were 33% and 44%, respectively. We anticipate that sales and marketing expenses as a percentage of total revenues will be in the range of 31% to 36% for 2005.

General and Administrative Expenses

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

General and administrative expenses increased 41% to \$2.7 million for the three months ended September 30, 2005 from \$1.9 million for the three months ended September 30, 2004 and increased 50% to \$8.4 million for the nine months ended September 30, 2005 from \$5.6 million for the nine months ended September 30, 2004. Approximately 75% of the increase was related to an increase in outside services and professional fees, with most of the remainder related to an increase in insurance expenses. Contributing to the increase in outside services of approximately \$512,000 and \$2.2 million for the three and nine months ended September 30, 2005,

Table of Contents

respectively, over the same period in 2004 were costs associated with Sarbanes-Oxley compliance and the integration of the Primus acquisition.

For the three months ended September 30, 2005 and 2004, general and administrative expenses as a percentage of total revenues were 12% and 11%, respectively, and for the nine months ended September 30, 2005 and 2004, general and administrative expenses as a percentage of total revenues were 13% and 12% respectively. We anticipate that general and administrative expenses will, as a percentage of revenue, be in the 12% to 14% range for 2005.

Restructuring

During the quarter ended September 30, 2005, we recorded a net restructuring benefit of \$52,000 for adjustments in estimates related to sublease costs included in the accruals relative to the 2001 and 2002 actions as well as adjustments in estimates related to severance costs included in the 2004 action. During the quarter ended June 30, 2005, we recorded a net restructuring charge of \$671,000, primarily due to a \$1.8 million charge related to the relocation of our San Francisco office and other facility charges; offset by \$1.1 million for adjustments in estimates related to sublease costs included in the accruals relative to the 2001, 2002 and 2004 actions. During the quarter ended March 31, 2005, we recorded a net restructuring charge of approximately \$204,000 due to adjustments in estimates related to the 2004 restructuring charge for employee severance benefits payable in international geographies. During the years ended 2004, 2003, 2002 and 2001, we recorded net restructuring charges/(benefits) of \$3.6 million, \$(10.5) million, \$19.0 million and \$75.6 million, respectively, as a result of the global slowdown in information technology spending. The significant drop in demand in 2001 for technology oriented products, particularly internet related technologies, caused management to significantly scale back our prior growth plans, resulting in a significant reduction in our workforce and consolidation of our facilities in 2001. Throughout 2002, the continued softness of demand for technology products, as well as near term revenue projections, caused us to further evaluate our marketing, sales and service resource capabilities as well as our overall general and administrative cost structure, which resulted in additional restructuring actions being taken in 2002. These actions resulted in a further reduction in headcount and consolidation of additional facilities. In 2003, as we continued to refine our business strategy and to consider future revenue opportunities, we took further restructuring actions to reduce costs, including product development costs, in order to help move us towards profitability. In 2004, our restructuring activities were undertaken to align our headcount more closely to our revenue projections and changing staff requirements as a result of strategic product realignments and our acquisition of Primus and to eliminate facilities that were not needed in order to efficiently run our operations. In April 2005, we relocated our San Francisco office to gain further efficiencies. The charges referred to above primarily pertain to the closure and consolidation of excess facilities, impairment of assets, employee severance benefits, and the settlement of certain contractual obligations. The 2005, 2004 and 2003 charges were recorded in accordance with SFAS No. 146, *Accounting for Costs Associated with Exit or Disposal Activities*, SFAS No. 88, *Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits* and Staff Accounting Bulletin (SAB) No. 100, *Restructuring and Impairment Charges*. The 2002 and 2001 charges were recorded in accordance with Emerging Issues Task Force Issue No. 94-3, *Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (Including Certain Costs Incurred in a Restructuring)*, SFAS 88 and SAB 100.

2001 Actions

Actions taken by us in 2001 included the consolidation and closure of excess facilities, a worldwide workforce reduction, the write-off of certain unrealizable assets and settling certain obligations that had no future benefit. In the second quarter of 2001, we recorded a restructuring charge of \$44.2 million, and in the fourth quarter of 2001, we recorded a restructuring charge of \$31.4 million. In connection with these actions, we also recorded in cost of product licenses an impairment charge for purchased software of \$1.4 million. Total restructuring charges for 2001 totaled \$75.6 million.

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

Accrued Restructuring	2005 Adjustments	Accrued
----------------------------------	-----------------------------	----------------

	Balance as of December 31, 2004	in Estimates Resulting in Reduced Charges	Payments	Restructuring Balance as of September 30, 2005
Facilities-related costs and impairments	\$ 6,254	\$ (792)	\$ (1,941)	\$ 3,521
Employee severance, benefits and related costs	57		(57)	
Total	\$ 6,311	\$ (792)	\$ (1,998)	\$ 3,521

30

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

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

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

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

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

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

During 2005, we made adjustments to estimates of sublease income related to the 2001 actions, resulting in a credit to the restructuring charge of \$792,000. The change in estimate was primarily due to our continued evaluation of the financial condition of our subtenants and their ability to meet their financial obligations to us.

Employee Severance, Benefits and Related Costs and Exchangeable Shares

As part of the 2001 restructuring actions, we recorded charges of \$7.9 million for employee severance. We terminated the employment of 530 employees, or 46% of our workforce, of which 249 of these employees were from sales and marketing, 117 from services, 101 from general and administrative and 63 from research and development. None of these employees remained employed as of September 30, 2002. In addition, we settled 11,762 exchangeable shares with an employee, who was terminated in connection with the restructuring action, and recorded \$1.3 million as a charge to restructuring for this settlement.

During 2003, we recorded additional charges of \$229,000 for severance related to an employee terminated as part of the 2001 restructuring action.

During 2004, we reached final settlement with this employee, resulting in a reduction to the restructuring charge of \$172,000.

Table of Contents**Asset Impairments**

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

Marketing Costs and Legal and Accounting

We recorded charges of \$851,000 to write off certain prepaid costs for future marketing services to their fair value of zero due to changes in our product development strategy. As a result, the prepaid marketing cost had no future utility to the Company. During 2002, we unexpectedly were able to recoup \$536,000 and recorded a credit for the amount received. During 2001, we also recorded \$405,000 for legal and accounting services incurred in connection with the 2001 restructuring action.

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

2002 Actions

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

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

	Accrued	2005		
	Restructuring	Adjustments		Accrued
	Balance as	in		Restructuring
	of	Estimates		Balance as of
	December	Resulting		September 30,
	31,	in		2005
	2004	Reduced		
		Charges	Payments	
Facilities-related costs and impairments	\$ 1,155	\$ (48)	\$ (429)	\$ 678

Facilities-Related Costs and Impairments

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

As a result of this action and the actions taken in 2001, we wrote off certain computer equipment and software, aggregating \$1.2 million, and furniture and fixtures, aggregating \$507,000, which were no longer being used due to the reduction in personnel and office locations. These assets were abandoned and written down to their fair value based on the expected discounted cash flows they would generate over their remaining economic life. Due to the short remaining economic life and current market conditions for such assets, the fair value of these assets was estimated to be zero. These assets ceased being used either as of December 31, 2002 or in the first quarter of 2003 and were disposed of in the quarter ended March 31, 2003. In addition, we wrote off leasehold improvements, which will

continue to be in use and are related to the facilities we are attempting to sublease, to their fair value of zero because the estimated cash flows to be generated by sublease income at those locations will not be sufficient to recover the carrying value of the assets.

During 2003, we recorded an adjustment of \$1.9 million primarily to increase our lease obligation accrual at two locations because of changes in assumptions as to the vacancy period and sublease income. The sublease income was adjusted by decreasing anticipated

Table of Contents

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

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

We executed a sub-lease agreement during the three months ended September 30, 2005. As a result, we recorded an adjustment to our estimates of sub-lease costs related to the 2002 actions, resulting in a credit to the restructuring charge of \$36,000. During the three months ended September 30, 2005 we made an adjustment in estimate resulting in a \$12,000 credit.

Employee Severance, Benefits and Related Costs

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

2003 Actions

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

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

	Accrued	2005		Accrued
	Restructuring	Adjustments		Restructuring
	Balance as of	in		Balance as of
	December 31,	Estimates		September 30,
	2004	Resulting in		2005
		Reduced	Payments	
		Charges		
Facilities-related costs and impairments	\$ 1,373	\$ (24)	\$ (309)	\$ 1,040

Second Quarter 2003 Actions

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

Facilities-Related Costs and Impairments

During the second quarter of 2003, we recorded facilities-related charges of \$1.1 million comprising \$866,000 for an operating lease related to idle office space, \$144,000 of leasehold improvements and fixed assets written down to their fair value, and \$61,000 for various office equipment leases. The lease charge was for office space we vacated and intended to sublease. The amount of the operating lease charge was based on assumptions from current real estate market data for sublease income rates and vacancy rates at the location. The estimated sublease income was \$500,000, based on a rental rate of \$35 per square foot with an estimated vacancy period prior to the expected sublease income

of 24 months. In the fourth quarter of 2003, as result of updated market conditions, the estimated sublet rental rate was lowered from \$35 per square foot to \$30 per square foot and the vacancy period was extended to 36

33

Table of Contents

months from 24 months resulting in an additional charge of \$227,000. In accordance with SFAS 146, we recorded the present value of the net lease obligation.

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

Employee Severance, Benefits and Related Costs

As part of the second quarter 2003 restructuring action, we recorded a charge of \$927,000 for severance and benefit costs related to cost reduction actions taken across the worldwide employee base. The severance and benefit costs were for 32 employees, or 7.4% of our workforce, consisting of 11 employees from sales and marketing, 3 from services, 3 from general and administrative and 15 from research and development. We accrued employee benefits pursuant to our ongoing benefit plans for domestic locations and under statutory minimum requirements in foreign locations. All employees were notified of their termination as of June 30, 2003. The termination process was completed during the fourth quarter of 2003. During the third quarter of 2003, we accrued an additional \$69,000 for employees at our foreign locations based on management's best estimate of the final payments for severance. During the fourth quarter of 2003, we reduced certain severance accruals by \$84,000 at our international locations as a result of final settlements.

Asset Impairments

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

Third Quarter 2003 Action

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

Facilities-Related Costs and Impairments

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

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

Employee Severance, Benefits and Related Costs

We recorded a charge of \$309,000 for severance and benefit costs related to cost reduction actions taken across the worldwide employee base. The severance and benefit costs were for 16 employees, or 4.3% of our workforce,

consisting of 7 employees from sales and marketing, 4 from services and 5 from research and development. We accrued employee benefits pursuant to our ongoing

Table of Contents

benefit plans. All employees were notified of their termination as of September 30, 2003. The termination process was completed during the fourth quarter of 2003.

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

During 2005, we recorded an adjustment to our cost estimates related to the 2003 actions, resulting in a credit to the restructuring charge of \$24,000.

2004 Actions

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

Facilities-Related Costs and Impairments

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

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

Employee Severance, Benefits and Related Costs

As part of the fourth quarter 2004 restructuring action, we recorded a charge of \$2.5 million for severance and benefit costs related to cost reduction actions taken across the worldwide employee base. The severance and benefit costs were for 56 employees, or 14% of our workforce, consisting of 27 employees from sales and marketing, 8 from services, 6 from general and administrative and 15 from research and development. We accrued employee benefits pursuant to our ongoing benefit plans for domestic locations and under statutory minimum requirements in foreign locations. All employees were notified of their termination as of December 31, 2004. As of December 31, 2004, 13 employees had been terminated. As of September 30, 2005 the termination process was completed.

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

	Accrued Restructuring Balance as of December 31, 2004	2005 Adjustments in Estimates Resulting in Additional Charges	Payments	Accrued Restructuring Balance as of September 30, 2005
Facilities-related costs and impairments	\$ 750	\$ (267)	\$ (303)	\$ 180
Employee severance, benefits and related costs	1,569	137	(1,508)	198
Total	\$ 2,319	\$ (130)	\$ (1,811)	\$ 378

Table of Contents

During the first quarter of 2005, we recorded a restructuring charge of \$200,000, resulting from adjustments to estimates made in 2004 for employee severance benefits payable in international geographies, and a \$4,000 charge to facilities related cost due to adjusting our estimates.

During the second and third quarter of 2005, we recorded credits of \$32,000 and \$31,000, respectively, to the employee severance costs due to adjusting our estimates. During the second quarter of 2005, we recorded a credit of \$32,000 to the employee severance costs, and a credit of \$271,000 to the facilities related cost charge, due to adjusting our estimates of net sublease obligations as a result of executing a sub lease agreement for which the term began in the second quarter of 2005.

2005 Actions

During 2005, the Company recorded net restructuring charges of \$823,000, comprised of new actions of \$1.8 million and net credits resulting from changes in estimates related to prior actions of \$1.0 million.

Facilities-Related Costs and Impairments

During the second quarter of 2005, we relocated our San Francisco office and reduced the amount of space we occupy in San Francisco. As a result of this action and other minor facilities charges, we recorded facilities-related charges of \$1.8 million primarily comprised of \$1.0 million of deferred rent related to the abandoned space, \$118,000 of leasehold improvements written down to their fair value, and \$557,000 for an operating lease related to idle office space vacated during the second quarter of 2005, net of assumptions for sublease income based on an executed sublease agreement. In accordance with SFAS 146, we recorded the present value of the net lease obligation.

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

	2005	Write-Offs And	Balance as of
	Charges	Payments	September 30, 2005
Facilities-related costs and impairments	\$ 1,817	\$ (1,410)	\$ 407

Abandoned Facilities Obligations

At September 30, 2005, we had lease arrangements related to seven abandoned facilities. The lease arrangements with respect to six of these facilities are ongoing, and one is the subject of a lease settlement arrangement under which we are obligated to make payments through 2006. All locations for which we have recorded restructuring charges have been exited, and thus management's plans with respect to these leases have been completed. A summary of the remaining facility locations and the timing of the remaining cash payments are as follows (in thousands):

Lease Locations	2005	2006	2007	2008	2009	Total
Cambridge, MA*	\$ 517	\$ 1,035				\$ 1,552
Cambridge, MA	34	91				125
Cambridge, MA	100	400				500
Waltham, MA	362	1,452	\$ 1,452	\$ 1,452	\$ 363	5,081
Chicago, IL	160	427				587
San Francisco, CA	128	513	512			1,153
Reading, UK	142	570	570	570	142	1,994
Facility obligations, gross	1,443	4,488	2,534	2,022	505	10,992
Contracted and assumed sub-lease income	(513)	(1,718)	(1,467)	(1,215)	(304)	(5,217)
Net cash obligations	\$ 930	\$ 2,770	\$ 1,067	\$ 807	\$ 201	\$ 5,775
	\$	\$ 135	\$ 270	\$ 270	\$ 67	\$ 742

Assumed sub-lease
income

* Represents a
location for
which we have
executed a lease
settlement
agreement

Interest and Other Income (Expense), Net

Interest and other income (expense), net decreased to \$172,000 for the three months ended September 30, 2005 from \$175,000 for the three months ended September 30, 2004 and increased to \$272,000 for the nine months ended September 30, 2005 from \$192,000

36

Table of Contents

for the nine months ended September 30, 2004. The increase was primarily due to an increase in interest income of \$48,000 and \$140,000 for the three and nine month periods, respectively.

Provision for Income Taxes

We expect to have no Federal and minimal foreign income taxes in 2005 due to the use of net operating loss carryforwards and the projection of a taxable loss in domestic and foreign locations in 2005. The tax provision recorded in 2005 relates to State and foreign taxes. As a result of net operating losses incurred, and after evaluating our anticipated performance over our normal planning horizon, we have provided a full valuation allowance for our net operating loss carryforwards, research credit carryforwards and other net deferred tax assets.

Liquidity and Capital Resources

Our capital requirements relate primarily to facilities, employee infrastructure and working capital requirements. Historically, we have funded our cash requirements primarily through public and private sales of equity securities, and commercial credit facilities. At October 31, 2005, we had \$18.0 million in cash and cash equivalents and \$9.0 million in marketable securities.

Cash used in operating activities was \$236,000 for the nine months ended September 30, 2005. This consisted of net income of \$2.6 million, depreciation and amortization of \$3.1 million, a non-cash restructuring charge of \$1.2 million and a decrease in accounts receivable of \$4.6 million, offset by a decrease in accrued restructuring of \$5.1 million. Other changes in working capital items consisted primarily of \$687,000 in cash used for accrued expenses, an increase in prepaid expenses of \$215,000, a decrease in accounts payable of \$1.5 million, a decrease in deferred rent of \$523,000 and a decrease in deferred revenues of \$4.7 million.

Cash used in operating activities was \$12.5 million for the nine months ended September 30, 2004. This consisted of operating losses of \$6.0 million, a decrease in accrued restructuring of \$7.6 million, a decrease in accrued expenses of \$2.5 million, offset by depreciation and amortization of \$1.5 million and a decrease in accounts receivable of \$1.5 million. Other changes in working capital items consisted primarily of a \$907,000 decrease in deferred revenue, and an increase in accounts payable of \$660,000 and accrued expenses of \$707,000.

Our investing activities for the nine months ended September 30, 2005 used cash of \$1.4 million and consisted primarily of payment of acquisition costs of \$1.0 million, capital expenditures of \$931,000, net proceeds from maturity of marketable securities of \$254,000, offset by a decrease in other assets of \$268,000. Our investing activities for the nine months ended September 30, 2004 provided \$1.4 million and consisted primarily of net maturities of marketable securities of \$1.8 million offset by capital expenditures of \$451,000

We expect that capital expenditures will total approximately \$1.5 million for the year ending December 31, 2005.

Net cash provided by financing activities was \$1.1 million for the nine months ended September 30, 2005, representing proceeds from the employee stock purchase plan and the exercise of stock options aggregating \$1.6 million, offset by principal payments on notes payable of \$387,000 and payments on capital leases of \$42,000. Net cash provided by financing activities was \$1.1 million for the nine months ended September 30, 2004, representing proceeds from the employee stock purchase plan and the exercise of stock options.

Accounts Receivable and Days Sales Outstanding

Our accounts receivable balance and days sales outstanding, or DSO, as of September 30, 2005 and December 31, 2004 were as follows: (in thousands)

	September 30, 2005	December 31, 2004
DSO	79	129
Revenue	\$ 64,960	\$ 69,219
Accounts Receivable	\$ 19,814	\$ 24,430

As of September 30, 2005 our DSO had decreased significantly from the DSO at December 31, 2004 due to collections on support and maintenance renewals as well as the effect of receiving payments during 2005 on deals that had closed at the end of 2004 but were

Table of Contents

recognized as revenue during 2005. Also contributing to the decrease is the effect of having a full 9 months of Primus revenue in 2005.

The higher DSO at December 31, 2004 is due to the impact of acquiring Primus accounts receivable balance in 2004 with only two months of Primus revenues in 2004, a high volume of support and maintenance renewals at year-end and product license deals that closed before year end but were not recognized into revenue during 2004.

Credit Facility

On June 13, 2002, we entered into a \$15 million revolving line of credit with Silicon Valley Bank (the Bank) which provided for borrowings of up to the lesser of \$15 million or 80% of eligible accounts receivable. Effective December 24, 2002 the revolving line of credit increased to \$20 million. The line of credit bears interest at the Bank's prime rate (6.75% at September 30, 2005). The line of credit is secured by all of our tangible and intangible intellectual and personal property and is subject to financial covenants including liquidity coverage and profitability. On December 24, 2004 we entered into the Seventh Loan Modification Agreement (the Seventh Amendment) with the Bank, which amended the Amended and Restated Loan and Security Agreement dated as of June 13, 2002. Under the Seventh Amendment, the profitability covenant was revised to allow for a quarterly net loss of \$1.5 million for the third quarter of 2005, and net profitability of at least \$1.00 for the fourth quarter of 2005 and for each quarter thereafter. We are required to maintain unrestricted and unencumbered cash, which includes cash equivalents and marketable securities, of \$20 million at the end of each month.

To avoid additional bank fees and expenses, we are required to maintain unrestricted cash, which includes cash equivalents and marketable securities, at the Bank in an amount equal to two times the amount of obligations outstanding, which includes letters of credit that have been issued but not drawn upon, under the loan agreement. In the event our cash balances at the Bank fall below this amount, we will be required to pay fees and expenses to compensate the Bank for lost income. At September 30, 2005, we were in compliance with all related financial covenants. In the event that we do not comply with any of the financial covenants within the line of credit or defaults on any of its provisions, the Bank's significant remedies include: (1) declaring all obligations immediately due and payable, which could include requiring us to cash collateralize our outstanding letters of credit (LCs); (2) ceasing to advance money or extend credit for our benefit; (3) applying to the obligations any balances and deposits held by us or any amount held by the Bank owing to or for the credit of our account; and (4) putting a hold on any deposit account held as collateral. If the agreement expires, is not extended, the Bank will require outstanding LCs at that time to be cash secured on terms acceptable to the Bank. The revolving line of credit expires on December 24, 2005. While there were no outstanding borrowings under the facility at September 30, 2005, we had issued LCs totaling \$7.1 million, which are supported by this facility. The LCs have been issued in favor of various landlords and equipment leasing companies to secure obligations under our facility leases pursuant to leases expiring from August 2006 through March 2009. As of September 30, 2005, approximately \$12.9 million was available under the facility.

Contractual Obligations

On September 30, 2005, our contractual cash obligation, which consists of operating and capital leases, were as follows (in thousands):

	Payments Due by Period				After 5 Years
	Total	Remainder of 2005	2-3 years	4-5 years	
Contractual Obligations					
Lease Commitments	\$ 14,145	\$ 2,030	\$ 8,923	\$ 3,192	\$

We lease our facilities and equipment under operating and capital leases that expire between 2005 and 2009. The aggregate minimum annual payments under these leases are \$14.1 million, which includes approximately \$2.0 million payable in the remainder of 2005. Of the \$14.1 million, \$9.7 million is for leases that are included in restructuring. In accrued restructuring at September 30, 2005, the \$9.7 million was reduced to \$5.8 million after taking into consideration estimated sublease income, contracted sublease income, vacancy periods and operating cash of the

various subleased properties. Of the \$14.1 million in lease payments, \$13.8 million is for facility leases and \$320,000 is for equipment leases.

We believe that there will not be any material real estate lease settlements beyond those completed to date. As a result, we believe that our balance of \$29.9 million in cash and cash equivalents and marketable securities at September 30, 2005, along with other working capital and cash expected to be generated by our operations will allow us to meet our liquidity needs over the next twelve

Table of Contents

months. However, our actual cash requirements will depend on many factors, including particularly, overall economic conditions both domestically and abroad and the revival of corporate internet technology investments. We may seek additional external funds through public or private securities offerings, strategic alliances or other financing sources. There can be no assurance that if we seek external funding, it will be available on favorable terms, if at all.

Recent Accounting Pronouncements

In December 2004, the Financial Accounting Standards Board issued SFAS No. 123R, *Share-Based Payment*, which replaces SFAS 123 and supersedes APB Opinion 25. SFAS 123R requires all share-based payments to employees, including grants of employee stock options, to be recognized in the financial statements based on their fair values. The pro forma disclosures previously permitted under SFAS 123 no longer will be an alternative to financial statement recognition. We are required to adopt SFAS 123R on January 1, 2006.

Public companies are required to adopt the new standard using a modified prospective method or may elect to restate prior periods using the modified retrospective method. Under the modified prospective method, companies are required to record compensation cost for new and modified awards over the related vesting period of such awards prospectively and record compensation cost prospectively for the unvested portion, at the date of adoption, of previously issued and outstanding awards over the remaining vesting period of such awards. No change to prior periods presented is permitted under the modified prospective method. Under the modified retrospective method, companies record compensation costs for prior periods retroactively through restatement of such periods using the exact pro forma amounts disclosed in the companies' footnotes. Also, in the period of adoption and after, companies record compensation cost utilizing the modified prospective method. We have not yet determined the method of adoption we will use. We have not completed our evaluation of the effects of adopting SFAS 123R.

Table of Contents

RISK FACTORS THAT MAY AFFECT RESULTS

This quarterly report contains forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. These statements are subject to risks and uncertainties and are based on the beliefs and assumptions of our management based on information currently available to our management. For this purpose, any statement that is not a statement of historical fact should be considered a forward-looking statement. We often use the words believes, anticipates, plans, expects, intends and similar expressions to help identify forward-looking statements. Forward-looking statements involve risks, uncertainties and assumptions.

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

Risks Related To Our Business

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

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

fluctuating economic conditions, particularly as they affect the length of our sales cycle and our customers willingness to implement new e-commerce solutions;

the timing of sales and revenue recognition of our products and services;

the timing of customer orders and product implementations;

delays in introducing new products and services;

the size of price discounting and/or concessions;

the mix of revenues derived from products and services;

timing of hiring and utilization of services personnel;

cost overruns related to fixed-price services projects;

the mix of domestic and international sales;

variation in our actual costs from our cost estimates related to long term hosting contracts;

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

costs related to possible acquisitions of technologies or businesses.

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

Failure of our recent Primus acquisition to achieve its potential benefits could harm our business and operating results.

In November 2004, we acquired our subsidiary Primus Knowledge Solutions, Inc. The acquisition will not achieve its anticipated benefits unless we are successful in combining our operations and integrating our products in a timely

manner. Integration is a

Table of Contents

complex, time consuming and expensive process and may result in disruption of our operations and revenues if not completed in a timely and efficient manner. We have been operating as a combined organization for less than one year, using common:

sales, marketing, service and support organizations;

research and development organizations;

information and communications systems;

operating procedures;

accounting systems and financial controls; and

human resource practices, including benefit, training and professional development programs.

There may be substantial difficulties, costs and delays involved in completing the integration of Primus into our business. These could include:

problems with compatibility of business cultures;

customer perception of an adverse change in service standards, business focus, billing practices or product and service offerings;

costs and inefficiencies in delivering products and services to our customers;

problems in successfully coordinating our research and development efforts;

difficulty in integrating sales, support and product marketing;

costs and delays in implementing common systems and procedures, including financial accounting systems; and

the inability to retain and integrate key management, research and development, technical sales and customer support personnel.

Further, we cannot assure you that we will realize all of the anticipated benefits and synergies of the acquisition. Any one or all of the factors identified above could cause increased operating costs, lower than anticipated financial performance, or the loss of customers, employees or business partners. The failure to successfully complete our integration of Primus would have a material adverse effect on our business, financial condition and results of operations.

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

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

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

In recent years, there has been significant litigation in the United States involving patents and other intellectual property rights. Companies providing Internet-related products and services are increasingly bringing and becoming subject to suits alleging infringement of proprietary rights, particularly patent rights. We could incur substantial costs in prosecuting or defending any

Table of Contents

intellectual property litigation. If we sue to enforce our rights or are sued by a third party that claims that our technology infringes its rights, the litigation could be expensive and could divert our management resources. For example, our Primus subsidiary has previously been involved in litigation alleging that Primus had infringed United States patents owned by ServiceWare. We may be required to incur substantial costs in defending other similar litigation in the future, which could have a material adverse effect on our operating results and financial condition.

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

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

cease selling or using products or services that incorporate the challenged intellectual property;

obtain a license, which may not be available on reasonable terms, to sell or use the relevant technology; or

redesign those products or services to avoid infringement.

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

We incurred losses in the second quarter of 2005, in the first, second and fourth quarters of 2004, in the first and third quarters of 2003 and in each quarter of 2002. As of September 30, 2005, we had an accumulated deficit of \$202.6 million. Although our revenues increased 34% to \$65.0 million for the nine months ended September 30, 2005 compared with \$48.6 million for the nine months ended September 30, 2004, this was primarily attributable to our acquisition of Primus. Our revenues decreased 5% to \$69.2 million for the year ended December 31, 2004 compared with \$72.5 million for the year ended December 31, 2003. Because we operate in a rapidly evolving industry, we have difficulty predicting our future operating results and we cannot be certain that our revenues will grow or our expenses will decrease at rates that will allow us to achieve profitability on a quarterly or annual basis. Additionally, if the weakness in growth of the US economy continues for an extended period of time or worsens, we may experience additional adverse effects on our revenue, net income and cash flows, which could result in a decline in the price of our common stock.

Turnover in our personnel may impair our ability to develop and implement a business strategy or maintain internal control, which could have a material adverse effect on our operating results and common stock price.

Members of our management team, including executives with significant responsibilities in our finance, sales, marketing and research and development operations and executives of our acquired Primus subsidiary, have left us during the past few years for a variety of reasons. We cannot assure you that there will not be additional departures in the future. These changes in management, and any future similar changes, may be disruptive to our operations or affect our ability to maintain effective internal controls over financial reporting. In addition, equity incentives such as stock options constitute an important part of our total compensation program for management, and the volatility or lack of positive performance of our stock price may from time to time adversely affect our ability to retain our management team or hire replacements.

We rely heavily on our direct sales force. In connection with our Primus acquisition, we have restructured and reduced the size of the combined sales force. Changes in the structure of our sales force have historically resulted in temporary lack of focus and reduced productivity.

Table of Contents

We have restructured our research and development group in connection with the Primus acquisition, which could result in interruptions in product development and reduced productivity.

In addition, the success of our Primus acquisition will depend in part on the retention of key technical and management personnel critical to its business and operations. Several senior Primus executives have resigned, and other Primus employees may not want to continue to work for us. In addition, competitors may seek to recruit employees during the integration, as is common in high technology mergers. If we are unable to retain personnel that are critical to the successful integration and our future operations, we could face disruptions in our operations that affect our ability to maintain effective internal controls over financial reporting, loss of existing customers, loss of key information, expertise or know-how, and unanticipated additional recruitment and training costs. In addition, the loss of key personnel could diminish the anticipated benefits of the acquisition.

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

Our long sales cycle, which can often take several quarters, makes it difficult to predict the quarter in which sales may occur. We have a long sales cycle because we generally need to educate potential customers regarding the use and benefits of our products and services. Our sales cycle varies depending on the size and type of customer contemplating a purchase and whether we have conducted business with a potential customer in the past.

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

Like most software companies, a significant proportion of our sales are concentrated near the end of each fiscal quarter. Failure to close or be able to recognize anticipated revenues on even a relatively small number of license deals at quarter end can have a significant impact on our reported operating results for that quarter. This concentration of sales at quarter end can also lead to customer pressure to provide higher price discounts than anticipated. In addition, there can be no assurance that deals that are not closed at the end of a fiscal quarter will be entered into during any subsequent quarter.

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

The market for online marketing, sales and services applications is intensely competitive, and we expect competition to intensify in the future. This level of competition could reduce our revenues and result in increased losses or reduced profits. Our primary competition currently comes from in-house development efforts by potential customers or partners, as well as from other vendors of Web-based application software. We currently compete with e-commerce and marketing vendors such as IBM, BroadVision, Blue Martini, RightNow Technologies, Demandware, Epiphany, Amazon.com, Unica and GSI Commerce.

The market for our service products is also rapidly evolving, and intensely competitive. Our suite of service products competes against various vendor software tools designed to address a specific element or elements of the complete set of eService processes, including e-mail management, support, knowledge management, and Web-based customer self-service and assisted service. We also face competition from in-house designed products and third-party custom development efforts. The high level of competition in this market has resulted in pricing pressures, which if such conditions continue or increase, could harm our results of operations. Some of the companies providing advanced natural language self service and traditional service resolution management solutions that may compete with us include eGain, Inqira, iPhrase Technologies, Kana and Knova.

In addition, competition may increase as a result of current competitors expanding their product offerings, new companies entering the market, software industry consolidations and formations of alliances among industry participants or with third parties. Many of our competitors have longer operating histories and significantly greater financial, technical, marketing and other resources than we do and may be able to respond more quickly to new or changing opportunities, technologies and customer requirements. Also, many current and potential competitors have

greater name recognition and more extensive customer bases that they can use to gain market share. These competitors may be able to undertake more extensive promotional activities, adopt more aggressive pricing policies and offer more attractive terms to purchasers than we can. Moreover, our current and potential competitors may bundle their products in a manner that may discourage users from purchasing our products. In addition, current and potential competitors have established or

Table of Contents

may establish cooperative relationships among themselves or with third parties to enhance their products and expand their markets. Accordingly, new competitors or alliances among competitors may emerge and rapidly acquire significant market share.

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

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

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

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

As of September 30, 2005 we had offices in the United Kingdom, France, Spain and Northern Ireland with sales personnel in United Kingdom, France and Spain. We derived 24% of our total revenues in the nine months ended September 30, 2005 from customers outside the United States. In November, 2004, we initiated a restructuring plan, which included closing our offices in Italy and Germany during the fourth quarter of 2004. Our operations outside North America are subject to additional risks, including:

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

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

difficulties in managing systems integrators and technology partners;

difficulties in staffing and managing foreign subsidiary operations;

differing technology standards;

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

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

difficulties related to entering into legal contracts under local laws and in foreign languages;

potentially adverse tax consequences; and

political and economic instability.

The impact of future exchange rate fluctuations on our operating results cannot be accurately predicted. We may increase the extent to which we denominate arrangements with international customers in the currencies of the countries in which the software or services are provided. From time to time we may engage in hedges of contracts denominated in foreign currencies. Any hedging policies implemented by us may not be successful, and the cost of these hedging techniques may have a significant negative impact on our operating results.

Failure by us to comply with the financial covenants in our line of credit or the refusal of our bank to renew this facility, could negatively impact our cash, cash equivalents and marketable securities balances.

Table of Contents

We renewed and amended our \$20.0 million line of credit in the fourth quarter of 2004. This line of credit is secured by all of our tangible and intangible intellectual and personal property and is subject to financial covenants including liquidity coverage and profitability. While there were no outstanding borrowings under the facility at September 30, 2005, our bank had issued letters of credit totaling \$7.1 million, which are supported by this facility. The letters of credit have been issued in favor of various landlords and equipment vendors to secure obligations pursuant to leases expiring from December 2005 through January 2009. This revolving line of credit expires on December 24, 2005.

The liquidity covenant in the line of credit mandates that we maintain cash, cash equivalents and marketable securities of \$20 million at the end of each month.

At October 31, 2005, we had \$27.0 million in cash, cash equivalents and marketable securities, which represents a decrease of \$2.9 million from \$29.9 million in cash, cash equivalents and marketable securities at September 30, 2005. The profitability covenant, as amended, allows for a net loss not to exceed \$1.5 million for the third quarter of 2005, and requires net profitability of at least \$1.00 for the fourth quarter of 2005 and for each quarter thereafter. In the event that we do not comply with any of the financial covenants within the line of credit or default on any of its provisions, the bank's significant remedies include declaring all obligations immediately due and payable and ceasing to advance money or extend credit for our benefit.

Accordingly, if we do not comply with any of the financial covenants in the line of credit or if our line of credit agreement expires, the bank may require outstanding letters of credit to be cash secured. If the bank required us to secure each outstanding letter of credit on a dollar for dollar basis, our cash, cash equivalents and marketable securities balances would decrease substantially and our liquidity would be materially impaired.

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

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

Approximately 2% of our product license revenues in 2005 resulted directly from our relationships with value added resellers. A substantial portion of our product license revenues are influenced by our relationships with systems integrators and our potential customers often rely on third parties to develop, deploy and manage websites for conducting commerce on the Internet. As a result, we cultivate relationships with systems integrators and value added resellers to encourage them to create demand for and support our products.

Our systems integrators and value added resellers are not required to implement solutions that include our products or to maintain minimum sales levels of our products. If we fail to train our systems integrators or value added resellers, including a sufficient number of accredited partners and certified professionals, we believe that the product license revenues resulting from our relationships with these channel partners will decrease. In addition, if systems integrators or value added resellers devote their efforts to integrating or reselling competitors' products our product revenues would decline. Any such reduction in revenue would not be accompanied by a significant offset in our expenses. As a result, our operating results would suffer and the price of our common stock probably would fall.

Competition with our resellers could limit our sales opportunities and jeopardize our relationship with our resellers.

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

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

Table of Contents

In addition to our acquisition of Primus, in the future, we may pursue additional acquisitions to obtain complementary businesses, products, services or technologies. Any such acquisition may not produce the revenues, earnings or business synergies that we anticipated, and an acquired business, product, service or technology might not perform as we expected. If we pursue an additional acquisition, our management could spend a significant amount of time and effort in identifying and completing the acquisition. If we complete an additional acquisition, we may encounter significant difficulties and incur substantial expenses in integrating the operations and personnel of the acquired company into our operations while preserving the goodwill of the acquired company. In particular, we may lose the services of key employees of the acquired company and we may make changes in management that impair the acquired company's relationships with employees and customers.

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

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

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

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

The market for our products is marked by rapid technological change, frequent new product introductions and Internet-related technology enhancements, uncertain product life cycles, changes in customer demands, coalescence of product differentiators, product commoditization and evolving industry standards. We may not be able to develop and market or acquire new products or product enhancements that comply with present or emerging Internet technology standards and to differentiate our products based on functionality and performance. In addition, we may not be able to establish or maintain strategic alliances with operating system and infrastructure vendors that will permit migration or upgrade opportunities for our current user base. New products based on new technologies or new industry standards could render our existing products obsolete and unmarketable. For example, functionality that once differentiated our products over time has been incorporated into products offered by the major operating system and infrastructure providers, as occurred in the case of our application server products, leading to our recent decision to discontinue active marketing of these products.

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

Our software products may contain errors or defects that could result in lost revenues, delayed or limited market acceptance, or product liability claims with substantial litigation costs.

Table of Contents

Complex software products such as ours often contain errors or defects, particularly when first introduced or when new versions or enhancements are released. We began shipping the ATG Version 7.0 products in the fourth quarter of 2004, at the end of the third quarter of 2005 we released our Wisdom-enabled Service Suite which is a comprehensive set of applications that provides a full-featured, adaptively customized environment for managing all forms of customer service interactions with individual attention.. Despite internal testing and testing by customers, our current and future products may contain serious defects. Serious defects or errors could result in lost revenues or a delay in market acceptance.

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

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

During 2005 we incurred a net restructuring charge of \$823,000, primarily due to a \$1.8 million charge related to the relocation of our San Francisco office and a \$172,000 charge related to adjustments in estimates related to the 2004 restructuring charge for employee severance benefits payable in international geographies, offset by \$1.1 million for adjustments in estimates related to sublease costs included in the 2001, 2002, and 2004 actions. At the end of 2004, we initiated a plan to effect a worldwide headcount reduction and a reduction in the amount of space we occupy in our headquarters facility in Cambridge, Massachusetts. The 2004 action resulted in a net restructuring charge of \$3.6 million, which included costs of employee severance and lease costs associated with vacated premises. In addition, there were changes in assumptions and estimates connected to prior restructuring charges and the leases that were settled during the period. These actions and changes in estimates of previously recorded charges resulted in recording a net restructuring benefit of \$10.5 million during 2003. In January 2003, we publicly announced a corporate restructuring involving a workforce reduction and the closing and consolidation of office facilities in selected locations. These actions resulted in recording a restructuring charge of \$19.0 million in the fourth quarter of 2002. In addition, we recorded restructuring charges of \$75.6 million in 2001. These restructuring activities required that we close facilities, maintain sales efforts and provide continuing customer support and service in regions where the sales and support staff have been reduced or eliminated, reallocate workload among continuing employees, and seek to reduce liability for idle lease space. The outcomes of such restructuring activities are difficult to predict. While we believe our restructuring and consolidation activities will reduce our cost structure, we may not achieve the cost reductions that we are expecting. In addition, our restructuring activities may result in lower revenues as a result of the decreased staff in our sales and marketing and professional services groups or other adverse impacts on productivity that we did not anticipate. Our restructuring and consolidation activities are further complicated by the integration of Primus operations with our other operations, which could make the risks described above more severe.

The loss of technology licensed from third parties could delay our ability to deliver our products.

We rely in part on technology that we license from third parties, which is integrated into our internally developed software. Third-party technology licenses might not continue to be available to us on commercially reasonable terms, or at all. The loss of any significant technology license could cause delays in our ability to deliver our products or services until equivalent technology is developed internally or equivalent third-party technology, if available, is identified, licensed and integrated.

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

We write our software in the Java computer programming language developed by Sun Microsystems and we incorporate Sun's Java 2 Platform, Enterprise Edition, or J2EE, and Sun's Java Runtime Environment, Java Naming and Directory Interface, Java Servlet Development Kit, Java Foundation Classes, JavaMail and JavaBeans Activation Framework into our products under licenses granted to us by Sun. Our Version 7.0 ATG Adaptive Scenario Engine has been designed to support Sun's J2EE standards. If Sun were to decline to continue to allow us to use these technologies for any reason, we would be required to (a) license the equivalent technology from another source,

(b) rewrite the technology ourselves or (c) rewrite portions of our software to accommodate the change or no longer use the technology.

While a number of companies have introduced Web applications based on Java, Java could fall out of favor, and support by Sun Microsystems or other companies could decline. Moreover, our new Version 7.0 ATG Adaptive Scenario Engine is designed to

Table of Contents

support J2EE standards for developing modular Java programs that can be accessed over a network. We have licensed the J2EE brand and certification tests from Sun. There can be no assurance that these standards will be widely adopted, that we can continue to support J2EE standards established by Sun from time to time or that the J2EE brand will continue to be made available to us on commercially reasonable terms. If Java or J2EE support decreased or we could not continue to use Java or related Java technologies or to support J2EE, we might have to rewrite the source code for our entire product line to enable our products to run on other computer platforms. Also, changes to Java or J2EE standards or the loss of our license to the J2EE brand could require us to change our products and adversely affect the perception of our products by our customers. If we were unable to develop or implement appropriate modifications to our products on a timely basis, we could lose revenue opportunities and our business could be harmed.

Many of our Primus products run on Microsoft Windows NT, Microsoft Windows 2000 and Sun Solaris UNIX. Some of these products require the use of third party software. Any change to our customers' operating systems could require us to modify our Primus products and could cause us to delay product releases. In addition, any decline in the market acceptance of these operating systems we support may force us to ensure that all of our products and services are compatible with other operating systems to meet the demands of our customers. If potential customers do not want to use the Microsoft, Sun Solaris or J2EE operating systems we support, we will need to develop more products that run on other operating systems adopted by our customers.

Risks Related To the Internet Industry***Our performance will depend on the growth of e-commerce and self-service.***

Our success will depend heavily on the continued use of the Internet for e-commerce. The United States economic downturn that began in 2000 reduced demand for our products as customers and potential customers delayed or cancelled the implementation of online marketing, sales and service applications. If the market for our products and services fails to mature, we will be unable to execute our business plan. Adoption of electronic commerce and online marketing, sales and service applications, particularly by those companies that have historically relied upon traditional means of commerce, will require a broad acceptance of different methods of conducting business. Our future revenues and profits will substantially depend on the Internet being accepted and widely used for commerce and communication. If Internet commerce does not continue to grow or grows more slowly than expected, our future revenues and profits may not meet our expectations or those of analysts. Similarly, purchasers with established patterns of commerce may be reluctant to alter those patterns or may otherwise resist providing the personal data necessary to support our consumer profiling capability.

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

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

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

Businesses use our ATG Adaptive Scenario Engine product to develop and maintain profiles to tailor the content to be provided to website visitors. When a visitor first arrives at a website, our software creates a profile for that visitor. If the visitor registers or logs in, the visitor's identity is added to the profile, preserving any profile information that

was gathered up to that point. ATG Adaptive Scenario Engine product tracks both explicit user profile data supplied by the user as well as implicit profile attributes derived from the user's behavior on the website. Privacy concerns may cause visitors to resist providing the personal data or to avoid websites that track the Web behavioral information necessary to support our profiling capability. More importantly, even the perception of security and privacy concerns, whether or not valid, may indirectly inhibit market acceptance of our products. In addition, legislative or

Table of Contents

regulatory requirements may heighten these concerns if businesses must notify website users that the data captured after visiting websites may be used to direct product promotion and advertising to that user. Other countries and political entities, such as the European Economic Community, have adopted such legislation or regulatory requirements. The United States may adopt similar legislation or regulatory requirements. If privacy legislation is enacted or consumer privacy concerns are not adequately addressed, our business, financial condition and operating results could be harmed.

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

Risks Related To The Securities Markets And Our Stock***Our common stock price may continue to be volatile.***

The market price of our common stock has fluctuated in the past and is likely to continue to be highly volatile. For example, the market price of our common stock has ranged from \$0.58 per share to \$126.88 per share since our initial public offering in July 1999 and has ranged from \$0.95 per share to \$1.40 per share between January 1, 2005 and September 30, 2005. Fluctuations in market price and volume are particularly common among securities of Internet and software companies. The market price of our common stock may fluctuate significantly in response to the following factors, some of which are beyond our control:

variations in our quarterly operating results;

changes in market valuations of Internet and software companies;

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

timing of completion of significant sales;

additions or departures of our key personnel;

future sales of our common stock; or

changes in financial estimates by securities analysts.

We may incur significant costs from class action litigation.

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

Our common stock may not continue to trade on the Nasdaq National Market, which could reduce the value of your investment and make your shares more difficult to sell

For our common stock to trade on the Nasdaq National Market, we must continue to meet the listing standards of that market. Among other things, those standards require that our common stock maintain a minimum closing bid price of at least \$1.00 per share. Recently, our common stock has traded at prices near and below \$1.00. If we do not continue to meet Nasdaq's applicable minimum listing standards, Nasdaq could delist us from the Nasdaq National

Market. If our common stock is delisted from the Nasdaq National Market, we could seek to have our common stock listed on the Nasdaq SmallCap Market. However, delisting of our common stock

Table of Contents

from the Nasdaq National Market could hinder your ability to sell, or obtain an accurate quotation for the price of, your shares of our common stock. Delisting could also adversely affect the perception among investors of ATG and its prospects, which could lead to further declines in the market price of our common stock. Delisting would also make it more difficult and expensive for us to raise capital. In addition, delisting might subject us to an SEC rule that could adversely affect the ability of broker-dealers to sell or make a market in our common stock, thus hindering your ability to sell your shares.

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

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

authorizing the issuance of blank check preferred stock;

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

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

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

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

authorizing anti-takeover provisions.

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

The regulatory environment surrounding accounting and corporate governance subjects us to certain legal uncertainties in the operation of our business and may increase the cost of doing business.

We will face increased regulatory scrutiny associated with the highly publicized financial scandals and the various accounting and corporate governance rules promulgated under the Sarbanes-Oxley Act of 2002 and related regulations. Our management will review and will continue to monitor all of the accounting policies and practices, legal disclosure and corporate governance policies under the new legislation, including those related to relationships with our independent auditors, enhanced financial disclosures, internal controls, board and board committee practices, corporate responsibility and executive officer loan practices, and intend to fully comply with such laws. Nevertheless, such increased scrutiny and penalties involve risks to both our company and our executive officers and directors in monitoring and ensuring compliance. A failure to properly navigate the legal disclosure environment and implement and enforce appropriate policies and procedures, if needed, could harm our company's business and prospects, including its ability to recruit and retain skilled officers and directors. In addition, we may be adversely affected as a result of new or revised legislation or regulations imposed by the Securities Exchange Commission, other U.S. or foreign governmental regulatory authorities or self-regulatory organizations that supervise the financial markets. We also may be adversely affected by changes in the interpretation or enforcement of existing laws and rules by these governmental authorities and self-regulatory organizations.

We are incurring significant costs to comply with changing laws and we may in the future need to report significant deficiencies or material weaknesses in our Annual Report, which could affect our operating results and cause our stock price to decline.

Section 404 of the Sarbanes Oxley Act of 2002 requires that we annually evaluate and report on our systems of internal controls and that our independent auditors must report on management's evaluation of those controls. As permitted by applicable rules of the Securities and Exchange Commission, our management report on internal financial control for 2004 did not include the internal controls of Primus. We cannot assure you that in the future there

will not be material weaknesses in our internal controls, including internal controls related to our Primus subsidiary. A negative reaction by the equity markets to the reporting of a material weakness could cause our stock price to decline.

50

Table of Contents

We are also spending an increased amount of management time and focus as well as external resources to comply with changing laws, regulations and standards relating to corporate governance and public disclosure. This has caused us to hire additional personnel and outside advisory services and has resulted in additional accounting and legal expenses. These additional expenses could adversely affect our operating results and the market price of our stock could suffer as a result.

In addition, if in the future we acquire companies with weak internal controls, it will take time to get the internal controls of the acquired company up to the same level of operating effectiveness as ours. Our inability to address these risks could negatively affect our operating results.

Changes in the accounting treatment of stock options could adversely affect our results of operations.

In accordance with Statement of Financial Accounting Standards (SFAS) No. 123R, *Share-Based Payment*, we will be required to expense employee stock options for financial reporting purposes, effective for our 2006 fiscal year. Such stock option expensing will require us to value our employee stock option grants pursuant to an option valuation formula and amortize that value against our earnings over the vesting period in effect for those options. We currently account for stock-based awards to employees in accordance with Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees*, and have adopted the disclosure-only alternative of SFAS No. 123, *Accounting for Stock-Based Compensation*. When we are required to expense employee stock options in the future, this change in accounting treatment could materially and adversely affect our reported results of operations as an increased amount of stock-based compensation expense would be charged against our reported earnings. For pro forma disclosure illustrating the effect such a change on our recent results of operations, see Note 2 of the Unaudited Condensed Consolidated Financial Statements. The adoption of SFAS 123R could adversely affect our ability to comply with the profitability covenants of our credit facility with our bank. See Note 11 to the Unaudited Condensed Consolidated Financial Statements.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

We maintain an investment portfolio consisting mainly of investment grade money market funds, corporate obligations and government obligations with a weighted average maturity of less than one year. These held-to-maturity securities are subject to interest rate risk. However, a 10% change in interest rates would not have a material impact to the fair values of these securities primarily due to their short maturity and our intent to hold the securities to maturity. There have been no significant changes to the fair values of these securities since September 30, 2005.

The majority of our operations are based in the U.S., and accordingly, the majority of our transactions are denominated in U.S. dollars. However, we have foreign-based operations where transactions are denominated in foreign currencies and are subject to market risk with respect to fluctuations in the relative value of currencies. Our primary foreign currency exposures relate to our short-term intercompany balances with our foreign subsidiaries. The primary foreign subsidiaries have functional currencies denominated in the British pound and Euro that are remeasured at each reporting period with any exchange gains and losses recorded in our consolidated statements of operations. Based on currency exposures existing at September 30, 2005, a 10% movement in foreign exchange rates would not expose us to significant gains or losses in earnings or cash flows. We may use derivative instruments to manage the risk of exchange rate fluctuations, however, at September 30, 2005 we held no outstanding derivative instruments. We do not use derivative instruments for trading or speculative purposes.

Item 4. Controls and Procedures

Our management, with the participation of our chief executive officer and chief financial officer, evaluated the effectiveness of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act) as of September 30, 2005. Based on this evaluation, our chief executive officer and chief financial officer concluded that, as of September 30, 2005, our disclosure controls and procedures were (1) designed to ensure that material information relating to our company, including our consolidated subsidiaries, is made known to our chief executive officer and chief financial officer by others within those entities particularly during the period in which this report was being prepared and (2) effective, in that they provide reasonable assurance that information required to be disclosed by us in the reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms.

In designing and evaluating our disclosure controls and procedures, management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable, and not absolute, assurance that the objectives of the control system will be met. In addition, the design of any control system is based in part upon certain assumptions about the likelihood of

Table of Contents

future events and the application of judgment in evaluating the cost-benefit relationship of possible controls and procedures. Because of these and other inherent limitations of control systems, there is only reasonable assurance that our controls will succeed in achieving their goals under all potential future conditions.

There has been no change in our internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) during the fiscal quarter ended September 30, 2005 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

Table of Contents**PART II. OTHER INFORMATION****Item 1. Legal Proceedings**

We and certain of our former officers have been named as defendants in seven purported class action suits that have been consolidated into one action currently pending in the United States District Court for the District of Massachusetts under the caption *In re Art Technology Group, Inc. Securities Litigation* (Master File No. 01-CV-11731-NG). This case alleges that we, and certain of our former officers, have violated Sections 10(b) and 20(a) of the Securities Exchange Act of 1934 and Rule SEC 10b-5 promulgated thereunder, which generally may subject issuers of securities and persons controlling those issuers to civil liabilities for fraudulent actions in connection with the purchase or sale of securities. The case was originally filed in 2001, and a consolidated amended complaint was filed in March 2002. In April, 2002, we filed a motion to dismiss the case. On September 4, 2003, the court issued a ruling dismissing all but one of the plaintiffs' allegations. The remaining allegation was based on the veracity of a public statement made by one of our former officers. In August 2004, we filed a renewed motion to dismiss and motion for summary judgment as to the remaining allegation, which the court granted in September 2005. The plaintiffs have moved for leave to file a second consolidated amended complaint, which, if allowed, would revive some of the claims previously dismissed by the court. The court has deferred a final order of dismissal of plaintiffs' case to allow it time to consider plaintiffs' motion for leave to file a second consolidated amended complaint. We have opposed that motion. Management believes that none of the claims that plaintiffs seek to assert in their second amended complaint has merit, and intends to continue to defend the action vigorously. While we cannot predict with certainty the outcome of the litigation, we do not expect any material adverse impact to our business, or the results of our operations, from this matter.

Our wholly owned subsidiary Primus Knowledge Solutions, Inc., two former officers of Primus, and FleetBoston Robertson Stephens, Inc., J.P. Morgan Securities Inc., U.S. Bancorp Piper Jaffray Inc., CIBC World Markets, Dain Rauscher, Inc. and Salomon Smith Barney Holdings Inc., the underwriters of Primus' initial public offering, have been named as defendants in an action filed in December 2001 in the United States District Court for the Southern District of New York under the caption *In re Primus Knowledge Solutions, Inc. Securities Litigation*, Civil Action 01-Civ.-11201 (SAS) on behalf of a purported class of purchasers of Primus common stock from June 30, 1999 to December 6, 2000, which was issued pursuant to the June 30, 1999 registration statement and prospectus for Primus initial public offering. The consolidated and amended complaint asserts claims under Sections 11 and 15 of the Securities Act of 1933 and Sections 10(b) (and SEC Rule 10b-5 promulgated thereunder) and 20(a) of the Securities Exchange Act of 1934. This action is one of more than 300 similar actions coordinated for pretrial purposes under the caption *In re Initial Public Offering Securities Litigation*, Civil Action No. 21-MC-92. Plaintiffs in these coordinated proceedings have brought claims under the federal securities laws against numerous underwriters, companies, and individuals, alleging generally that defendant underwriters engaged in improper and undisclosed activities concerning the allocation of shares in the IPOs of more than 300 companies during the period from late 1998 through 2000. Among other things, the plaintiffs allege that the prospectus pursuant to which shares of Primus common stock were sold in the IPO contained certain false and misleading statements regarding the practices of Primus' underwriters with respect to their allocation of shares of common stock in Primus' IPO to their customers and their receipt of commissions from those customers related to such allocations, and that such statements and omissions caused Primus post-IPO stock price to be artificially inflated. On February 19, 2003, the Court denied in part and granted in part the motion to dismiss filed on behalf of defendants, including Primus. The Court's order did not dismiss any claims against Primus. The individual defendants have been dismissed from the action without prejudice pursuant to a tolling agreement. By action of a special committee of disinterested directors (who were neither defendants in the litigation nor members of Primus's Board of Directors at the time of the actions challenged in the litigation), Primus decided to accept a settlement proposal presented to all issuer defendants. In the settlement, plaintiffs will dismiss and release all claims against Primus and the individual defendants in exchange for a contingent payment by the insurance companies collectively responsible for insuring the issuers in all of the consolidated IPO cases, and for the assignment or release of certain potential claims that we may have against the underwriters. We will not be required to make any cash payments in the settlement, unless the pro rata amount paid by the insurers in the settlement on our behalf exceeds the amount of the insurance coverage, a circumstance that we believe is not likely to occur. A stipulation of settlement of

claims against the issuer defendants, including Primus, was submitted to the Court for preliminary approval in June 2004. On August 31, 2005, the Court granted preliminary approval of the settlement. The settlement is subject to a number of conditions, including final Court approval after proposed settlement class members have an opportunity to object or opt out. If the settlement does not occur, and litigation against Primus continues, we believe we have meritorious defenses and intend to defend the case vigorously. While we cannot predict with certainty the outcome of the litigation or whether the settlement will be approved, we do not expect any material adverse impact to our business, or the results of our operations, from this matter.

Table of Contents

We are also subject to various other claims and legal actions arising in the ordinary course of business. In the opinion of management, the ultimate disposition of these matters is not expected to have a material effect on our business, financial condition or results of operations.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

None.

Item 3. Defaults Upon Senior Securities

None.

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

None.

Item 5. Other Information

None.

Item 6. Exhibits

10.1 Offer letter with Julie M.B. Bradley dated July 6, 2005

10.2 Non-Employee Director Compensation Plan

10.3 1999 Outside Director Stock Option Plan, as amended (including form of option agreement)

10.4 1996 Stock Option Plan, as amended

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

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

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

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

Table of Contents

SIGNATURES

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

ART TECHNOLOGY GROUP, INC.
(Registrant)

By: /s/ ROBERT D. BURKE
Robert D. Burke
President and Chief Executive Officer
(principal executive officer)

By: /s/ JULIE M.B. BRADLEY
Julie M.B. Bradley
Senior Vice President, Finance and Chief
Financial Officer
(principal financial officer)

By: /s/ PAUL G. FITZGERALD
Paul G. Fitzgerald
Vice President, Finance and Corporate
Controller (principal accounting officer)

Date: November 8, 2005

Table of Contents

EXHIBIT INDEX

- 10.1 Offer letter with Julie M.B. Bradley dated July 6, 2005
- 10.2 Non-Employee Director Compensation Plan
- 10.3 1999 Outside Director Stock Option Plan, as amended (including form of option agreement)
- 10.4 1996 Stock Option Plan, as amended
- 31.1 Certification of Principal Financial Officer Pursuant to Exchange Act Rules 13a-14 and 15d-14, as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 31.2 Certification of Principal Financial Officer Pursuant to Exchange Act Rules 13a-14 and 15d-14, as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 32.1 Certification of Principal Executive Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- 32.2 Certification of Principal Financial Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002