ART TECHNOLOGY GROUP INC
Form 10-Q
May 12, 2003

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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 March 31, 2003

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 No o

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

As of May 7, 2003 there were 71,431,020 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)

	March 31, 2003	December 31, 2002
ASSETS		
Current Assets:		
Cash and cash equivalents	$ 49,022	$ 45,829
Marketable securities	17,617	22,729
Accounts receivable, net of reserves of $1,289 ($1,941 in 2002)	17,857	25,221
Unbilled services	20	5
Prepaid expenses and other current assets	2,641	2,484
Total Current Assets	87,157	96,268
Property and Equipment, Net	5,491	6,998
Other Assets	1,409	1,569
	$ 94,057	$ 104,835
LIABILITIES AND STOCKHOLDERS EQUITY		
Current Liabilities:		
Accounts payable	$ 2,166	$ 2,563
Accrued expenses	14,654	18,219
Deferred revenue	16,172	15,674
Accrued restructuring, short-term	16,698	19,819
Total Current Liabilities	49,690	56,275
Accrued restructuring, less current portion	31,001	32,537
Commitments and Contingencies Stockholders Equity:		
Preferred stock, $.01 par value		
Authorized 10,000,000		
Issued and outstanding no shares		
Common stock, $.01 par value		
Authorized 500,000,000		
Issued and outstanding 71,417,842 shares and 70,941,478 shares at March 31, 2003 and December 31, 2002 respectively	714	709
Additional paid-in capital	217,399	217,288
Deferred compensation	(133)	(394)
Accumulated deficit	(202,623)	(199,869)
Accumulated other comprehensive income	(1,991)	(1,711)
Total Stockholders Equity	13,366	16,023

	$ 94,057	$ 104,835

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 March 31,	
	2003	**2002**
Revenues:		
Product licenses	$ 7,505	$ 12,520
Services	11,920	14,803
Total Revenues	19,425	27,323
Cost of Revenues:		
Product licenses	485	1,043
Services	5,706	8,975
Total Cost of Revenues	6,191	10,018
Gross Profit	13,234	17,305
Operating Expenses:		
Research and development	4,860	5,570
Sales and marketing	8,768	12,378
General and administrative	2,640	2,490
Stock-based compensation	81	271
Total Operating Expenses	16,349	20,709
Loss from Operations	(3,115)	(3,404)
Interest and Other Income, Net	361	555
Net loss before provision for income taxes	(2,754)	(2,849)
Provision for Income Taxes		
Net loss	(2,754)	$ (2,849)
Basic and diluted net loss per share	(0.04)	$ (0.04)
Basic and diluted weighted average common shares outstanding	70,982	69,494

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

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

	Three Months Ended March 31,	
	2003	**2002**
Cash Flows from Operating Activities:		
Net loss	$ (2,754)	$ (2,849)
Adjustments to reconcile net loss to net cash used in operating activities		
Stock-based compensation	81	271
Depreciation and amortization	1,320	1,821
Loss on disposal of fixed assets, net	185	17
Changes in current assets and liabilities		
Accounts receivable, net	7,364	10,281
Unbilled services	(15)	87
Prepaid expenses and other current assets	(157)	1,106
Accounts payable	(397)	(1,144)
Accrued expenses	(3,565)	(5,461)
Deferred revenues	498	(1,477)
Accrued restructuring	(4,657)	(4,086)
Net cash used in operating activities	(2,097)	(1,434)
Cash Flows from Investing Activities:		
Net proceeds from sales of (purchases of) marketable securities	5,112	(13,548)
Purchases of property and equipment	(46)	(394)
Proceeds on sale of fixed assets	41	75
Decrease in other assets	160	900
Net cash provided by investing activities	5,267	(12,967)
Cash Flows from Financing Activities:		
Proceeds from exercise of stock options		42
Proceeds from employee stock purchase plan	296	1,034
Payments on long-term obligations		(500)
Net cash provided by financing activities	296	576
Effect of Foreign Exchange Rate Changes on Cash and Cash Equivalents	(273)	10
Net Decrease in Cash and Cash Equivalents	3,193	(13,815)
Cash and Cash Equivalents, Beginning of Period	45,829	49,493
Cash and Cash Equivalents, End of Period	$49,022	$ 35,678

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

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

(1) OPERATIONS AND BASIS OF PRESENTATION

Art Technology Group, Inc. (ATG or the Company) is a Delaware company incorporated on December 31, 1991. ATG offers an integrated suite of Internet online marketing, sales and service applications, as well as related application development, integration and support services.

ATG develops and markets software that enables consumer, retail and financial services companies to dynamically market, sell and provide services to their customers online. The Company offers proven, flexible online marketing, sales, and self-service software applications for consumer facing e-commerce sites. ATG also offers their clients related professional services including support, education and implementation 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 2002 Annual Report on Form 10-K. In the opinion of management, the accompanying unaudited condensed consolidated financial statements and notes contain all adjustments, consisting of normal recurring accruals, considered necessary for a fair presentation of the Company s financial position, results of operations and cash flows at the dates and for the periods indicated. The operating results for the three months ended March 31, 2003 are not necessarily indicative of the results to be expected for the full year ending December 31, 2003.

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

(2) STOCKHOLDERS EQUITY

Stock-Based Compensation

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

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

	Three Months Ended March 31,	
	2003	**2002**
Net loss as reported	$ (2,754)	$ (2,849)
Add: Stock-based employee compensation expense included in reported net loss	81	271
Deduct: Total stock based employee compensation expense determined under fair value based method for all awards	(14,107)	(15,356)
Pro forma net loss	$(16,780)	$(17,934)
Basic and diluted net loss per share		
As reported	$ (0.04)	$ (0.04)
Pro forma	$ (0.24)	$ (0.26)

Increase in shares available under option plans

During the three months ended March 31, 2003, the Company s Board of Directors approved resolutions, subject to shareholder approval, to increase the number of shares of common stock available for future issuances under the 1999 Outside Director s Stock Option Plan and the 1999 Employee Stock Purchase Plan to 800,000 shares from 300,000 shares, and to 5,000,000 shares from 3,000,000 shares, respectively.

Option Exchange Program

On August 1, 2002, the Company offered all full-time and part-time employees, other than the officers as defined in Rule 16a-1(f) of the Securities and Exchange Act of 1934, and directors, the opportunity to participate in a stock option exchange program. The voluntary program gave employees the opportunity to exchange options with exercise prices of $15.00 or more per share that were granted under the Amended and Restated 1996 Stock Option Plan. However, if an employee elected to cancel any awards, all options granted after January 26, 2002 were also required to be canceled and the employee could not be granted any additional shares of stock before March 3, 2003. The new options were exercisable for one share of ATG s common stock for every three shares of the Company s common stock issuable upon exercise of a surrendered option to be granted at least six months and one day after the old options were cancelled. Approximately 3,000,495 options were eligible for exchange under this program.

On August 29, 2002, 1,997,819 options were cancelled under the stock option exchange program. On March 3, 2003, 479,447 replacement options were granted to employees of ATG in accordance with the Option Exchange Program, at a grant price of $0.99 per share. Twenty-five percent of each new option vested immediately on the date of grant. The remaining seventy-five percent will vest in three equal installments in six-month intervals.

(3) NET INCOME (LOSS) PER SHARE

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

The following table sets forth basic and diluted net income (loss) per share computational data for the three months ended March 31, 2003 and 2002 (in thousands, except per-share amounts):

	Three Months Ended March 31,	
	2003	**2002**
Net loss	$ (2,754)	$ (2,849)
Weighted average common shares outstanding used in computing basic net loss per share	70,982	69,494
Weighted average common equivalent shares outstanding:		
Employee common stock options		
Total weighted average common stock and common stock equivalents outstanding used in computing diluted net loss per share	70,982	69,494
Basic net loss per share	$ (0.04)	$ (0.04)
Diluted net loss per share	$ (0.04)	$ (0.04)
Antidilutive common stock equivalents	12,514	14,065

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(4) REVENUE RECOGNITION

ATG recognizes product license revenue from licensing the rights to use its software to end-users. ATG also generates service revenues from integrating its software with its customers operating environments, the sale of maintenance services and the sale of certain other consulting and development services. ATG generally has separate agreements with its customers, which govern the terms and conditions of its software license, consulting and support and maintenance services. These separate agreements, along with ATG s price list and business practices of selling products and 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 98-9.

ATG recognizes revenue in accordance with Statement of Position (SOP) No. 97-2, *Software Revenue Recognition* and SOP 98-9, *Modification of SOP 97-2, Software Revenue Recognition, with Respect to Certain Transactions*. Revenues from software product license agreements are recognized upon execution of a license agreement and delivery of the software, provided that the fee is fixed or determinable and deemed collectible by management. If conditions for acceptance are required subsequent to delivery, revenues are recognized upon customer acceptance if such acceptance is not deemed to be perfunctory. In multiple element arrangements, ATG uses the residual value method in accordance with SOP 97-2 and SOP 98-9. Revenue earned on software arrangements involving multiple elements which qualify for separate element accounting treatment is allocated to each undelivered element using the relative fair values of those elements based on vendor specific objective evidence with the remaining value assigned to the delivered element, the software license. Typically, the Company s software licenses do not include significant post-delivery obligations to be fulfilled by the Company and payments are due within a three-month period from the date of delivery. Consequently, license fee revenue is generally recognized when the product is shipped. Revenues from software maintenance agreements are recognized ratably over the term of the maintenance period, which is typically one year. ATG enters into reseller arrangements that typically provide for sublicense fees payable to ATG based upon a percentage of ATG s list price. Revenues are recognized under reseller agreements as earned for guaranteed minimum royalties, generally ratably over one year, 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 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. Unbilled services represent service revenues that have been earned by ATG in advance of billings. 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 Securities* (FAS 115). Under FAS 115, investments for which ATG has the positive intent and the ability to hold to maturity, consisting of cash equivalents and marketable securities, are reported at amortized cost, which approximates fair market value. Cash equivalents are highly liquid investments with maturities at the date of acquisition of less than 90 days. Marketable securities are investment grade debt securities with maturities at the date of acquisition of greater than ninety days. At March 31, 2003 and December 31, 2002, all of ATG s marketable securities were held in commercial paper and corporate bonds and were classified as held-to-maturity, and have maturities that are less than one year. The average maturity of ATG s marketable securities was approximately 3.6 months at March 31, 2003 and December 31, 2002, respectively. At March 31, 2003, and December 31, 2002, the difference between the amortized cost and market value of ATG s marketable securities was approximately $(19,000) and $(21,000), respectively. Realized gains and losses for the three months ended March 31, 2003 and 2002 were not material. At March 31, 2003 and December 31, 2002, ATG s cash, cash equivalents and marketable securities consisted of the following:

	March 31, 2003	December 31, 2002
	(In thousands)	
Cash and cash equivalents		
Cash	$36,993	$39,130
Money market accounts	12,029	6,699
Total cash and cash equivalents	$49,022	$45,829
Marketable securities		
Corporate securities	$17,617	$22,729

Total marketable securities	$17,617	$22,729

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(6) COMPREHENSIVE INCOME (LOSS)

SFAS No. 130, *Reporting Comprehensive Income,* requires that a full set of general purpose financial statements be expanded to 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 March 31,	
	2003	2002
	(In thousands)	
Net loss	$(2,754)	$(2,849)
Foreign currency translation loss	(280)	(32)
Comprehensive loss	$(3,034)	$(2,881)

The accumulated other comprehensive loss at March 31, 2003 and December 31, 2002, of $1,991,000 and $1,711,000 respectively, consisted entirely of the cumulative foreign currency translation adjustment.

(7) DISCLOSURES ABOUT SEGMENTS OF AN ENTERPRISE

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

Revenues from sources outside of the United States were approximately $4.8 million and $7.8 million for the three months ended March 31, 2003 and 2002, 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 months ended March 31, 2003 and 2002 were delivered from its headquarters located in the United States.

The following table represents the percentage of total revenues by geographic region from customers for the three months ended March 31, 2003 and 2002:

	Three Months Ended March 31,	
	2003	2002
United States	75%	71%
United Kingdom (UK)	17	9
Europe, Middle East and Africa (excluding UK)	4	16
Other	4	4
	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. The line of credit bore interest at the Bank s prime rate. The line of credit was secured by all of the Company s tangible and intangible intellectual and personal property and is subject to financial covenants including liquidity coverage and profitability. As a result of this agreement, ATG was no longer required to fully cash secure all of its letters of credit (LC s). However, the Company was required to maintain $18 million of unrestricted cash with the Bank at all times during the term of the line of credit. As a result of this requirement, this revolving line of credit did not increase the amount of net cash available to the Company during the term of the agreement.

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In December 2002, ATG increased its eligible line of credit to $20 million from $15 million. While there were no outstanding borrowings under the facility at March 31, 2003, ATG has issued letters of credit (LC s) totaling $14.8 million, which are supported by this facility. The line of credit bears interest at the Bank s prime rate (4.25% at March 31, 2003). As of March 31, 2003 approximately $5.2 million was available for future borrowings. The line of credit is secured by all of ATG s tangible and intangible intellectual and personal property and is subject to financial covenants including liquidity coverage and profitability. The liquidity covenant mandates ATG maintain $40 million in cash at the end of each month throughout the duration of the facility. The profitability covenant allows for net losses not to exceed $4.0 million for the first quarter of 2003, $2.0 million for the second quarter of 2003 and $1.0 million for the third and fourth quarters of 2003. The Bank has granted additional provisions, to be used if necessary, for a maximum $25 million in restructuring charges for the duration of the facility. Of the $25 million, a maximum of $7.5 million may be taken as a cash expense during the term of the facility; a second provision is made for a maximum of $12.0 million in cash to be paid toward real estate buy-outs. ATG is required to maintain $27 million in unrestricted cash with the Bank at all times, and in the event the balance should decrease, ATG will be required to pay fees and expenses to compensate the Bank for lost income. As of March 31, 2003, the Company was in compliance with all related financial covenants. In the event that ATG does not comply with any of the 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 our 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 LC s at that time to be cash secured on terms acceptable to the Bank. The revolving line of credit expires on December 23, 2003.

(9) COMMITMENTS AND CONTINGENCIES

Leases

ATG has offices, primarily for sales and support personnel, in 9 domestic locations as well as 8 foreign countries. At March 31, 2003, ATG has issued $14.8 million of LC s under its line of credit in favor of various landlords to secure obligations under our facility leases, which expire from 2003 through 2011.

The approximate future minimum payments of ATG s facility leases and certain operating equipment leases as of March 31, 2003, are as follows:

	Operating Leases
	(In thousands)
Remainder of 2003	$13,920
2004	15,477
2005	16,096
2006	14,086
2007	9,398
Thereafter	18,782
Total future minimum lease payments	$87,759

Of the $87.8 million in future minimum lease payments, $66.9 million was included in the Company s 2001 and 2002 restructuring charges. The $66.9 million has been reduced to a $42.0 million restructuring accrual after taking into consideration estimated sublease income and estimated vacancy periods until the various properties are sub-leased (see Note 10). Subsequent to March 31, 2003, the Company finalized settlement agreements with certain landlords as more fully described in Note 15, Subsequent Events.

Rent expense included in the accompanying statements of operations was approximately $1.5 million and $2.4 million for the three months ended March 31, 2003 and 2002, respectively.

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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 a patent or copyright of a third party. The software license agreements generally limit the scope of and remedies for such indemnification obligations in a variety of industry-standard respects, including but not limited to certain geography-based scope limitations, the right to replace or modify an infringing product, and the right to terminate the license and refund a portion of the original license fee if a remedy is not commercially practical. The Company believes its internal development processes and other policies and practices limit its exposure related to the indemnification provisions of the software license agreements. In addition, the Company requires its employees to sign a proprietary information and inventions agreement, which assigns the rights to its employees development work to the Company. To date, the Company has not had to reimburse any of its customers for any losses related to these indemnification provisions and no material claims are outstanding as of March 31, 2003.

With respect to real estate lease agreements, 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. These indemnification provisions generally survive the termination of the agreement, although the provision 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

December 31, 2001

As a result of a global slowdown in information technology spending, ATG undertook plans to restructure its operations during 2001. Actions taken by ATG included: 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, ATG recorded a restructuring charge of $44.2 million, and in the fourth quarter of 2001, ATG recorded a restructuring charge of $32.7 million. Total restructuring charges for 2001 totaled $76.9 million.

The significant components of the 2001 restructuring charge (in thousands):

RESTRUCTURING CHARGES

	Quarter Ended June 30, 2001	Quarter Ended December 31, 2001	Year Ended December 31,2001	Payments and Write-Offs in 2001	Balance at December 31, 2001	2001 Adjustments in Estimate made in Quarter Ended June 30, 2002	2001 Adjustments in Estimate made in Quarter Ended December 31, 2002	Payments	Balance at December 31, 2002
Facilities-related costs and impairments	$ 38,100	$ 22,818	$ 60,918	$ 16,208	$ 44,710	$ 447	$ 907	$ 9,016	$ 37,048
Employee severance, benefits and related costs	4,757	3,181	7,938	6,748	1,190			920	270
Asset impairments	212	5,358	5,570	5,570					
Exchangeable share settlement		1,263	1,263	1,263					

Marketing costs	851		851	851		(536)			(536)
Legal and accounting costs	315	90	405	232	173			173	
Total	$44,235	$32,710	$76,945	$30,872	$46,073	$ (89)	$ 907	$10,109	$36,782

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	Balance at December 31, 2002	Payments and Write-Offs	Balance at March 31, 2003
Facilities-related costs and impairments	$37,048	$2,010	$35,038
Employee severance, benefits and related costs	270	270	
Asset impairments			
Exchangeable share settlement			
Marketing costs	(536)	(536)	
Legal and accounting costs			
Total	$36,782	$1,744	$35,038

The facilities-related cost component consisted of idle lease space and termination payments for offices worldwide, which were no longer required due to the reduction in personnel. In determining the facilities-related costs, ATG estimated the vacancy period and sublease income. A component of the fourth quarter facility-related cost was a change in estimate of the second quarter facility-related restructuring charge. The net change in estimate was an additional charge of $1.5 million in the fourth quarter. Of the $1.5 million charge, a credit of $8.2 million was realized due to the buy out of a lease included in the second quarter charge of $9.3 million, which is being paid ratably over 4.5 years. This credit was offset by an increase of approximately $9.7 million due to updated assumptions as a result of a market analysis indicating lower sublease rates and longer vacancy periods for two leases provided for in the second quarter. Included in the facility-related costs was the write-off of abandoned leasehold improvements and fixed assets of $7.7 million and $2.2 million, respectively. These fixed assets were directly related to the restructured excess office facilities.

The employee severance cost component of the restructuring charge was related to reductions in personnel. As part of the restructuring ATG terminated the employment of 530 employees, or 46% of ATG s workforce. Approximately 47% of these employees were from sales and marketing, 22% from services, 19% from general and administrative and 12% from research and development. In addition, ATG settled 11,762 exchangeable shares with a certain employee. Upon settlement, ATG recorded $1.3 million as a charge to restructuring.

The asset impairment-related costs included the write-off of the remaining unamortized goodwill of approximately $4.0 million, which was related to the two professional service organizations acquired in 2000. In addition, the Company determined that approximately $1.4 million of purchased software was deemed impaired due to ATG s revised product development strategy.

During the second quarter of 2002, ATG recorded a net charge increasing the 2001 restructured lease obligation accruals by $447,000. The Company increased one lease obligation estimate by $1.3 million as a result of adjusting the estimated sublease income and vacancy assumptions due to the continued weakening of the real estate market in that location. Offsetting this increase, ATG recognized a benefit of $853,000 from two other restructured lease obligation accruals due to favorable sublease transactions consummated during the second quarter. This net charge has been offset by the Company receiving a refund of $536,000 relating to the marketing component of the restructuring charge recorded in fiscal 2001, resulting in a net credit to income of $89,000 for the quarter ended June 30, 2002. Also, during the fourth quarter of 2002, ATG recorded a charge of $907,000 to increase charges recorded in 2001 for lease obligations of idle locations.

December 31, 2002

As a result of the continued weakness in global information technology spending, ATG undertook plans to restructure its operations during 2002. Actions taken by ATG included: consolidation and closure of excess facilities, a worldwide workforce reduction and, the write-off of certain idle assets. In the second quarter ATG recorded a restructuring credit of $89,000, due to a change in the 2001 estimated restructuring charge, and in the fourth quarter of 2002, ATG recorded an aggregate restructuring charge of $19.1 million. Restructuring charges for 2002 totaled $19.0 million.

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The significant components of the 2002 restructuring charge (in thousands):

RESTRUCTURING CHARGES

	Quarter Ended December 31, 2002	Payments and Write-Offs in 2002	Balance at December 31, 2002	Payments	Balance at March 31, 2003
Facilities-related costs and impairments	$ 14,634	$ 2,613	$ 12,021	$ 814	$ 11,207
Employee severance, benefits and related costs	3,553		3,553	2,099	1,454
Total	$ 18,187	$ 2,613	$ 15,574	$ 2,913	$ 12,661

During the fourth quarter of 2002, the Company recorded a restructuring charge of $19.1 million, which consisted of actions initiated in the fourth quarter of 2002 and an adjustment of $907,000 to increase the charges recorded in 2001 for lease obligations of idle locations. The facilities-related charge associated with the 2002 fourth quarter action was $13,476,000 comprising $12,021,000 for operating leases related to office space that was either idle or to be vacated during the first quarter of 2003 and $1,455,000 of leasehold improvements and furniture and fixtures written down to their fair value. The Company also recorded a charge of $3,553,000 for severance and benefit costs related to cost reduction actions taken across the worldwide employee base, and as a result of this action and the actions taken in 2001, the Company wrote-off $1,158,000 of computer equipment and software, which were no longer being used due to the reduction in personnel and office locations.

The lease charge was for office space the Company vacated and intends to sub-lease. The amount of the operating lease charge was based on assumptions from current real estate market data for sub-lease income rates and vacancy rates at each respective location. The severance and benefit costs were for 125 employees, or 23% of the Company s workforce, consisting of 53 employees 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. As a result of a reduction of employees on a worldwide basis in the 2002 and 2001 restructuring actions, as well as the closure of certain office locations, the Company wrote-off computer equipment and software and furniture and fixtures that it had abandoned and would not be used in the future. These assets were written down to their fair value based on the expected cash flows they would generate over their remaining economic life. Due to the short remaining economic life and current market conditions for such assets, the fair value of these assets was estimated as zero. In addition, the Company wrote-off leasehold improvements related to the facilities it is attempting to sub-lease because the estimated cash flows to be generated from those locations would not have been sufficient to recover the carrying value of the assets. The Company had substantially completed the above actions by March 31, 2003.

As of March 31, 2003, the Company had an accrued restructuring liability of $47.7 million, of which $35.0 million relates to 2001 restructuring charges and $12.7 million relates to 2002 restructuring charges. The long-term portion of the accrued restructuring liability was $31.0 million.

(11) LITIGATION

The Company and certain 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 SEC Rule 10b-5, 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 us 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. The plaintiffs have filed their opposition to the motion, and the Company has submitted a response. While management believes the claims against the Company are without merit, and intends to defend the action vigorously, the litigation is in the preliminary stage.

A breach of contract claim was filed in Germany by DIFA Deutsche Immobilien Fonds AG against Art Technology Group GMBH, a subsidiary of the Company, on July 18, 2002. The suit alleges that ATG GmbH failed to pay rent on office space leased by the plaintiff and failed to deliver a bank guarantee, thereby breaching its lease obligations to plaintiff. The German court returned a ruling on January 22, 2003 adverse to ATG and found in favor of the plaintiff in the approximate amount of 1.4 million euros (approximately $1,600,000 as of May 7, 2003) plus 8% interest and the delivery of a security deposit in the form of a bank guarantee in the amount of approximately 675,000 euros (approximately $771,000 as of May 7, 2003). The judgment amount represents unpaid rent from February to June 2002, which was accrued as part of the restructuring charge recorded in 2001 and remains accrued at March 31, 2003. At the plaintiff s option, it may seek to institute suit in the future for additional rents that have accrued since the date established in the ruling. The prevailing party in a German lawsuit is also entitled to collect court costs and attorneys fees from the non-prevailing party according to a fee and cost schedule established by law. The fees and costs in this case total approximately 65,000 euros (approximately $74,000 as of May 7, 2003), (exclusive of fees and costs associated with a potential appeal). ATG filed an appeal to the suit on February 6, 2003. ATG s appeal of the suit is based, in part, on interpretations of law made by the first judge relating to alleged modifications to the original agreement with plaintiff.

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 year-end. Prior to translation, the Company re-measures foreign currency denominated assets and liabilities into the functional currency of the respective Company entity, resulting in unrealized gains or losses recorded in Interest and Other Income, Net in the accompanying Condensed Consolidated Statements of Operations. Revenues and expenses are translated using average exchange rates in effect during the year. Gains and losses from foreign currency translation are credited or charged to accumulated other comprehensive loss included in Stockholders Equity in the accompanying Condensed Consolidated Balance Sheets. During the three months ended March 31, 2003 and 2002, the Company recorded gains of $157,000, and $50,000, respectively, from transactional gains and losses and re-measurement gains and losses.

(13) HEDGING ACTIVITIES

A portion of our revenues, earnings and cash flows are exposed to changes in foreign exchange rates. Under our foreign currency-hedging program, we may at times seek to manage our foreign exchange risk through the use of foreign currency forward-exchange contracts. ATG may use these contracts to offset the potential earnings and cash flow effects from short-term foreign currency assets and liabilities that arise from operations. FAS 133, *Accounting for Derivative Instruments and Hedging Activities* (FAS 133) requires that all derivative contracts and hedging activities be recorded at fair value in the financial statements.

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Such contracts are marked to market in each reporting period with the resulting change in fair value recognized immediately in Other Income in the Condensed Consolidated Statement of Operations as unrealized gains and losses up through their maturity, at which time the gains or losses become realized. These gains and losses offset the changes in fair value of the asset or liability being hedged. Realized gains and losses were not material in the three months ended March 31, 2003. As of March 31, 2003 there were no foreign currency-hedging contracts outstanding. Furthermore, the Company does not have any option or other derivative contracts outstanding at March 31, 2003.

(14) RECENT ACCOUNTING PRONOUNCEMENTS

In January 2003, the FASB issued Interpretation No. 46 *Consolidation of Variable Interest Entities* (FIN 46), which is an interpretation of Accounting Research Bulletin No. 51, *Consolidated Financial Statements*. FIN 46 addresses consolidation by business enterprises of variable interest entities and requires existing unconsolidated variable interest entities to be consolidated by their primary beneficiaries if the entities do not effectively disperse risks among parties involved. Variable interest entities that effectively disperse risks will not be consolidated unless a single party holds an interest or combination of interests that effectively recombines risks that were previously dispersed. FIN 46 applies immediately to variable interest entities created after January 31, 2003 and to variable interest entities in which an enterprise obtains an interest after that date. It applies in the first fiscal year or interim period beginning after June 15, 2003, to variable interest entities in which an enterprise holds a variable interest that it acquired before February 1, 2003. FIN 46 applies to public enterprises as of the beginning of the applicable interim or annual period. We do not expect that the adoption of FIN 46 will have a material effect on our financial position or results of operations.

(15) SUBSEQUENT EVENTS

On May 8, 2003, the Company announced that it had successfully settled three excess real estate obligations at facilities located in San Francisco, CA, Cambridge, MA, and Toronto, Canada. Pursuant to the agreements, the Company made one-time cash payments totaling $9.7 million to fully settle $38.2 million of future lease obligations. The Company anticipates that during the second quarter of 2003, it will record a restructuring benefit to its operating results in the range of $7.0 million to $9.0 million.

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

Overview

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

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

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

As of March 31, 2003 we had offices in England, France, Germany, Japan, Sweden, and the United States. Revenues from customers outside the United States accounted for 25% and 29% of our total revenues for the three months ended March 31, 2003 and 2002, respectively.

Critical Accounting Policies and Estimates

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

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

Revenue Recognition

Not only is revenue recognition a key component of our results of operations, the timing of our revenue recognition also determines the timing of certain expenses, such as commissions. In measuring revenues, we follow the specific guidelines of SOP 97-2 and SOP 98-9. SOP 97-2 requires that four basic criteria must be met before revenue can be recognized: (1) persuasive evidence of 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.

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

Accounts Receivable and Bad Debt

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

Research and Development Costs

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

Restructuring Expenses

During 2002 and 2001, we recorded restructuring charges of $19.0 million and $76.9 million, respectively, pertaining to the closure and consolidation of excess facilities, impairment of assets as discussed below, employee severance benefits, and settling of certain contractual obligations. The charges were recorded in accordance with ETIF 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, *Employers Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits* and SAB 100, *(Restructuring and Impairment Charges).* In determining the charges to record, we made certain estimates and judgments surrounding the amounts ultimately to be paid for the actions we have taken. At March 31, 2003, 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 sub-lease income or the period of time the facilities will be vacant and sub-leased. On May 8, 2003, we announced that we had successfully settled three excess real estate obligations at facilities located in San Francisco, CA, Cambridge, MA, and Toronto, Canada. Pursuant to the agreements, we made one-time cash payments totaling $9.7 million to fully settle $38.2 million of future lease obligations. We anticipate that during the second quarter of 2003, we will record a restructuring benefit to our operating results in the range of $7.0 million to $9.0 million. Although we do not anticipate significant changes to our remaining 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 are successful in terminating our remaining lease obligations prior to the scheduled termination date. Such changes could have a material impact to our operating results. Any future restructuring actions the Company takes will be recorded in accordance with FAS 146, *Accounting for Costs Associated with Exit or Disposal Activities*.

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Impairment or Disposal of Long Lived Assets

We review our long-lived assets whenever events or changes in circumstances indicate that the carrying amount of such an asset may not be recoverable. Recoverability of these assets is measured by comparison of their carrying amount to future undiscounted cash flows the assets are expected to generate. If such assets are considered impaired, the impairment to be recognized is equal to the amount by which the carrying value of the assets exceeds the 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 2002 and 2001, we evaluated the realizability of our long-lived assets including fixed assets and leasehold improvements related to our restructured facility leases and intangible assets consisting primarily of unamortized goodwill. In 2002, we determined that $1.7 million of furniture and fixtures, computer equipment and software were impaired as a result of our decision to abandon the assets because of the termination of employees and related closures of offices in our 2002 and 2001 restructuring plans. These assets were no longer being used or will not be used in the future upon completion of the 2002 restructuring plan, which has been substantially completed by March 31, 2003. In addition, $909,000 of leasehold improvements were deemed to be impaired due to exiting certain office locations and the estimated sub-lease income was not sufficient to recover the carrying value of the assets. In 2001, we determined that $7.7 million of leasehold improvements and $2.2 million of furniture, fixtures and equipment were impaired as a result of these restructured operating leases. In addition we determined that approximately $1.4 million of purchased software was impaired due to our revised product development strategy. Lastly we wrote-off the remaining unamortized goodwill of $4.0 million due to the closure and abandonment of two professional service acquisitions completed in fiscal year 2000.

Accounting for Income Taxes

We account for income taxes in accordance with Statement of Financial Accounting Standards No. 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 by assessing our valuation allowance and by adjusting the amount of such allowance, if necessary.

At March 31, 2003 and December, 31, 2002, we have provided a full valuation allowance against our 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.

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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 March 31, 2003	Three Months Ended March 31, 2002
Revenues:		
Product license	39%	46%
Services	61%	54%
Total revenues	100%	100%
Cost of revenues:		
Product license	2%	4%
Services	29%	33%
Total cost of revenues	32%	37%
Gross margin	68%	63%
Operating expenses:		
Research and development	25%	20%
Sales and marketing	45%	45%
General and administrative	14%	9%
Stock-based compensation		1%
Total operating expenses	84%	76%
Income (loss) from operations	(16%)	(12%)
Interest and other income (expense), net	2%	2%
Income (loss) before provision for income taxes	(14%)	(10%)
Provision for income taxes		
Net income (loss)	(14%)	(10%)

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 March 31, 2003	Three Months Ended March 31, 2002
Cost of product license revenues	6%	8%
Cost of services revenues	48%	61%

Three Months ended March 31, 2003 and 2002

Revenues

Total revenues decreased 29% to $19.4 million for the three months ended March 31, 2003 from $27.3 million for the three months ended March 31, 2002. The decrease was primarily attributable to the slowing economy, reduced information technology spending among our customer base, and the lengthening of the sales cycle. Revenues generated from international customers decreased to $4.8 million, or 25% of total revenues, for the three months ended March 31, 2003, from $7.8 million, or 29% of total revenues, for the three months ended March 31, 2002. We expect total revenues to decrease in 2003 and the international revenues as a percentage of total revenues to be approximately 30%.

No individual customer accounted for more than 10% of total revenues for the three months ended March 31, 2003 or 2002.

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Product License Revenues

Product license revenues decreased 40% to $7.5 million for the three months ended March 31, 2003 from $12.5 million for the three months ended March 31, 2002. The decrease was primarily attributable to the slowing economy, reduced information technology spending among our customer base and the lengthening of the sales cycle. Product license revenues generated from international customers decreased to $1.2 million for the three months ended March 31, 2003 from $4.1 million for the three months ended March 31, 2002. We expect product license revenues to increase as a percent of total revenues to about 50% and in absolute dollars in 2003.

Product license revenues as a percentage of total revenues for the three months ended March 31, 2003 and 2002 were 39% and 46%, respectively. We expect this percentage to be about 50% for the remainder of 2003.

Services Revenues

Services revenues decreased 19% to $11.9 million for the three months ended March 31, 2003 from $14.8 million for the three months ended March 31, 2002. The decrease was primarily attributable to the slowing economy, reduced information technology spending, declining product revenue and a reduction in our services capacity as we increased our use of channel partners. Additionally, as a result of lower product sales, support and maintenance revenues and professional services revenues have decreased. We expect services revenues to decrease as a percent of total revenue and to decrease in absolute dollars in 2003.

Support and maintenance revenues were 64% of total service revenues for the three months ended March 31, 2003 as compared to 63% for the three months ended March 31, 2002. Support revenues on a dollar value basis, were lower for the three months ended March 31, 2003 due to the decrease in product revenues from 2002 compared to 2001 and the fact that some customers are decreasing or terminating their support coverage.

Services revenues as a percentage of total revenues for the three months ended March 31, 2003 and 2002, were 61% and 54%, respectively. We expect this percentage to be about 50% for the remainder of 2003.

Cost of Product License Revenues

Cost of product license revenues decreased 53% to $485,000 for the three months ended March 31, 2003 from $1.0 million for the three months ended March 31, 2002. This decrease is primarily related to lower product revenues during the first quarter of 2003, and satisfaction of payment obligations related to the BroadVision settlement which was satisfied in 2002. In February 2000, we settled a lawsuit filed by BroadVision in December 1998, which alleged that we were infringing on a patent for a method of conducting e-commerce. As part of the settlement, we agreed to pay BroadVision a total of $15.0 million in license fees, which were being accounted for as cost of product license revenues. For 2002, approximately half of our cost of product license revenues related to the BroadVision settlement that was fully satisfied as of December 31, 2002.

For the three months ended March 31, 2003 and 2002, cost of product license revenues as a percentage of total revenues was 2% and 4%, respectively. We anticipate the cost of product license revenues, as a percentage of total revenues, to be between 2% and 3% for the remainder of 2003.

Cost of Services Revenues

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

Cost of services revenues decreased 36% to $5.7 million for the three months ended March 31, 2003 from $9.0 million for the three months ended March 31, 2002. The decrease was primarily attributable to a reduction in our professional services workforce and the reduction in service revenues related to reduced product license revenues. Approximately 62% of the decrease was attributable to decreased compensation costs due to a reduction in our work force. The remaining 38% of the decrease was due to a decrease in operating expenses as a result of our restructuring efforts and cost containment initiatives.

For the three months ended March 31, 2003 and 2002, cost of services revenues as a percentage of total revenues were 29% and 33%, respectively. We anticipate the cost of services revenues, as a percentage of total revenues, to be in the 30% to 35% range for the remainder of

2003.

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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 13% to $4.9 million for the three months ended March 31, 2003 from $5.6 million for the three months ended March 31, 2002. The decrease was primarily attributable to a reduction in our workforce. Approximately 84% of the decrease is related to decreased salaries and related benefits. The remaining 16% of the decrease was due to a decrease in operating expenses as a result of our restructuring efforts and cost containment initiatives.

For the three months ended March 31, 2003 and 2002, research and development expenses as a percentage of total revenues were 25% and 20%, respectively. Based on cost reduction initiatives, we anticipate that research and development expenses as a percentage of total revenues will be about 22% for the remainder of 2003.

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 29% to $8.8 million for the three months ended March 31, 2003 from $12.4 million for the three months ended March 31, 2002. The decrease is primarily attributable to cost saving initiatives that resulted from a reduction in the workforce of our sales and marketing group, a reduction in our spending on marketing programs and a reduction in commissions from decreased product revenues. Approximately 41% of the decrease was related to a decrease in compensation and benefits costs, and 18% of the decrease was related to a reduction in our marketing and promotional expenses. The remaining 41% was due to a decrease in operating expenses as a result of our restructuring efforts and cost containment initiatives.

For three months ended March 31, 2003 and 2002, sales and marketing expenses as a percentage of total revenues were 45%, respectively. We expect that sales and marketing expenses for the remainder of 2003 will be in the range of 38% to 41% 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.