ART TECHNOLOGY GROUP INC
Form 10-Q
August 09, 2004

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SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

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

For the Quarterly Period Ended June 30, 2004

OR

o **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	**04-3141918**
(State or other jurisdiction of incorporation or organization)	(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 x Noo

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

As of August 6, 2004 there were 73,887,620 shares of the Registrant s common stock outstanding.

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

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

	June 30, 2004	December 31, 2003
ASSETS		
Current Assets:		
Cash and cash equivalents	$ 22,533	$ 31,934
Marketable securities	2,832	9,650
Accounts receivable, net of reserves of $770 ($799 in 2003)	10,897	15,364
Prepaid expenses and other current assets	2,633	1,949
Total current assets	38,895	58,897
Property and equipment, net	3,013	3,751
Long term marketable securities	7,390	
Other assets	4,304	4,712
	$ 53,602	$ 67,360
LIABILITIES AND STOCKHOLDERS EQUITY		
Current Liabilities:		
Accounts payable	$ 1,933	$ 1,146
Accrued expenses	10,383	12,363
Deferred revenue	14,196	14,915
Accrued restructuring, short-term	4,149	9,427
Total current liabilities	30,661	37,851
Accrued restructuring, less current portion	7,150	8,572
Commitments and contingencies (Notes 8 and 9)		
Stockholders Equity:		
Preferred stock, $0.01 par value		
Authorized 10,000,000 shares		
Issued and outstanding no shares		
Common stock, $0.01 par value		
Authorized 200,000,000 shares		
Issued and outstanding 73,828,622 shares and 72,936,165 shares at June 30, 2004 and December 31, 2003,	738	729

respectively		
Additional paid-in capital	219,765	218,927
Deferred compensation		(11)
Accumulated deficit	(201,725)	(195,691)
Accumulated other comprehensive loss	(2,987)	(3,017)
Total Stockholders Equity	15,791	20,937
	$ 53,602	$ 67,360

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

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2004	2003	2004	2003
Revenues:				
Product license	$ 3,144	$ 9,464	$ 9,508	$16,970
Services	11,188	11,842	21,634	23,761
Total Revenues	14,332	21,306	31,142	40,731
Cost of Revenues:				
Product license	331	647	730	1,131
Services	5,125	5,104	9,910	10,844
Total Cost of Revenues	5,456	5,751	10,640	11,975
Gross Profit	8,876	15,555	20,502	28,756
Operating Expenses:				
Research and development	4,150	4,967	8,280	9,841
Sales and marketing	7,231	8,096	14,572	16,882
General and administrative	1,739	2,374	3,669	5,030
Restructuring benefit		(5,442)		(5,442)
Total Operating Expenses	13,120	9,995	26,521	26,311
Income (Loss) from Operations	(4,244)	5,560	(6,019)	2,445
Interest and Other Income, Net	64	490	17	851
Income (loss) before provision for income taxes	(4,180)	6,050	(6,002)	3,296
Provision for Income Taxes	67		32	
Net income (loss)	$ (4,247)	$ 6,050	$ (6,034)	$ 3,296
Basic net income (loss) per share	$ (0.06)	$ 0.08	$ (0.08)	$ 0.05

Diluted net income (loss) per share	$ (0.06)	$ 0.08	$ (0.08)	$ 0.05
Basic weighted average common shares outstanding	73,193	71,475	73,289	71,228
Diluted weighted average common shares outstanding	73,193	73,141	73,289	72,324

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

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

	Six Months Ended June 30,	
	2004	**2003**
Cash Flows from Operating Activities:		
Net income (loss)	$ (6,034)	$ 3,296
Adjustments to reconcile net income (loss) to net cash used in operating activities Stock-based compensation	11	99
Depreciation and amortization	1,039	2,373
Non-cash restructuring charge		847
Loss on disposal of fixed assets, net	100	60
Changes in current assets and liabilities		
Accounts receivable, net	4,467	8,651
Prepaid expenses and other current assets	(684)	50
Other assets	404	(1,365)
Accounts payable	787	(419)
Accrued expenses	(1,980)	(3,004)
Deferred revenues	(719)	(83)
Accrued restructuring	(6,700)	(21,146)
Net cash used in operating activities	(9,309)	(10,641)
Cash Flows from Investing Activities:		
Maturities of marketable securities	8,743	17,778
Purchases of marketable securities	(9,313)	(9,049)
Purchases of property and equipment	(345)	(775)
Proceeds from sale of equipment		45
Decrease in other assets	4	153
Net cash provided by (used in) investing activities	(911)	8,152
Cash Flows from Financing Activities:		
Proceeds from exercise of stock options	332	70
Proceeds from employee stock purchase plan	515	543
Net cash provided by financing activities	847	613

Effect of Foreign Exchange Rate Changes on Cash and Cash Equivalents	(28)	(857)
Net Decrease in Cash and Cash Equivalents	(9,401)	(2,733)
Cash and Cash Equivalents, Beginning of Period	31,934	45,829
Cash and Cash Equivalents, End of Period	$22,533	$ 43,096

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

ART TECHNOLOGY GROUP, INC.
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(1) OPERATIONS AND BASIS OF PRESENTATION

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

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

The accompanying unaudited condensed consolidated financial statements of the Company have been prepared pursuant to the rules of the Securities and Exchange Commission for quarterly reports on Form 10-Q. The disclosures do not include all of the information and footnotes required by accounting principles generally accepted in the United States, and while the Company believes that the disclosures presented are adequate to make information not misleading, these financial statements should be read in conjunction with the audited financial statements and related notes included in the Company s 2003 Annual Report on Form 10-K. In the opinion of management, the accompanying unaudited condensed consolidated financial statements and notes contain all adjustments, consisting of normal recurring accruals, considered necessary for a fair presentation of the Company s financial position, results of operations and cash flows at the dates and for the periods indicated. The operating results for the three and six months ended June 30, 2004 are not necessarily indicative of the results to be expected for the full year ending December 31, 2004.

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

Certain amounts reported in previous periods have been reclassified to conform to the current period presentation. Such reclassifications were not material.

(2) STOCKHOLDERS EQUITY

Stock-Based Compensation

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

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

	Three months ended June 30,	Six months ended June 30,

	2004	2003	2004	2003
Net income (loss) as reported	$(4,247)	$ 6,050	$ (6,034)	$ 3,296
Add: Stock-based compensation expense included in reported income (loss)		18	11	99
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards	(4,522)	(10,909)	(10,958)	(25,016)
Pro forma net loss	$(8,769)	$ (4,841)	$(16,981)	$(21,621)
Basic and diluted net income (loss) per share				
As reported	$ (0.06)	$ 0.08	$ (0.08)	$ 0.05
Pro forma	$ (0.12)	$ (0.07)	$ (0.23)	$ (0.30)

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

During the three months ended June 30, 2004, shareholders approved resolutions to further amend the Amended and Restated 1996 Stock Option Plan to allow for the grant of restricted stock awards, performance share awards and other forms of equity based compensation that were not previously provided for in the plan and extend the term of the plan until December 31, 2013. Additionally, shareholders approved resolutions to further amend the Amended and Restated 1999 Outside Director Stock Option Plan (the Director Plan) to allow for the grant of restricted stock and extend the term of the Director Plan until December 31, 2013. Pursuant to the amendments to the Director Plan, $2,500 of each outside director s annual retainer will be paid in the form of restricted stock.

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(3) NET INCOME (LOSS) PER SHARE

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

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

	Three months ended June 30,		Six months ended June 30,	
	2004	2003	2004	2003
Net income (loss)	$ (4,247)	$ 6,050	$ (6,034)	$ 3,296
Weighted average common shares outstanding	73,194	71,475	73,289	71,228
Weighted average common stock equivalents outstanding:				
Employee stock options		1,666		1,096
Total weighted average common stock and common stock equivalents	73,193	73,141	73,289	72,324
Basic net income (loss) per share	$ (0.06)	$ 0.08	$ (0.08)	$ 0.05
Diluted net income (loss) per share	$ (0.06)	$ 0.08	$ (0.08)	$ 0.05

(4) REVENUE RECOGNITION

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

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

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

(5) CASH, CASH EQUIVALENTS AND MARKETABLE SECURITIES

ATG accounts for investments in marketable securities under FAS 115, *Accounting for Certain Investments in Debt and Equity*

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Securities (FAS 115). Under FAS 115, investments for which ATG has the positive intent and the ability to hold to maturity, consisting of cash equivalents and marketable securities, are reported at amortized cost, which approximates fair market value. Cash equivalents are highly liquid investments with maturities at the date of acquisition of less than 90 days. Marketable securities are investment grade debt securities with maturities at the date of acquisition of greater than ninety days. At June 30, 2004 and December 31, 2003, all of ATG s marketable securities were classified as held-to-maturity. The average maturity of ATG s marketable securities was approximately 9.2 months and 3.5 months at June 30, 2004 and December 31, 2003, respectively. At June 30, 2004 the average maturity of the marketable securities classified as long-term was 17.5 months. At June 30, 2004 and December 31, 2003, the difference between the amortized cost and market value of ATG s marketable securities were gains (losses) of approximately ($87,000) and $4,000, respectively. At June 30, 2004 and December 31, 2003, ATG s cash, cash equivalents and marketable securities consisted of the following (in thousands):

	June 30, 2004	December 31, 2003
Cash and cash equivalents		
Cash	$ 7,395	$11,767
Money market accounts	12,716	20,167
U.S. Government Agency	2,022	
Commercial Paper	400	
Total cash and cash equivalents	$22,533	$31,934
Marketable securities		
Corporate securities	$ 9,221	$ 8,642
U.S. Government Agency	1,001	1,008
Total marketable securities	$10,222	$ 9,650

(6) COMPREHENSIVE INCOME (LOSS)

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2004	2003	2004	2003

Net income (loss)	$ (4,247)	$ 6,050	$ (6,034)	$ 3,296
Foreign currency translation income (loss)	68	(522)	30	(802)
Comprehensive income (loss)	$ (4,179)	$ 5,528	$ (6,004)	$ 2,494

The accumulated other comprehensive loss at June 30, 2004 and December 31, 2003, of $3.0 million consisted entirely of the cumulative foreign currency translation adjustment.

(7) DISCLOSURES ABOUT SEGMENTS OF AN ENTERPRISE

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

Revenues from sources outside of the United States were approximately $4.3 million and $9.9 million for the three months ended June 30, 2004 and 2003, respectively, and $10.8 million and $14.7 million for the six months ended June 30, 2004 and 2003,

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respectively. ATG s revenue from international sources was primarily generated from customers located in Europe and Asia/Pacific. All of ATG s software licenses for the three and six months ended June 30, 2004 and 2003 were delivered from its headquarters located in the United States.

The following table represents the percentage of total revenues by geographic region from customers for the three and six months ended June 30, 2004 and 2003:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2004	**2003**	**2004**	**2003**
United States	70%	53%	65%	64%
United Kingdom (UK)	8	27	17	17
Europe, Middle East and Africa (excluding UK)	20	17	13	15
Other	2	3	5	4
	100%	100%	100%	100%

(8) LONG-TERM OBLIGATIONS

Credit Facility

Effective June 13, 2002, ATG entered into a $15 million revolving line of credit with Silicon Valley Bank (the Bank) which provided for borrowings of up to the lesser of $15 million or 80% of eligible accounts receivable. Effective December 24, 2002 the revolving line of credit increased to $20 million.

Effective November 25, 2003, ATG modified its existing revolving line of credit with the Bank. This $20 million line of credit is secured by all of ATG s tangible and intangible intellectual and personal property and is subject to financial covenants including liquidity coverage and profitability. The liquidity covenant mandates ATG maintain $25.0 million in cash, which includes cash equivalents and marketable securities, at the end of each month throughout the duration of the facility. The profitability covenant, which was modified in June 2004 pursuant to the Fifth Loan Modification Agreement, allows for net losses not to exceed: $5.0 million for the second quarter of 2004, $2.0 million for the third quarter of 2004 and $1.0 million for the fourth quarter of 2004. ATG is required to maintain $25 million in unrestricted cash, which includes cash equivalents and marketable securities, at the Bank. In the event ATG s cash balances at the Bank fall below $25 million, ATG will be required to pay fees and expenses to compensate the Bank for lost income. At June 30, 2004, ATG was in compliance with all amended related financial covenants. In the event that ATG does not comply with any of the financial covenants within the line of credit or defaults on any of its provisions, the Bank s significant remedies include: (1) declaring all obligations immediately due and payable; (2) ceasing to advance money or extend credit for the Company s benefit; (3) applying to the obligations any balances and deposits held by the Company or any amount held by the Bank owing to or for the credit or the account of ATG; and, (4) putting a hold on any deposit account held as collateral. If the agreement expires, or is not extended, the Bank will require outstanding Letters of Credit (LC s) at that time to be cash secured on terms acceptable to the Bank. The revolving line of credit expires on November 25, 2004.

While there were no outstanding borrowings under the facility at June 30, 2004, ATG has issued LC s totaling $10.6 million, which are supported by this facility. The LC s have been issued in favor of various landlords and equipment vendors to secure lease obligations pursuant to leases expiring from August 2004 through August 2009. The line of credit bears interest at the Bank s prime rate (4.25% at June 30, 2004). As of June 30, 2004, approximately $9.4 million was available under the facility.

(9) COMMITMENTS AND CONTINGENCIES

Leases

ATG has offices, primarily for sales and support personnel, in 8 domestic locations as well as four foreign countries. At June 30, 2004, ATG has issued $10.6 million of LC s under its line of credit in favor of various landlords and equipment vendors to secure lease obligations, which expire from 2004 through 2009.

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The approximate future minimum payments of ATG s facility leases and certain operating equipment leases as of June 30, 2004, are as follows (in thousands):

	Operating Leases
Remainder of 2004	$ 3,317
2005	6,693
2006	5,106
2007	2,299
2008	1,846
Thereafter	461
Total future minimum lease payments	$19,722

The $19.7 million in future minimum lease payments includes $12.6 million of obligations on facilities that are included in the Company s restructuring accrual. The $12.6 million was reduced to an $11.0 million restructuring accrual after taking into consideration contracted and estimated sublease income, vacancy periods and operating costs of the various subleased properties (Note 10).

Rent expense included in the accompanying statements of operations was $1.2 million and $1.4 million for the three months ended June 30, 2004 and 2003, respectively, and $2.4 million and $2.9 million for the six months ended June 30, 2004 and 2003, respectively. Rent expense does not include $1.5 million and $2.7 million for the three months ended June 30, 2004 and 2003 and $2.5 million and $4.6 million for the six months ended June 30, 2004 and 2003, respectively, in rent charged to the restructuring accrual.

Indemnifications

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

With respect to software license agreements, these indemnifications generally include provisions indemnifying the customer against losses, expenses, and liabilities from damages that may be awarded against the customer in the event the Company s software is found to infringe upon the intellectual property of others. The software license agreements generally limit the scope of and remedies for such indemnification obligations in a variety of industry-standard respects. The Company believes its internal development processes and other policies and practices limit its exposure related to the indemnification provisions of the software license agreements. In addition, the Company requires its employees to sign a proprietary information and inventions agreement, which assigns the rights to its employees development work to the Company. To date, the Company has not had to reimburse any of its customers for any losses related to these indemnification provisions and no material claims are outstanding as of June 30, 2004.

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

(10) RESTRUCTURING

During the years ended 2003, 2002 and 2001, the Company recorded net restructuring charges/(benefits) of ($10.5) million, $19.0 million and $75.6 million, respectively, as a result of the global slowdown in information technology spending. The 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. 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 2003 charges were recorded in accordance with FAS 146, *Accounting for Costs Associated with Exit or Disposal Activities*, FAS 88, *Employers Accounting for Settlements and*

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Curtailments of Defined Benefit Pension Plans and for Termination Benefits (FAS 88) and Staff Accounting Bulletin (SAB) 100, *Restructuring and Impairment Charges*. The 2002 and 2001 charges were recorded in accordance with Emerging Issues Task Force Issue No. 94-3, *Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (Including Certain Costs Incurred in a Restructuring)*, FAS 88 and SAB 100.

2001 Actions

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

A summary of the restructuring accrual activity in 2004 is as follows (in thousands):

	Accrued Restructuring Balance as of December 31, 2003	Payments	Accrued Restructuring Balance as of June 30, 2004
Facilities-related costs and impairments	$ 10,208	$ 2,178	$ 8,030
Employee severance, benefits and related costs	229		229
Total	$ 10,437	$ 2,178	$ 8,259

Facilities-Related Costs and Impairments

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

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

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

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

Employee Severance, Benefits and Related Costs and Exchangeable Shares

As part of the 2001 restructuring actions, the Company recorded charges of $7.9 million for employee severance. The Company terminated the employment of 530 employees, or 46% of the Company s workforce, of which 249 of these employees were from sales and marketing, 117 from services, 101 from general and administrative and 63 from research and development. None of these

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employees remained employed as of June 30, 2002. In addition, the Company settled 11,762 exchangeable shares with a certain employee, who was terminated in connection with the restructuring action, and recorded $1.3 million as a charge to restructuring for this settlement. During 2003, the Company recorded additional charges of $229,000 for severance related to a specific employee terminated as part of the 2001 restructuring action.

Asset Impairments

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

Marketing Costs and Legal & Accounting

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

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

2002 Actions

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

A summary of the restructuring accruals activity in 2004 related to the 2002 restructuring actions is as follows (in thousands):

	Accrued Restructuring Balance as of December 31, 2003	Payments	Accrued Restructuring Balance as of June 30, 2004
Facilities-related costs and impairments	$ 5,887	$4,418	$ 1,469
Total	$ 5,887	$4,418	$ 1,469

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 intended to sublease. The estimated sublease income was $4.8 million and based on rental rates ranging from $23 to $35 per square foot with estimated vacancy periods prior to the expected sublease income ranging from 12 to 21 months.

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

As a result of this action and the actions taken in 2001, the Company wrote-off certain computer equipment and software, aggregating $1.2 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

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cash flows they would generate over their remaining economic lives. Due to the short remaining economic lives and current market conditions for such assets, the fair value of these assets was estimated to be zero. These assets ceased being used either as of December 31, 2002 or in the first quarter of 2003 and were disposed of in the quarter ended March 31, 2003. In addition, the Company wrote-off leasehold improvements, which will continue to be in use, related to the facilities it is attempting to sublease, to their fair value of zero because the estimated cash flows to be generated by sublease income at those locations will not be sufficient to recover the carrying value of the assets.

Employee Severance, Benefits and Related Costs

As part of the 2002 restructuring action, the Company recorded a charge of $3.6 million for severance and benefit costs related to cost reduction actions taken across the worldwide employee base. The severance and benefit costs were for 125 employees, or 23% of the Company s workforce, none of whom remained employed at December 31, 2003. Of the 125 employees, 53 of the employees were from sales and marketing, 45 from services, 19 from general and administrative and 8 from research and development. The Company accrued employee benefits pursuant to ongoing benefit plans and statutory minimum requirements in foreign locations. The Company began the termination process on January 6, 2003 and all employees had been terminated by June 30, 2003. During the second quarter of 2003, the Company recorded an adjustment to increase the severance accrual by $327,000 based on final severance settlements with certain employees at its foreign locations. During the fourth quarter of 2003, the Company reduced certain severance accruals by $86,000, primarily at its foreign locations, primarily as a result of amounts being settled at less than the amount recorded due to foreign currency exchange movements.

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 restructuring accruals activity in 2004 is as follows (in thousands):

	Balance at December 31, 2003	Payments	Balance at June 30, 2004
Facilities-related costs and impairments	$ 1,614	$ 58	$ 1,556
Employee severance, benefits and related costs	61	46	15
Total	$ 1,675	$ 104	$ 1,571

Second Quarter 2003 Action

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

Facilities-Related Costs and Impairments

During the second quarter of 2003, the Company recorded facilities-related charges of $1.1 million comprising $866,000 for an operating lease related to idle office space, $144,000 of leasehold improvements and fixed assets written down to their fair value, and $61,000 for various office equipment leases. The lease charge was for office space the Company vacated and intends to sublease. The amount of the operating lease charge was based on assumptions from current real estate market data for sublease income rates and vacancy rates at the location. The estimated sublease income was $500,000 and based on a rental rate of $35 per square foot with an estimated vacancy period prior to the expected sublease income of 24 months. In the fourth quarter, as a result of updated market conditions, the estimated sublet rental rate was lowered to $30 per square foot from $35 per square foot and the vacancy period was extended to 36 months from 24 months resulting in an additional charge of $227,000. In accordance with FAS 146, the Company 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 lives. Due to the short remaining economic life and current market conditions for such assets, the fair value of these assets was estimated to be zero. These assets ceased being used by June 30, 2003 and were disposed of by September 30, 2003. In addition, the Company wrote off leasehold improvements, which continue to be in use, related to the facility it is attempting to sublease to their fair value of zero because the estimated cash flows to be generated from that location will not be sufficient to recover the carrying value of the assets.

Employee Severance, Benefits and Related Costs

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

Asset Impairments

The Company recorded a charge in cost of product license revenues of $169,000 to reduce the carrying value of third-party software embedded into one of its products, which was a minor component of the Company s 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 had 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 Action

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

Facilities -Related Costs and Impairments

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

As of June 30, 2004 the Company had an accrued restructuring liability of $11.3 million, of which $8.3 million related to 2001 restructuring charges, $1.5 million relates to 2002 restructuring charges, and $1.5 million related to 2003 restructuring charges. The long-term portion of the accrued restructuring liability was $7.2 million.

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Abandoned Facilities Obligations

At June 30, 2004, the Company had lease arrangements related to six abandoned facilities. The lease arrangements with respect to five of these facilities are ongoing, and the other facility 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		2004	2005	2006	2007	2008	2009	Total
Cambridge, MA	*	$1,035	$2,069	$ 1,035				4,139
Cambridge, MA		69	137	91				297
Waltham, MA		733	1,466	1,466	1,466	1,466	366	6,963
Chicago, IL		262	524	393				1,179
San Francisco, CA		55	111	111	111			388
Reading, UK		290	579	579	579	579	181	2,787
Facility obligations, gross		$2,444	$4,886	$ 3,675	$ 2,156	$ 2,045	$ 547	15,753
Contracted and assumed sub-let income		(593)	(435)	(1,104)	(1,263)	(1,218)	(304)	(4,917)
Net cash obligations		$1,851	$4,451	$ 2,571	$ 893	$ 827	$ 243	10,836
Assumed sub-lease income		$ 0.0	$ 0.0	$ 200	$ 300	$ 200	$ 100	800

* Represents a location for which the Company has executed a lease settlement agreement.

(11) LITIGATION

The Company and certain former officers have been named defendants in seven purported class action suits currently pending in the United States District Court for the District of Massachusetts. Each of these cases alleges that the Company and certain former officers have violated Sections 10(b) and 20(a) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder, which generally may subject issuers of securities and persons controlling those issuers to civil liabilities for fraudulent actions or defects in the public disclosure required by securities laws. Four of the cases were filed on various dates in October 2001 in the U.S. District Court for the District of Massachusetts. Three of the cases were initially filed in the Central District of California (the California actions) on various dates in August and September 2001. The California actions were consolidated and transferred to the District of Massachusetts on or about November 27, 2001. On December 13, 2001, the Court issued an Order of Consolidation in which it consolidated all actions filed against the Company and appointed certain individuals as Lead Plaintiffs in the consolidated action. It also appointed two law firms as Co-Lead Counsel, and a third law firm as Liaison Counsel. Counsel for the plaintiffs has filed a Consolidated Amended Complaint applicable to all of the consolidated actions. On April 19, 2002, the Company filed a motion to dismiss the case. On September 4, 2003 the court issued a ruling dismissing all but one of the plaintiffs allegations. The remaining allegation is based on the veracity of a public statement made by a former officer of the Company. While management believes the remaining claim against the

Company is without merit, and intends to defend the action vigorously, the litigation is still in the preliminary stage.

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

(12) FOREIGN CURRENCY TRANSLATION

The financial statements of the Company s foreign subsidiaries are translated in accordance with FAS 52, *Foreign Currency Translation* (FAS 52). The Company has determined that the functional currency of its foreign subsidiaries is the local currency. As a result, the Company translates the assets and liabilities of its foreign subsidiaries at the exchange rates in effect at quarter-end. Prior to translation, the Company re-measures foreign currency denominated assets and liabilities into the functional currency of the respective Company entity, resulting in unrealized gains or losses recorded in Interest and Other Income, Net in the accompanying Condensed Consolidated Statements of Operations. Revenues and expenses are translated using average exchange rates in effect during each respective reporting period. Gains and losses from foreign currency translation are credited or charged to Accumulated Other Comprehensive Loss included in Stockholders Equity in the accompanying Condensed Consolidated Balance Sheets. The Company recorded foreign currency related gains(losses) of $31,000 and $296,000, respectively, for the three months ended June 30, 2004 and 2003, and $(91,000) and $453,000, respectively, for the six months ended June 30, 2004 and 2003.

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(13) RECENT ACCOUNTING PRONOUNCEMENTS

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

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

Overview

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

We were founded in December 1991. From 1991 through 1995, we devoted our efforts principally to building, marketing and selling our professional services capabilities and to research and development activities related to our software products. Beginning in 1996, we began to focus on selling our software products. To date, we have enhanced and released several versions of our products. We market and sell our products worldwide through our direct sales force, systems integrators, technology alliances, value added resellers and original equipment manufacturers.

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

As of June 30, 2004 we had offices in France, Germany, Italy, the United Kingdom and the United States. Revenues from customers outside the United States accounted for 30% and 47% of our total revenues for the three months ended June 30, 2004 and 2003, respectively, and 35% and 36% for the six months ended June 30, 2004 and 2003, respectively.

Critical Accounting Policies and Estimates

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

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

Revenue Recognition

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

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

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

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

Accounts Receivable and Bad Debt

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

Restructuring Expenses

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

In order to estimate the costs related to our restructuring efforts, management made its best estimates of the most likely expected outcomes of the significant actions to accomplish the restructuring. These estimates principally related to charges for excess facilities and included estimates of future sublease income, future net operating expenses of the facilities, brokerage commissions and other expenses. The most significant of these estimates related to the timing and extent of future sublease income that would reduce our lease obligations. Included in our accrued restructuring balance at June 30, 2004 was estimated sublease income of $0.8 million, net of adjustments. We based our estimates of sublease income on, among other things, (a) opinions of independent real estate experts, (b) current market conditions and rental rates, (c) an assessment of the time period over which reasonable estimates could be made, (d) the status of negotiations with potential subtenants and (e) the locations of the facilities. These estimates, together with other

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estimates made by us in connection with the restructuring actions, may vary significantly from the actual results, depending in part on factors beyond our control. For example, the actual results will depend on our success in negotiating with lessors, the time periods required for us to locate and contract suitable subleases and the market rental rates at the time of such subleases. Adjustments to the facilities reserve may be required if actual lease settlement costs or sublease income differ from the amounts previously estimated. We review the status of our restructuring activities on a quarterly basis and, if appropriate, record changes to our restructuring obligations in our financial statements for such quarter based on management s then-current estimates.

Impairment or Disposal of Long Lived Assets

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

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

Accounting for Income Taxes

We account for income taxes in accordance with FAS 109, *Accounting for Income Taxes* (FAS 109) which requires that deferred tax assets and liabilities be recognized using enacted tax rates for the effect of temporary differences between the book and tax bases of recorded assets and liabilities. FAS 109 also requires that deferred tax assets be reduced by a valuation allowance if it is more likely than not that some portion or all of the deferred tax assets will not be realized. We evaluate quarterly the realizability of our deferred tax assets and adjust the amount of such allowance, if necessary. At June 30, 2004 and December 31, 2003, we have provided a full valuation allowance against our net deferred tax assets due to the uncertainty of their realizability.

In addition, we have provided for potential amounts due in various foreign tax jurisdictions. Judgment is required in determining our worldwide income tax expense provision. In the ordinary course of global business, there are many transactions and calculations where the ultimate tax outcome is uncertain. Some of these uncertainties arise as a consequence of cost reimbursement arrangements among related entities. Although we believe our estimates are reasonable, no assurance can be given that the final tax outcome of these matters will not be different from that which is reflected in our historical income tax provisions and accruals. Such differences could have a material impact on our income tax provision and operating results in the period in which such determination is made. In the fourth quarter of 2003 we reversed previously accrued taxes of $332,000 for foreign locations due to a change in our estimates of potential amounts due in those locations. In the first quarter of 2004 we reversed previously accrued taxes of $105,000 also due to changes in estimates of potential amounts due.

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Results of Operations

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2004	2003	2004	2003
REVENUES:				
Product license	22%	44%	31%	42%
Services	78	56	69	58
Total revenues	100	100	100	100
Cost of revenues:				
Product license	2	3	2	3
Services	36	24	32	26
Total cost of revenues	38	27	34	29
Gross margin	62	73	66	71
OPERATING EXPENSES:				
Research and development	29	23	26	24
Sales and marketing	51	38	47	41
General and administrative	12	11	12	13
Restructuring costs		(25)		(13)
Total operating expenses	92	47	85	65
INCOME (LOSS) FROM OPERATIONS	(30)	26	(19)	6
Interest and Other Income, Net		2		2
Income (loss) before benefit from income taxes	(30)	28	(19)	8
PROVISION FOR INCOME TAXES				
Net income (loss)	(30)%	28%	(19)%	8%

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:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2004	2003	2004	2003
Cost of product license revenues	11%	7%	8%	7%
Gross Margin on product license revenues	89%	93%	92%	3%
Cost of services revenues	46%	43%	46%	46%
Gross Margin on services revenues	54%	57%	54%	54%

Three and Six Months Ended June 30, 2004 and 2003

Revenues

Total revenues decreased 33% to $14.3 million for the three months ended June 30, 2004 from $21.3 million for the three months ended June 30, 2003 and decreased 24% to $31.1 million for the six months ended June 30, 2004 from $40.7 million for the six months ended June 30, 2003. The decreases were primarily attributable to longer sales cycles and delayed purchasing decisions by our customers, along with a shift in our business focus from infrastructure products to application products, particularly in the e-commerce and self-service area. Several deals that we anticipated closing during the quarter ended June 30, 2004, including a multi-million dollar government contract, were delayed at the end of June, 2004. We anticipate closing these delayed deals during the second half of 2004; however, we cannot assure you that we can complete these deals when we expect or at all. As a result we experienced decreases in product license revenues and services revenues relating to both our infrastructure products business and our application products business. Our focus in 2004 has been principally on e-commerce and self-service applications. We expect revenues to increase in the second half of 2004 as compared to the first half of 2004.

Revenues generated from international customers decreased to $4.3 million, or 30% of total revenues, for the three months ended June 30, 2004, from $9.9 million, or 47% of total revenues, for the three months ended June 30, 2003, and decreased to $10.8 million, or 35% of total revenues, for the six months ended June 30, 2004, from $14.7 million, or 36% of total revenues for the six months ended June 30, 2003. We expect international revenues to be approximately 30% to 35% of total revenues for the remainder of 2004.

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No individual customer accounted for more than 10% of total revenues for the three or six months ended June 30, 2004 or 2003, respectively.

Product License Revenues

Product license revenues decreased 67% to $3.1 million for the three months ended June 30, 2004 from $9.5 million for the three months ended June 30, 2003 and decreased 44% to $9.5 million for the six months ended June 30, 2004 from $17.0 million for the six months ended June 30, 2003. The decreases were primarily attributable to longer sales cycles and delayed purchasing decisions by our customers, along with a shift in our business focus from infrastructure products to application products, particularly in the e-commerce and self-service area. Several deals that we anticipated closing during the quarter ended June 30, 2004, including a multi-million dollar government contract, were delayed at the end of June, 2004. We anticipate closing these delayed deals during the second half of 2004; however, we cannot assure you that we can complete these deals when we expect or at all. As a result we experienced decreases in product license revenues relating to both our infrastructure products business and our application products business. Our focus in 2004 has been principally on e-commerce and self-service applications. We expect product license revenues to increase in the second half of 2004 as compared to the first half of 2004.

Product license revenues generated from international customers decreased to $927,000 for the three months ended June 30, 2004 from $6.6 million for the three months ended June 30, 2003. The decrease in international product revenue was attributable to not having closed any large international deals during the second quarter of 2004. Product license revenues generated from international customers decreased to $4.3 million for the six months ended June 30, 2004 from $7.8 million for the six months ended June 30, 2003.

Product license revenues as a percentage of total revenues for the three months ended June 30, 2004 and 2003 were 22% and 44%, respectively, and for the six months ended June 30, 2004 and 2003 were 31% and 42%, respectively.

Our resellers generally receive a discount from our list prices. The extent of any discount is based on negotiated contractual agreements between us and the reseller. We do not grant our resellers the right of return, price protection or favorable terms. We rely upon resellers to market and sell our products to governmental entities and to customers in geographic regions where it is not cost effective for us to reach out to end users directly. We have approximately 20 active resellers. No single reseller generates a significant portion of our total revenues. Reseller revenues and the percentage of revenues from resellers can vary significantly from quarter to quarter depending on the revenues from large deals, if any, closed through this channel during a quarter.

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2004	**2003**	**2004**	**2003**
Reseller revenues	$122	$3,573	$1,018	$4,269
% of product revenues	4%	38%	11%	25%

Services Revenues

Services revenues decreased 6% to $11.2 million for the three months ended June 30, 2004 from $11.8 million for the three months ended June 30, 2003 and decreased 9% to $21.6 million for the six months ended June 30, 2004 from $23.8 million for the six months ended June 30, 2003. The decreases were primarily attributable to decreased services volume associated with decreased product license revenues as well as a reduction in our services capacity due to reduced headcount in professional services. We expect services revenues to increase in the second half of 2004 as compared to the first half of 2004 and to decrease as a percentage of total revenues.

Support and maintenance revenues were 61% of total service revenues for the three months ended June 30, 2004 as compared to 68% for the three months ended June 30, 2003 and 65% of total services revenues for the six months ended June 30, 2004 as compared to 66% for the six months ended June 30, 2004. Support and maintenance revenues, on a dollar value basis, were lower for the three and six months ended June 30, 2004 due to a combination of decreasing product revenues and some customers electing to decrease or terminate 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 and royalties paid to vendors whose technology is incorporated into our products.

Cost of product license revenues decreased 49% to $331,000 for the three months ended June 30, 2004 from $647,000 for the three months ended June 30, 2004 and decreased 35% to $730,000 for the six months ended June 30, 2004 from $1.1 million for the six months ended June 30, 2003. The decreases are primarily related to lower product revenues during the first half of 2004, lower royalties paid on third party software embedded into our products and an impairment charge related to purchased software recorded in the quarter ended June 30, 2003.

For the three months ended June 30, 2004 and 2003, cost of product license revenues as a percentage of total revenues was 2% and

3%, respectively, and for the six months ended June 30, 2004 and 2003 was 2% and 3%, respectively. We anticipate the cost of product license revenues, as a percentage of total revenues, to stay in the 2% to 3% range for the remainder of 2004.

Gross Margin on Product License Revenues

For the three months ended June 30, 2004 and 2003, gross margin on product license revenues were 89%, or $2.8 million, and 93%, or $8.8 million, respectively, and for the six months ended June 30, 2004 and 2003 were 92%, or $8.8 million, and 93%, or $15.8 million, respectively. The decrease in gross margin for the three months ended June 30, 2004 as compared with the three months ended June 30, 2003 is due primarily to the non-variable costs included in cost of product license revenues, such as the salaries of our engineering staff. We expect gross margin on product license revenue to be in the 92-94% range for the remainder of 2004.

Cost of Services Revenues

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

Cost of services revenues remained flat at $5.1 million for the three months ended June 30, 2004 as compared to the three months ended June 30, 2003 and decreased 9% to $9.9 million for the six months ended June 30, 2004 from $10.8 million for the six months ended June 30, 2004. The decrease for the six months ended June 30, 2004 was attributable to a reduction in our professional services workforce and reduced costs due to our restructuring efforts. Approximately 18% of the decrease was the result of reduced compensation costs due to a reduction in our work force. The remainder of the decrease was due to a decrease in rent expense, operating costs and lower infrastructure expenses as a result of our restructuring efforts.

For the three months ended June 30, 2004 and 2003, cost of services revenues as a percentage of total revenues were 36% and 24% and for the six months ended June 30, 2004 and 2003 were 32% and 27%, respectively. We anticipate the cost of services revenues, as a percentage of total revenues, to be in the 25% to 28% range for the remainder of 2004.

Gross Margin on Services Revenues

For the three months ended June 30, 2004 and 2003, gross margin on services revenues were 54%, or $6.1 million, and 57%, or $6.7 million, respectively, and for the six months ended June 30, 2004 and 2003 were 54%, or $11.7 million, and 54%, or $12.9 million, respectively. We expect this percentage to remain about the same for the remainder of 2004.

Research and Development Expenses

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

Research and development expenses decreased 16% to $4.2 million for the three months ended June 30, 2004 from $5.0 million for the three months ended June 30, 2003 and decreased 16% to $8.3 million for the six months ended June 30, 2004 from $9.8 million for the six months ended June 30, 2003. The decreases were primarily attributable to a reduction in our workforce. Approximately 90% of the decrease for the three month period, and 76% of the decrease for the six month period was related to decreased salaries and related benefits. The remainder of the decrease was due to a decrease in operating expenses as a result of our restructuring efforts, offset in part by an increase in outside services and professional fees.

Research and development expenses as a percentage of total revenues was 29% and 23% for the three months ended June 30, 2004 and 2003, respectively, and was 26% and 24% for the six months ended June 30, 2004 and 2003, respectively. Based on continued cost reduction initiatives, we anticipate that research and development expenses as a percentage of total revenues will be about 22% to 24% for the remainder of 2004.

Sales and Marketing Expenses

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

Sales and marketing expenses decreased 11% to $7.2 million for the three months ended June 30, 2004 from $8.1 million for the three months ended June 30, 2003 and decreased 14% to $14.6 million for the six months ended June 30, 2004 from $16.9 million for the six months ended June 30, 2003. The decreases are primarily attributable to cost saving initiatives that resulted from a reduction in the workforce of our sales and marketing group, a reduction in our spending on marketing programs and a reduction in commissions from decreased product revenues. Approximately 90% of the decrease for the three month period, and 84% of the decrease for the six month period was related to a decrease in compensation, commissions and benefits costs. The remainder of the decrease was due to a decrease in operating expenses resulting from our restructuring efforts and decreased spending on marketing programs, offset in part by increased spending on professional and recruitment fees.

Sales and marketing expenses as a percentage of total revenues were 51% and 38% for three months ended June 30, 2004 and

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2003, respectively, and were 47% and 42% for the six months ended June 30, 2004 and 2003, respectively. We expect that the level of sales and marketing expenses for the remainder of 2004 will, as compared to the first half remain flat in absolute dollars, and decrease as a percentage of total revenues. However, sales and marketing expenses can fluctuate as a percentage of total revenues depending on economic conditions, level and timing of global expansion, program spending, the rate at which new sales personnel become productive and the level of revenue.

General and Administrative Expenses

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

General and administrative expenses decreased 27% to $1.7 million for the three months ended June 30, 2004 from $2.4 million for the three months ended June 30, 2003 and decreased 27% to $3.7 million for the six months ended June 30, 2004 from $5.0 million or the six months ended June 30, 2003. Approximately 90% of the decrease for the three month period, and 40% of the decrease for the six month period was related to a decrease in our workforce, with the remainder related to decreases in rent expense and facilities related charges, insurance costs and other operating expenses resulting from our restructuring efforts and cost containment initiatives, offset by an increase in equipment leasing.

For the three months ended June 30, 2004 and 2003, general and administrative expenses as a percentage of total revenues was 12% and 11%, respectively and for the six months ended June 30, 2004 and 2003 was 12% and 13%, respectively. Due to cost reduction initiatives we anticipate that the level of general and administrative expenses will, as compared to the first half of 2004, trend lower as a percentage of total revenues and in absolute dollars for the remainder of 2004.

Restructuring (Benefit) Charges

During the years ended 2003, 2002 and 2001, we recorded net restructuring charges/(benefits) of ($10.5) million, $19.0 million and $75.6 million, respectively, as a result of the global slowdown in information technology spending. The significant drop in demand in 2001 for technology oriented products, particularly internet related technologies, caused us 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.

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 2003 charges were recorded in accordance with FAS 146, *Accounting for Costs Associated with Exit or Disposal Activities*, FAS 88, *Employers Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits* (FAS 88) and Staff Accounting Bulletin (SAB) 100, *Restructuring and Impairment Charges*. The 2002 and 2001 charges were recorded in accordance with Emerging Issues Task Force Issue No. 94-3, *Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (Including Certain Costs Incurred in a Restructuring)*, FAS 88 and SAB 100.

2001 Actions

Actions taken by 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 an impairment charge in cost of product licenses for purchased software of $1.4 million. Total restructuring charges for 2001 totaled $75.6 million.

A summary of the restructuring accruals activity in 2004 related to the 2001 restructuring actions is as follows (in thousands):

	Accrued Restructuring Balance as of December 31, 2003	**Payments**	**Accrued Restructuring Balance as of June 30, 2004**
Facilities-related costs and impairments	$ 10,208	$2,178	$ 8,030
Employee severance, benefits and related costs	229		229
Total	$ 10,437	$2,178	$ 8,259

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Facilities-Related Costs and Impairments

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

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 to $18 from $25 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 its 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 its lease accruals relating to its 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.

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

Employee Severance, Benefits and Related Costs and Exchangeable Shares

As part of the 2001 restructuring actions, 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 June 30, 2002. In addition, we settled 11,762 exchangeable shares with a certain employee, who was terminated in connection with the restructuring action, and recorded $1.3 million as a charge to restructuring for this settlement. During 2003, we recorded additional charges of $229,000 for severance related to a specific employee terminated as part of the 2001 restructuring action.

Asset Impairments

The asset impairment charges included the write-off of approximately $4.0 million of the remaining unamortized goodwill related to the two professional service organization acquisitions completed in 2000. We 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 in the accompanying Consolidated Statements of Operations related to purchased software to record the software at its net realizable value of zero due to ATG abandoning a certain product development strategy. The purchased software had no future use to us.

Marketing Costs and Legal & 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 us. 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 $18.2 million.

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A summary of the restructuring accruals activity in 2004 related to the 2002 restructuring actions is as follows (in thousands):

	Accrued Restructuring Balance as of December 31, 2003	Payments	Accrued Restructuring Balance as of June 30, 2004
Facilities-related costs and impairments	$ 5,887	$4,418	$ 1,469
Total	$ 5,887	$4,418	$ 1,469

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 intended to sublease. The estimated sublease income was $4.8 million and based on rental rates ranging from $23 to $35 per square foot with estimated vacancy periods prior to the expected sublease income ranging from 12 to 21 months.

During 2003, we recorded an adjustment of $1.9 million primarily to increase our lease obligation accrual at two locations because of changes in the assumptions of the vacancy period and sublease income. The sublease income was adjusted by decreasing anticipated sublease rates to $18 from $23 per square foot for one facility and from $35 to $30 per square foot at the other location. 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 us 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.

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 lives. 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, 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.

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, none of whom remained employed at December 31, 2003. Of the 125 employees, 53 of the employees were from sales and marketing, 45 from services, 19 from general and administrative and 8 from research and development. We accrued employee benefits pursuant to ongoing benefit plans and statutory minimum requirements in foreign locations. We began the termination process on January 6, 2003 and all employees had been terminated by June 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 its foreign locations. During the fourth quarter of 2003, we reduced certain severance accruals by $86,000, primarily at its foreign locations, primarily as a result of amounts being settled at less than the amount recorded due to foreign currency exchange movements.

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.

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A summary of the restructuring accruals activity in 2004 related to the 2003 restructuring actions is as follows (in thousands):

	Balance at December 31, 2003	Payments	Balance at June 30, 2004
Facilities-related costs and impairments	$ 1,614	$ 58	$ 1,556
Employee severance, benefits and related costs	61	46	15
Total	$ 1,675	$ 104	$ 1,571

Second Quarter 2003 Action

During the quarter ended June 30, 2003, we recorded an initial 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 intend to sublease. The amount of the operating lease charge was based on assumptions from current real estate market data for sublease income rates and vacancy rates at the location. The estimated sublease income was $500,000 and based on a rental rate of $35 per square foot with an estimated vacancy period prior to the expected sublease income of 24 months. In the fourth quarter, as a result of updated market conditions, the estimated sublet rental rate was lowered to $30 per square foot from $35 per square foot and the vacancy period was extended to 36 months from 24 months resulting in an additional charge of $227,000. In accordance with FAS 146, we has 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 lives. 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, related to the facility we are 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 have discontinued marketing of this software and ceased future development work specifically related to this third-party software. However, we have not changed its overall product strategy for the purpose for which the software was acquired.

Third Quarter 2003 Action

During the third quarter of 2003, 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 intend to sublease. The amount of the operating lease charge was based on assumptions from current real estate market

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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, we determined that it is unlikely we will sublet this space before its lease expires resulting in an additional charge of $198,000. In accordance with FAS 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 lives. 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 benefit plans. All employees were notified of their termination as of September 30, 2003. The termination process was completed during the fourth quarter of 2003.

As of June 30, 2004 we had an accrued restructuring liability of $11.3 million, of which $8.3 million related to 2001 restructuring charges, $1.5 million relates to 2002 restructuring charges, and $1.5 million related to 2003 restructuring charges. The long-term portion of the accrued restructuring liability was $7.2 million.

Abandoned Facilities Obligations

At June 30, 2004, we had lease arrangements related to six abandoned facilities. The lease arrangements with respect to five of these facilities are ongoing, and the other facility 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 our plans with respect to these leases have been completed. A summary of the remaining facility locations and the timing of the remaining cash payments is as follows (in thousands):

Lease Locations		**2004**	**2005**	**2006**	**2007**	**2008**	**2009**	**Total**
Cambridge, MA	*	$1,035	$2,069	$ 1,035				4,139
Cambridge, MA		69	137	91				297
Waltham, MA		733	1,466	1,466	1,466	1,466	366	6,963
Chicago, IL		262	524	393				1,179
San Francisco, CA		55	111	111	111			388
Reading, UK		290	579	579	579	579	181	2,787
Facility obligations, gross		$2,444	$4,886	$ 3,675	$ 2,156	$ 2,045	$ 547	15,753
Contracted and assumed sub-let income		(593)	(435)	(1,104)	(1,263)	(1,218)	(304)	(4,917)

Net cash obligations	$1,851	$4,451	$ 2,571	$ 893	$ 827	$ 243	10,836
Assumed sub-lease income	$ 0.0	$ 0.0	$ 200	$ 300	$ 200	$ 100	800

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

Rental rates vary from $15.00 per square foot to $30.00 per square foot depending upon local market rates. Remaining vacancy periods as of June 30, 2004 vary from 12 months to 27 months depending upon rentable square feet in the local market and recent vacancy histories. Rental assumptions or sublease start dates may vary considerably from the above assumptions, which could cause us to take an additional charge. If the estimated sublease dates were to be extended by six months, based on our current estimates, we would potentially have to recognize an additional $138,000 in our statement of operations for restructuring and other related charges. In addition, we have a history of settling lease obligations favorably as compared with the amounts we have accrued, which could result in a benefit.

Interest and Other Income (Expense), Net

Interest and Other Income (Expense), Net decreased to $64,000 for the three months ended June 30, 2004 from $490,000 for the three months ended June 30, 2003 and decreased to $17,000 for the six months ended June 30, 2004 from $851,000 for the six months ended June 30, 2003. The decrease was primarily due to a decrease in foreign currency related gains of $270,000 and $550,000 for the three and six month periods, respectively due primarily to reduced foreign currency exposure as a result of lower short-term intercompany trading balances with our foreign subsidiaries. Interest income was also lower during the three and six months ended June 30, 2004 compared to the three months ended June 30, 2003 due to a lower average balance of cash and cash equivalents and marketable securities.

Provision for Income Taxes

As a result of net operating losses incurred, and after evaluating our anticipated performance over our normal planning horizon, we have provided a full valuation allowance for our net operating loss carryforwards and other net deferred tax assets. Due to the uncertainty surrounding the utilization of our net deferred tax assets, net operating losses and research credits carryforwards, we have recorded a 100% valuation allowance. In the first quarter of 2004 we reversed previously accrued taxes of $105,000 due to a one-time event while accruing an additional $172,000 for current period foreign taxes.

Liquidity and Capital Resources

Our capital requirements relate primarily to facilities, employee infrastructure and working capital requirements. Historically, we have funded our cash requirements primarily through the public and private sales of equity securities, and commercial credit facilities. At July 31, 2004, we had $20.5 million in cash and cash equivalents and $7.9 million in marketable securities.

Cash used in operating activities was $9.3 million for the six months ended June 30, 2004. This consisted of operating losses of $6.0 million, a decrease in accrued restructuring of $6.7 million, a decrease in accrued expenses of $2.0 million, offset by depreciation and amortization of $1.0 million and a decrease in accounts receivable of $4.5 million. Other changes in working capital items consisted primarily of a $719,000 decrease in deferred revenue, a $684,000 decrease in prepaid expenses, and an increase in accounts payable of $787,000. Cash used in operating activities was $10.6 million for the six months ended June 30, 2003. This consisted of income from operations of $3.3 million, depreciation and amortization of $2.4 million, non-cash restructuring charges of $847,000, a decrease in accounts receivable of $8.7 million, offset by a decrease in accrued restructuring of $21.1 million. Other changes in working capital items consisted primarily of $3.0 million in cash used for accrued expenses and a decrease in deferred revenues of $83,000.

Our investing activities for the six months ended June 30, 2004 used $911,000 and consisted primarily of capital expenditures of $345,000 and net purchases of marketable securities of $570,000. We expect that capital expenditures will total approximately $1.5 million for the year ended December 31, 2004. Our investing activities for the six months ended June 30, 2003 provided $8.2 million and consisted primarily of capital expenditures of $775,000, net maturities of marketable securities of $8.7 million and a decrease in other assets of $153,000.

Net cash provided by financing activities was $847,000 for the six months ended June 30, 2004, representing proceeds from the employee stock purchase plan and the exercise of stock options. Net cash provided by financing activities was $613,000 for the six months ended June 30, 2003 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 June 30, 2004 and December 31, 2003 were as follows (dollars in thousands):

	June 30, 2004	December 31, 2003
DSO	68	88
Accounts Receivable	$10,897	$15,364

We note that as of June 30, 2004 the DSO had decreased from the DSO at December 31, 2003 due to improved collections during the six months ended June 30, 2004 as well as reduced product sales in the second quarter of 2004 compared with the fourth quarter of 2003.

Credit facility

Effective June 13, 2002, we entered into a $15 million revolving line of credit with Silicon Valley Bank, or the Bank, which provided for borrowings of up to the lesser of $15 million or 80% of eligible accounts receivable. Effective December 24, 2002 the revolving line of credit increased to $20 million.

Effective November 25, 2003, we modified our existing working capital facility with the Bank. Our $20 million line of credit is secured by all of our tangible and intangible intellectual and personal property and is subject to financial covenants including liquidity coverage and profitability. The liquidity covenant mandates we maintain $25.0 million in cash, which includes cash equivalents and marketable securities, at the end of each month throughout the duration of the facility. The profitability covenant, which was modified in June 2004 pursuant to the Fifth Loan Modification Agreement, allows for net losses not to exceed: $5.0 million for the second quarter of 2004, $2.0 million for the third quarter of 2004 and $1.0 million for the fourth quarter of 2004. We are required to maintain $25 million in unrestricted cash, which includes cash equivalents and marketable securities, at the Bank. In the event our cash balances at the Bank fall below $25 million, we will be required to pay fees and expenses to compensate the Bank for lost income. At June 30, 2004, we were in compliance with all amended related financial covenants. In the event that we do not comply with any of the financial covenants within the line of credit or defaults on any of its provisions, the Bank s significant remedies include:

- Declaring all obligations immediately due and payable;
- Ceasing to advance money or extend credit for our benefit;
- Applying to the obligations any balances and deposits held by us or any amount held by the Bank owing to or for the credit of our account;
- Putting a hold on any deposit account held as collateral.

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

While there were no outstanding borrowings under the facility at June 30, 2004, we have issued LC s totaling $10.6 million, which are supported by this facility. The LC s have been issued in favor of various landlords and equipment vendors to secure obligations pursuant to leases expiring from August 2004 through August 2009. The line of credit bears interest at the Bank s prime rate (4.25% at June 30, 2004). As of June 30, 2004, approximately $9.4 million was available under the facility.

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

Contractual Obligations

On June 30, 2004, our contractual cash obligations, which consist solely of operating leases, were as follows (in thousands):

	Payments Due by Period				
Contractual Obligations	**Total**	**Remainder of 2004**	**1-3 years**	**4-5 years**	**5 years**
Lease Commitments	$19,722	$ 3,317	$11,799	$4,145	$461

Recent Accounting Pronouncements

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

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RISK FACTORS THAT MAY AFFECT RESULTS

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

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

Risks Related To Our Business

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

We incurred losses in the first and second quarter of 2004, in the first and third quarters of 2003 and in each quarter of 2002. As of June 30, 2004, we had an accumulated deficit of $201.7 million. Our revenues decreased 24% to $31.1 million for the six months ended June 30, 2004 compared with $40.7 million for the six months ended June 30, 2003. We believe the recent economic downturn within the software industry could continue to have an adverse effect on demand for our products and services, and therefore adversely affect our revenues as well. Because we operate in a rapidly evolving industry, we have difficulty predicting our future operating results and we cannot be certain that our revenues will grow or our expenses will decrease at rates that will allow us to achieve profitability on a quarterly or annual basis. Additionally, in recent years the slowdown in the software industry and the decrease in spending by companies in our target markets have reduced the rate of growth of the Internet as a channel for consumer branded retail and financial services companies. If current economic conditions continue for an extended period of time or worsen, we may experience additional adverse effects on our revenue, net income and cash flows, which could result in a decline in the price of our common stock.

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

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

- fluctuating economic conditions, particularly as they affect our customers willingness to implement new e-commerce solutions;
- the timing of sales of our products and services;
- the timing of customer orders and product implementations;
- delays in introducing new products and services;
- increased expenses, whether related to sales and marketing, product development or administration;
- the mix of revenues derived from products and services;

timing of hiring and utilization of services personnel;

cost overruns related to fixed-price services projects;

the mix of domestic and international sales; and

costs related to possible acquisitions of technologies or businesses.

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

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

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

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

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

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

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

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

Like most software companies, a significant proportion of our sales are concentrated near the end of each fiscal quarter. Failure to close even a relatively small number of license deals at quarter end can have a significant impact on our reported operating results for that quarter. 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. Competition could materially and adversely affect our ability to obtain revenues from license fees from new or existing customers and professional services revenues from existing customers. While the list price for our software generally has been maintained over the past three years, in the first quarter of 2004, we reduced our list prices on purchases exceeding certain volumes. Additional volume based reductions in our list price could adversely affect our business, operating results and financial condition.

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

The market for online marketing, sales and services applications is intensely competitive, and we expect competition to intensify in the future. This level of competition could reduce our revenues and result in increased losses or reduced profits. Our primary competition currently comes from in-house development efforts by potential customers or partners, as well as from other vendors of Web-based application software. We currently compete with Internet application software vendors such as BroadVision and commerce, marketing and self-service vendors such as Chordiant, E.piphany and Kana. We also compete with platform application server products and vendors such as BEA

Systems, IBM, and Microsoft, among others. In addition, we compete indirectly with portal software vendors such as Vignette (through its acquisition of Epicentric), SAP Portals, a subsidiary of SAP, and Plumtree and customer relationship management vendors such as Siebel and PeopleSoft.

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

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

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

Historically, we have derived a significant portion of our revenues from existing customers that purchase our support and maintenance services and enhanced versions of our products. Retention of our existing customer base requires that we provide high levels of customer service and product support to help our customers maximize the benefits that they derive from our products. To

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compete, we must introduce enhancements and new versions of our products that provide additional functionality. Further, we must manage the transition from our older products so as to minimize the disruption to our customers caused by such migration and integration with the customers information technology platform. If we are unable to continue to obtain significant revenues from our existing customer base, our ability to grow our business would be harmed and our competitors could achieve greater market share.

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

Approximately 50% of our product license revenues related to our relationships with systems integrators and value added resellers. Since a substantial portion of our product license revenues are related to our relationships with systems integrators and our potential customers often rely on third-parties to develop, deploy and manage Web sites for conducting commerce on the Internet, 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 these relationships.

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

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

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

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

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.

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.

We renewed and amended our $20.0 million line of credit in the fourth quarter of 2003. 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 June 30, 2004, we have issued letters of credit totaling $10.6 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 August 2004 through August 2009. This revolving line of credit expires on November 25, 2004.

The liquidity covenant in the line of credit mandates we maintain $25.0 million in cash, which includes cash equivalents and marketable securities, at the end of each month throughout the duration of the facility. At July 31, 2004, we had $28.4 million in cash, including cash equivalents and marketable securities, which represents a decrease of $13.2 from $41.6 million in cash on December 31, 2003. The profitability covenant, which was modified in June 2004 pursuant to the Fifth Loan Modification Agreement, allows for net losses not to exceed: $5.0 million for the second quarter of 2004, $2.0 million for the third quarter of 2004 and $1.0 million for the fourth quarter of 2004. Our net loss was $4.2 million for the second quarter of 2004. 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.

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

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

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

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

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

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

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

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

redesign those products or services to avoid infringement.

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

The market for our products is marked by rapid technological change, frequent new product introductions and Internet-related technology enhancements, uncertain product life cycles, changes in customer demands, coalescence of product differentiators, product commoditization and evolving industry standards. We may not be able to develop and market or acquire new products or product enhancements that comply with present or emerging Internet technology standards and to differentiate our products based on functionality and performance. In particular, there can be no assurance that our current or potential clients will adopt the e-commerce and self-service applications that we began focusing on in 2003. In addition, we may not be able to establish strategic alliances with operating system and infrastructure vendors that will permit migration opportunities for our current user base. New products based on new technologies or new industry standards could render our existing products obsolete and unmarketable. For example, functionality that once differentiated our products over time has been incorporated into products offered by the major operating system and infrastructure providers.

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

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

As of June 30, 2004 we had offices in the United Kingdom, France, Germany and Italy, and additionally had sales personnel in Spain. We derived 35% of our total revenues in the six months ended June 30, 2004 from customers outside the United States. In December 2002, we initiated a restructuring plan, which included the closing of our offices in Australia, Canada, and the Netherlands at varying times during the first quarter of 2003. Our operations outside North America are subject to additional risks, including:

- changes in regulatory requirements, exchange rates, tariffs and other barriers;
- longer payment cycles and problems in collecting accounts receivable in Western Europe and the Far East;
- difficulties in managing systems integrators and technology partners;
- difficulties in staffing and managing foreign subsidiary operations;
- differing technology standards;
- difficulties and delays in translating products and product documentation into foreign languages to the extent that our products are sold in countries that do not have English as their primary language;
- reduced protection for intellectual property rights in some of the countries in which we operate or plan to operate;
- potentially adverse tax consequences; and
- political and economic instability.

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

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

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

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

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

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

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

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

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

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

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

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

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. For example, we have an agreement with a third-party vendor to supply search technology, which will terminate in December 2006 and may only be terminated for breach prior to then. 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 J2EE, Java Runtime Environment, Java Naming and Directory Interface, Java Servlet Development Kit, Java Foundation Classes, JavaMail and JavaBeans Activation Framework into our products under licenses granted to us by Sun. Our ATG 6.3 Relationship Management Platform has been designed to support Sun s J2EE standards. If Sun were to decline to continue to allow us to use these technologies for any reason, we would be required to (a) license the equivalent technology from another source, (b) rewrite the technology ourselves or (c) rewrite portions of our software to accommodate the change or no longer use the technology.

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

Risks Related To the Internet Industry

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

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

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

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

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

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

Our products use cookies to track demographic information and user preferences. A cookie is information keyed to a specific user that is stored on a computer s hard drive, typically without the user s knowledge. Cookies are generally removable by the user, although removal could affect the content available on a particular site. Germany has imposed laws limiting the use of cookies, and a number of Internet commentators and governmental bodies in the United States and other countries have urged passage of laws

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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 stock price may continue to be volatile.

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

variations in our quarterly operating results;

changes in market valuations of Internet and software companies;

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

our failure to complete significant sales;

additions or departures of our key personnel;

future sales of our common stock; or

changes in financial estimates by securities analysts.

We may incur significant costs from class action litigation.

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

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

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

authorizing the issuance of blank check preferred stock;

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

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

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

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

authorizing anti-takeover provisions.

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

Item 3. Quantitative and Qualitative Disclosures About Market Risk

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

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June 30, 2004.

The majority of our operations are based in the U.S., and accordingly, the majority of our transactions are denominated in U.S. dollars. However, we have foreign-based operations where transactions are denominated in foreign currencies and are subject to market risk with respect to fluctuations in the relative value of currencies. The Company s primary foreign currency exposures relate to its short-term intercompany balances with its foreign subsidiaries. The primary foreign subsidiaries have functional currencies denominated in the British pound, Euro and Australian dollar that are remeasured each reporting period with any exchange gains and losses recorded in the Company s Consolidated Statements of Operations. Based on currency exposures existing at June 30, 2004, a 10% movement in foreign exchange rates would not expose us to significant gains or losses in earnings or cash flows. We may use derivative instruments to manage the risk of exchange rate fluctuations, however, at June 30, 2004, there were no outstanding derivative instruments. We do not use derivative instruments for trading or speculative purposes.

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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 June 30, 2004. Based on this evaluation, our chief executive officer and chief financial officer concluded that, as of June 30, 2004, our disclosure controls and procedures were (1) designed to ensure that material information relating to our company, including our consolidated subsidiaries, is made known to our chief executive officer and chief financial officer by others within those entities, particularly during the period in which this report was being prepared and (2) effective, in that they provide reasonable assurance that information required to be disclosed by us in the reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC s rules and forms.

No change in our internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) occurred during the fiscal quarter ended June 30, 2004 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

The Company and certain former officers have been named defendants in seven purported class action suits currently pending in the United States District Court for the District of Massachusetts. Each of these cases alleges that the Company and certain officers have violated Sections 10(b) and 20(a) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder, which generally may subject issuers of securities and persons controlling those issuers to civil liabilities for fraudulent actions or defects in the public disclosure required by securities laws. Four of the cases were filed on various dates in October 2001 in the U.S. District Court for the District of Massachusetts. Three of the cases were initially filed in the Central District of California (the California actions) on various dates in August and September 2001. The California actions were consolidated and transferred to the District of Massachusetts on or about November 27, 2001. On December 13, 2001, the Court issued an Order of Consolidation in which it consolidated all actions filed against the Company and appointed certain individuals as Lead Plaintiffs in the consolidated action. It also appointed two law firms as Co-Lead Counsel, and a third law firm as Liaison Counsel. Counsel for the plaintiffs has filed a Consolidated Amended Complaint applicable to all of the consolidated actions. On April 19, 2002, the Company filed a motion to dismiss the case. On September 4, 2003 the court issued a ruling dismissing all but one of the plaintiffs allegations. The remaining allegation is based on the veracity of a public statement made by a former officer of the Company. While management believes the remaining claim against the Company is without merit, and intends to defend the action vigorously, the litigation is still in the preliminary stage.

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

Item 2. Changes in Securities, Use of Proceeds and Issuer Purchases of Equity Securities

None.

Item 3. Defaults Upon Senior Securities

None.

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

We held our Annual Meeting of Stockholders on May 19, 2004. At the meeting, Ilene H. Lang was re-elected as a Class II Director. The vote with respect to Ms. Lang s election is set forth below:

	Total Vote for Ms. Lang	Total Vote Withheld From Ms. Lang
Ms. Lang	61,464,049	1,423,955

Additional Directors whose terms of office continue after the meeting are Phyllis S. Swersky, John R. Held, Mary E. Makela, Paul G. Shorthose, and Robert D. Burke. David B. Elsbree was appointed to our Board of Directors in June, 2004.

The stockholders also approved an amendment of our Amended and Restated 1996 Stock Option Plan to among other things allow for the grant of restricted stock awards, performance share awards and other forms of equity based compensation that were not provided for in the plan and extend the term of the plan until December 31, 2013. The vote on this matter was 7,998,224 shares for, 7,407,700 shares against and 148,616 shares abstaining, with 47,333,464 broker non-votes.

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The stockholders also approved an amendment of our Amended and Restated 1999 Outside Director Stock Option Plan, to among other things allow for the grant of restricted stock awards and extend the term of the plan until December 31, 2013. The vote on this matter was 8,066,289 shares for, 7,329,837 shares against and 158,414 shares abstaining, with 47,333,464 broker non-votes.

Item 5. Other Information

None.

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Item 6. Exhibits and Reports on Form 8-K

(a) Exhibits

10.25 Loan arrangement between the Registrant and Silicon Valley dated June 16, 2004

10.26 5th Loan Modification Agreement between the Registrant and Silicon Valley Bank dated June , 2004

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

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

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

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

(b) Reports on Form 8-K

None

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

Date: August 9, 2004