EMBARCADERO TECHNOLOGIES INC
Form 10-K/A
April 25, 2005
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-K/A

(Amendment No. 1)

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

For the Fiscal Year Ended December 31, 2004 or

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

For the transition period from __________ to __________

Commission File Number 000-30293

EMBARCADERO TECHNOLOGIES, INC.

(Exact Name of Registrant as Specified in Its Charter)

Delaware	**68-0310015**
(State or other jurisdiction	**(I.R.S. Employer**
of incorporation or	**Identification No.)**

organization)

100 CALIFORNIA STREET, SUITE 1200

SAN FRANCISCO, CA 94111

(Address of principal executive offices, zip code)

(415) 834-3131

(Registrant s telephone number, including area code)

Securities registered pursuant to Section 12 (b) of the Act:

NONE	**NONE**
(Title of Class)	**(Names of Each Exchange on which Registered)**

Securities registered pursuant to Section 12 (g) of the Act:

Common Stock, $0.001 Par Value

Indicate by check mark whether the registrant (1) filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for 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. x Yes ¨ No

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of Registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. x

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

Aggregate market value of the voting stock held on June 30, 2004 by non-affiliates of the registrant: $285,002,084. Number of shares of Common Stock outstanding at March 31, 2005: 26,349,884.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the definitive proxy statement for the Registrant s 2005 Annual Meeting of Stockholders are incorporated by reference into Part III hereof.

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10-K/A EXPLANATORY NOTE

Embarcadero Technologies, Inc. is filing this amendment to Form 10-K for the year ended December 31, 2004, filed with the Securities and Exchange Commission on April 7, 2005 (the Original Filing) to:

- amend and restate Item 9A to include Management s Report on Internal Control Over Financial Reporting;
- include a Report of Independent Registered Public Accounting Firm relating to our internal control over financial reporting; and
- include a Consent of Independent Registered Public Accounting Firm required as a result of the revisions discussed above.

As a result of these amendments, the certifications pursuant to Section 302 and Section 906 of the Sarbanes-Oxley Act of 2002, filed as exhibits to the Original Filing, have been re-executed and re-filed as of the date of this Form 10-K/A.

Except for the amendments described above, this Form 10-K/A does not modify or update other disclosures in, or exhibits to, the Original Filing.

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EMBARCADERO TECHNOLOGIES, INC.

ANNUAL REPORT ON FORM 10-K

For the Fiscal Year Ended December 31, 2004

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All statements contained in this Annual Report on Form 10-K that are not historical facts are forward-looking statements within the meaning of the federal securities laws that relate to future events or our future financial performance. In some cases, you can identify forward-looking statements by terminology such as may, will, should, expect, plan, anticipate, believe, estimate, predict, intend, potential, or continue or the negative of these terms or other comparable terminology. Such statements are only predictions. Risks and uncertainties and the occurrence of other events could cause actual results to differ materially from these predictions. The risks and uncertainties discussed below under Factors That May Affect Future Results and elsewhere in this report should be considered carefully in evaluating our business. Although we believe that the expectations reflected in the forward-looking statements are reasonable, we cannot guarantee future results, levels of activity, performance, or achievements. Moreover, we assume no responsibility for the accuracy and completeness of these statements. We are under no duty to update any of the forward-looking statements after the date of this report or to adjust these statements to reflect actual results.

PART I

Item 1. Business

Overview

Embarcadero® Technologies, Inc. is a leading provider of data lifecycle management solutions that help companies build, optimize, test, and manage their critical data, database, and application infrastructures, allowing them to provide better service with fewer resources. Nearly 11,000 companies, including 97 of the Fortune 100, rely on Embarcadero Technologies products to manage the explosive growth in data and ensure optimal performance of their complex multi-platform applications and systems.

Embarcadero s solutions help companies make sense of the data that is at the heart of every major business decision. These solutions are powerful, flexible, and easy-to-use, saving companies time and money and increasing their ability to respond to corporate initiatives. With today s emphasis on smart IT investment, Embarcadero products help maximize the productivity of application development and data management teams in complex environments, enabling them to deliver the right data in time to make the right decisions.

Industry Background

Information assets have become an integral part of how organizations compete effectively and provide superior services to their customer base. Organizational expectations regarding the on-demand availability of reliable information continue to rise as more managers seek data-driven reports to help them make critical business decisions. The management and leverage of data across an organization is becoming increasingly central to an organization s competitive advantage. Businesses are becoming reliant on enterprise applications to run critical components of their operations and collect important customer and market information in order to strengthen their competitive position. As a result, organizations are demanding that their information infrastructure be agile, high quality, and operationally efficient. In other words, their information infrastructure must be flexible enough to align with key business objectives. Inflexible systems can create hurdles to executing business plans and absorb a disproportionate amount of resources.

At the same time, organizations must also ensure that the data that they are using is accurate, up-to-date, and consistently available. Organizations are also demanding efficiency and a high return on investment for their investments in information and data management. However, managing the lifecycle of data including the systems that collect and store it, and the applications that rely on it is an increasingly difficult task. Companies must learn to thrive in a world of exploding volumes of data, exponential growth in data complexity, and increasing demands of systems, applications, and users.

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One of the first challenges that organizations face is effectively leveraging their existing information assets. Corporate data is often housed in disparate systems across multiple database platforms and gathered from a variety of sources such as the Internet, custom-built applications, distributed systems, and traditional mainframe systems, among others. Each time a company adds a new data source to its IT environment, the relationships with other data sources grow exponentially. As a result many organizations struggle to keep pace with simultaneous pressures to enhance and support existing applications, build new applications, and manage more data within increasingly complex computing environments.

In addition, tight IT budgets and limited resources have created a need for software solutions that are adaptive to user needs by appealing to both novice and experienced users that allow scalable purchase options to fit short-term and long-term budget needs. Experienced database and application IT professionals are being asked to do more in less time, while less experienced IT personnel are being asked to become more proficient at a faster rate. Both groups also find themselves tied to performing routine tasks instead of working on projects that add value. This strain on IT professionals is compounded by the growing complexity of IT systems and the need for IT staff to efficiently manage different types of database and application environments.

Moreover, managing the performance of both new and existing systems has become a top priority for many organizations. These companies must ensure that their systems are up-and-running with optimal performance. Poor performance of a business-critical application can cost a company as much as a complete outage of service and can have ongoing implications that further impact revenue such as perceptions of poor customer service or negative brand associations. As such, downtime whether in the form of a system slowdown or complete outage must be avoided.

To maximize technology investments and fully leverage the data that is so critical to operations, organizations need to optimize the performance of their technical resources. These resources include:

- Hardware and software infrastructures
- Intellectual property of the organization in the form of data
- The people tasked with managing that data and the related applications and systems

Organizations seek to maximize the performance, reliability, and availability of their hardware and software infrastructure. To maximize the productivity of their staff, organizations need solutions that work across different technologies, automate routine tasks, and help leverage expertise across different technologies. In an environment of complex company mergers, outmoded legacy systems, and on-demand information, organizations are looking for solutions that provide cross-platform availability, performance, and security.

Responsiveness and Managing Complex Data Environments

Traditional software products for managing software applications, supporting databases, and administering the underlying data do not adequately address the challenges of complex and evolving data environments. The resulting gap means that IT organizations struggle to provide the flexibility required for today s dynamic business environment. Often, the products they look to fail to address the full data lifecycle, or introduce other limitations such as:

Requiring staff to have deep specialized knowledge that limits the flexibility of the organization and results in additional training costs

Supporting only one or a limited subset of all databases or platforms, or supporting different databases and platforms in an inconsistent way

Lacking an integrated approach to proactively identifying and correcting performance problems to improve service levels

Delivering tools designed for expert database administrators and application developers that are too complex for less experienced IT personnel

Not providing solutions that adequately address rapid and regular change and therefore incur a high degree of risk for changes that have become routine

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- Requiring a lengthy installation process and extensive configuration which increases the time between conception and implementation, making it difficult for organizations to rapidly develop applications and manage information
- Offering solutions built on outdated code based in old programming languages that cannot be easily incorporated into current IT and application environments, and cannot be iterated quickly enough to address the rapid evolution in the requirements of their users
- Not being cost-effective and often ending up costing more than the applications or systems they are designed to manage

Complete data lifecycle management is the process of effectively and efficiently managing IT infrastructure to optimize information delivery and accessibility, and improve services levels while lowering costs. By implementing effective data lifecycle management solutions, organizations can:

- Deliver better service in the face of growing demand
- Proactively plan for change
- Increase responsiveness to user demands
- More fully leverage their hardware, software, and information assets

Many software providers require users to employ different products with dissimilar user interfaces and capabilities to address each phase of the data lifecycle. As a result, we believe that there is a significant opportunity for a suite of integrated products that can manage the data lifecycle and effectively meet the demands of dynamic business environments. This set of solutions should provide the following benefits:

- Deliver a higher degree of flexibility and responsiveness
- Enhance the reliability and availability of today s business applications
- Accelerate time-to-market by allowing users to deliver work results sooner
- Alleviate the strain on IT resources, especially database professionals and application developers
- Manage an increasingly diversified and distributed database and application infrastructure
- Maximize the value that can be extracted from existing systems

Increase the service-levels in terms of effective solutions delivered in a timely manner an IT organization or application development team can offer their company

The Embarcadero Solution

Embarcadero s solutions focus on the three key areas of data lifecycle management: Model-driven Data Solutions, Cross-platform Data Management, and Data Performance and Availability. Through the effective management and optimization of these key areas, companies are able to get the most out of one of their most important and strategic assets their data which is at the core of every critical business application and decision. By simplifying data lifecycle management, these solutions allow companies to more fully leverage investments made in their information technology infrastructures, improve the productivity of their staff, and simplify and automate the integration of information across their organizations.

Our products are designed to work individually as well as together to provide rapid development and optimal performance of applications, which is critical as enterprises deploy and extend their information technology infrastructure. These products can be bundled to offer an integrated data lifecycle solution for a particular database platform, such as Oracle, or to support a multi-vendor database environment, such as Oracle®, Microsoft® SQL Server®, MySQL® and IBM® DB2® UDB databases running simultaneously. They are designed to provide maximum flexibility and utility to our customers by adapting from novice to expert users, from single instances to enterprise-wide installations, and from homogenous environments to multifaceted complex systems. In addition to facilitating the deployment of new systems, Embarcadero s solutions allow customers to leverage their existing infrastructure and extract maximum value from previous IT investments, as well as gain visibility into trends so that they can proactively address performance and availability issues before they become critical.

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Our key products and their core functionality are summarized below:

Embarcadero Solution	Related Products	Description
Model-driven Data Solutions	ER/Studio®	Provides a visual modeling solution for analyzing, designing, creating, and maintaining database applications that simplifies and integrates the needs of all data management stakeholders
	DT/Studio®	Enables organizations to transform, migrate, and consolidate data from a wide range of data sources in weeks, not months
Cross-platform Data Management	DBArtisan®	Helps DBAs maximize availability, performance and security. DBArtisan boosts productivity so existing staff can manage more databases.
	Rapid SQL®	Provides an integrated cross-platform database development environment that raises productivity by simplifying SQL scripting, object management, version control, and schema deployment
	Embarcadero Job Scheduler	Automates the execution of operating system and database maintenance jobs, as well other routine tasks including nightly data loads and batch processing
Data Performance and Availability	Embarcadero Performance Center	Delivers a 24/7 performance monitoring solution with customizable thresholds and highly readable status information, accessible through several sources including standard Web browsers
	Extreme Test®	Employs goals-based load testing for measuring and analyzing enterprise application performance and offers a completely integrated test development and execution environment

Our products support the most widely used database and OS platforms, including Oracle, Microsoft SQL Server, IBM DB2 Universal Database, MySQL and Sybase®, running in Unix®, Windows® NT, and Linux® environments.

Our software offerings:

Increase Flexibility of the Information Infrastructure. Give the rapid pace of change of today s business environment, companies need to be ready to shift resources, collaborate effectively, and shorten the delivery time for critical IT enhancements. Our cross-platform data management solutions free database professionals from specialized platforms. Human resources can be easily redeployed as demand ebbs and flows through different areas of the company. Our modeling solutions provide visibility into existing information assets and thereby enhance collaboration and promote reuse. Instead of recreating the wheel, teams can easily reuse and build on existing work.

Improve Efficiency and Productivity of Data Management and Database Professionals. Our performance management solutions enable organizations to enhance the productivity of IT professionals managing both data lifecycle and related applications. Our products increase the productivity of database professionals, from novice to expert, through the intuitive user interface leveraged across our product line. This reduces the amount of training needed to begin using our software and simplifies the complexity of creating and deploying key business applications. Our products also allow organizations to replace numerous and costly point or platform-specific products with an integrated solution that addresses each phase of data lifecycle management.

Improve Service Levels in the Face of Increasing Demand. Our products across the data lifecycle spectrum help organizations not only understand problems when they are critical, but also can prevent problems before they happen. Our data modeling solutions help analysts see the operational impact of design decisions up front to ensure effective implementation. Our cross-platform data management solutions provide intelligent analysis tools to shed light on problematic trends and areas for improvement, as well as automation and change control functionality to

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standardize operating procedures and mitigate risk. Our data performance and availability solutions also ensure maximum uptime, availability, and high-performance.

Develop and Support Critical Business Applications. The IT infrastructure of an organization provides the backbone for data and application management. Organizations rely on their IT infrastructure to support the applications and the underlying data that helps them make better decisions in a timely manner. By managing the essential infrastructure of databases, our solutions allow customers to efficiently create, maintain, and enhance applications that meet the rigorous requirements of today s complex and increasingly distributed business environment.

Our design products allow customers to reduce the time between conception and implementation of their enterprise applications.

Our data movement products allow customers to transform and move critical information between disparate systems and platforms.

Our data management products ensure the performance, security, availability, and recoverability of key business applications across many database platforms.

Our performance products allow companies to test and optimize complex application code from an easy-to-use graphical user interface.

Extract Value from Existing Technology. Our cross-platform data management and data performance and availability solutions enable organizations to optimize the use of their existing data, database, and application infrastructure. In the current environment of intense budget scrutiny related to IT spending, our solutions allow customers to realize a quick return on investment. We believe our suite of products, with its multi-vendor support, provides the leading integrated solution for designing, developing, and administering a variety of databases. Our data performance and availability solutions give IT professionals the ability to proactively manage database and system health and allocate resources efficiently. This enables our customers to lower infrastructure costs, reduce systems downtime, and ensure consistent accessibility of data across the enterprise.

Manage Growing Data Assets. The difficulty of managing the explosive growth in data is compounded by the complexity and diversity of the systems and applications that store and access data. Our model driven data solutions help professionals design, manage, and deploy systems in a way that improves the accessibility, accuracy, and relevance of the data so critical to businesses today. Our products help customers understand and leverage enterprise data assets to gain competitive advantage. We enable our customers to create and reuse data and metadata across enterprise systems. This helps them avoid redundancies and reduce costs while facilitating collaboration across their IT organizations.

Facilitate Rapid Adoption. Since our inception, we have strived to make it easy for our customers to discover, try, purchase, and use our products. We design our products to install rapidly with minimal configuration, and our products require limited on-going maintenance. Customers can rapidly implement and utilize our products to design, develop, and manage the data infrastructures that support their critical applications. We believe these factors give our products a competitive advantage relative to most traditional solutions.

Extend Product Leadership. We are continually building upon our current product offerings to enhance and expand these offerings and incorporate new technologies as they are introduced to the market. Additionally, we may enhance our product leadership through the licensing or acquisition of complementary technologies or businesses. Many of our products share a core technology architecture, which we believe provides significant advantages over competing products. This architecture reduces the cost of product development, accelerates the time-to-market for new products, and enables us to maintain a common interface across our product suite.

Our customers number in the thousands, including 97 of the Fortune 100, and span almost all industries including, but not limited to, financial services, consumer goods and services, technology, healthcare, and government. No single customer accounted for ten percent or more of our total revenues in 2004, 2003, or 2002.

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Sales and Marketing

North American Sales. We sell our software in the United States and Canada primarily through a direct sales force comprised of a telesales group and a field sales organization. Our sales model has enabled us to efficiently build a broad customer base. By leveraging the effective use of the telephone and Internet for product evaluations and sales, our telesales approach enables us to respond rapidly to customer needs while maintaining an efficient, low-cost sales model. Our telesales group is complemented by a focused field sales organization that targets major accounts. The field sales organization, including software consultants, comprised of 46 sales people world-wide at the end of 2004, has facilitated further penetration into and better management of large customer accounts and is driving larger sales transactions and enterprise-wide implementations of our products. Sales cycles range between two to three months for departmental sales and up to six to twelve months for larger-scale enterprise-wide implementations. Embarcadero has a renewed focus on channel sales in which we are working more closely with OEM partners, service partners and value-added resellers. As part of this process, we have formalized our partner program and dedicated sales and marketing resources to work with our channel partners.

International Sales. International sales represented 19.8% and 21.1% of our total revenues in 2004 and 2003, respectively, and were generated primarily by Embarcadero Europe Ltd., which manages the sales, marketing, and support of our products in Europe, the Middle East, and Africa. In other overseas markets, we sell our products through independent distributors and through our sales office in Australia. We have agreements with distributors in various countries in Central and Latin America, as well as the Asia Pacific region. Our international distributors perform sales, marketing, and technical support functions for their local customers. We intend to continue to increase our international distribution by expanding direct selling efforts through Embarcadero Europe Ltd. and our existing distributors, as well as by developing relationships with additional international distributors.

For a geographic breakdown of our revenue and long-lived assets, see Note 12 to our Consolidated Financial Statements included in this Annual Report on Form 10-K.

Marketing. Our marketing efforts are focused on driving our core business while helping our new enterprise-scale products gain momentum in their segments. Key activities in 2004 included aggressive lead generation and download campaigns, building relationships with our customers, researching our markets, delivering more comprehensive sales support materials, and enhancing the positioning and brand of our company and products. Other strategic initiatives included putting in place the infrastructure for an expanded channel marketing strategy, as well as for deeper penetration into the government sector. These efforts include executing demand creation programs such as worldwide seminar road shows and telemarketing campaigns. We also established a customer marketing program in order to help us better understand our customers needs, promote new offerings to our install base, and highlight the successes our customers have had with our technology. Other key marketing initiatives include advertising in trade journals, promoting a strong web presence, managing a strategic public relations program, participating in major industry trade shows and user group events, and forging partnerships with other technology companies, most notably, MySQL. We intend to continue our marketing efforts to increase account penetration throughout our existing customer base, extend our customer base in the areas of our new product offerings, and build market share in the data lifecycle management industry.

Customer Service and Technical Support

Most customers purchase a maintenance and support contract upon purchase of a software license. Maintenance and support contracts entitle customers to all product upgrades and technical support during the term of the contract. Our standard maintenance contract covers a 12-month period, is payable in advance, and is renewable at the customer s option.

Technical support is provided for North American customers through our office in San Francisco, California. We offer technical support from 6 a.m. to 6 p.m., Pacific Time, Monday through Friday. For certain Embarcadero products 24x7 Priority Level 1 (P1) telephone assistance is available. We deliver technical support by email, fax, or telephone. All calls and emails are routed on a first come, first serve basis through an integrated queue, with telephone calls given priority. As sales of our products grow and as new products are delivered, we plan to hire more support personnel and expand our support offerings. The timing of such expansion depends upon growth of sales and timing of new product delivery.

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Internationally, our distributors are generally responsible for providing customer service and technical support. Our European subsidiary, Embarcadero Europe Ltd., based in Maidenhead, United Kingdom, provides multilingual support for its customers from 9:00 a.m. to 5:00 p.m., Greenwich Mean Time, Monday through Friday.

Research and Development

During fiscal years 2004, 2003, and 2002, research and development expenses were $15.6 million, $15.6 million, and $14.5 million, respectively. These amounts represented 27.8%, 30.0%, and 29.5%, respectively, of our total revenues in each of those years. Our research and development efforts are focused on enhancing our existing products as well as developing new applications that enable organizations to better manage their corporate data and the systems that support and house that data. Members of our research and development group have extensive experience in databases, database management software, design, performance management, and Internet technologies. We organize our research and development staff into discrete engineering teams responsible for specific products, for both new development and enhancements to existing products, in each of our product segments. These engineering teams work in four development labs located in San Francisco and Monterey, California, Littleton, Colorado, and Toronto, Ontario, Canada. We supplement our internal software development efforts by using outside contractors and/or purchasing technology when we believe that utilizing such outside resources will help us to complete discrete programming tasks more effectively or efficiently than we can accomplish internally.

Our future success depends largely upon our ability to enhance existing products and develop new solutions that reinforce our competitive position and increase our value proposition to customers. We have made and will continue to make substantial financial and organizational investments in research and development. Extensive product development input is obtained through customer feedback, by monitoring evolving user requirements, and by evaluating competing products. Our product management group is responsible for translating customer requirements and market opportunities into product development initiatives. Our engineering teams are in turn responsible for executing on these product development initiatives.

Proprietary Rights

We rely on copyright and trademark laws, trade secrets, confidentiality procedures, and contractual provisions to establish and protect our proprietary rights. We also enter into confidentiality agreements with employees and consultants and attempt to restrict access to proprietary information on a need-to-know basis.

We license our software products primarily under shrink-wrap licenses delivered electronically with the software products. Shrink-wrap licenses are not negotiated with or signed by individual licensees and purport to take effect upon installation of the product. These measures afford only limited protection. Policing unauthorized use of our products is difficult. In addition, the laws of some foreign countries do not protect our proprietary rights as well as United States laws.

We may have to enter into litigation to enforce our intellectual property rights or to determine the validity and scope of the proprietary rights of others with respect to our rights. We are not aware of any case in which we are infringing on the proprietary rights of others.

Competition

The market for our products is highly competitive, dynamic, and subject to rapidly changing technology. We compete primarily against other providers of data and database management, data performance and availability, enterprise data design and modeling, and data movement technologies, which include Computer Associates, Quest Software, BMC Software, IBM/Rational Software, Borland Software Corporation, Informatica Corporation, Ascential Software, and other independent software vendors.

Our database products also compete with products offered by the manufacturers of the database services with which they are compatible, including Oracle, Microsoft, Sybase, MySQL, and IBM. Some of these competing products are provided at no charge to the database customers. We expect that companies such as Oracle, Microsoft, Sybase, and IBM will continue to develop and incorporate into their products applications which compete with our products and may take advantage of their substantial financial, technical, marketing, and distribution resources in those efforts.

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We presently compete on numerous factors, including product functionality and heterogeneity, reliability, ease-of-use, performance, scalability, time-to-market, customer support, and total cost of ownership. We believe that we currently compete favorably overall. However, the market for our products is dynamic and we may not compete successfully in the future with respect to one or more of these factors.

Employees

As of December 31, 2004, we had 283 employees, 115 of whom were engaged in research and development, 114 in sales and marketing, 27 in customer service and support, and 27 in general and administration. Our future performance depends largely on our continuing ability to attract, train and retain highly qualified technical, sales, service, marketing, and managerial personnel. None of our employees is represented by a collective bargaining agreement. We have not experienced any work stoppages and consider our relations with our employees to be good.

Executive Officers

Our executive officers as of March 31, 2005 are shown below

Name	Age	Position
Stephen R. Wong	45	President, Chief Executive Officer and Chairman of the Board
Raj P. Sabhlok	41	Chief Financial Officer and Senior Vice President of Corporate Development
Robert Lamvik	48	Vice President, Sales

Stephen R. Wong is one of our co-founders and has served as the Chairman of our board of directors since July 1993. From July 1993 until October 1999, Mr. Wong served as our Chief Executive Officer and since June 2000, Mr. Wong has served as our President and Chief Executive Officer. From May 1985 to May 1990, Mr. Wong served as an associate, and subsequently as a partner, of Montgomery Medical Ventures, a venture capital firm, where he specialized in technology transfer and early stage investments. Mr. Wong holds an A.B. degree from Harvard College and an M.B.A. degree from the Harvard Business School.

Raj P. Sabhlok has served as our Chief Financial Officer and Senior Vice President of Corporate Development since January 2000. From March 1995 until January 2000, Mr. Sabhlok was employed by BMC Software, Inc., an enterprise software company, where he served as the Director of Business Development from April 1997. From February 1988 until February 1995, Mr. Sabhlok held a number of technical, marketing and sales management positions with The Santa Cruz Operation, Inc., a UNIX software development company. Mr. Sabhlok holds a B.A. degree in Mathematics from the University of California, Santa Cruz and an M.B.A. degree from Duke University.

Robert Lamvik has served as our Vice President of Sales since February 2004. Mr. Lamvik has over twenty-five years of experience in high technology sales leadership. He was formerly vice president of Americas field operations for Sun Microsystems Software Division including iPlanet, Java Enterprise System, and Solaris sales. He has also held management and executive roles at Advanced Micro Devices, the Santa Cruz Operation, and Okidata Corporation. He holds a B.S. degree in mathematical sciences from Oregon State University.

Additional Information

The address of our Internet Web site is www.embarcadero.com. We make available, free of charge through our website, our Annual Reports on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K, Section 16 filings, and other periodic SEC reports, along with amendments to all of those reports, as soon as reasonably practicable after we file the reports with the SEC.

Item 2. Properties

Our headquarters currently occupy approximately 24,300 square feet in San Francisco, California, pursuant to a lease we executed in April 2004, and which expires in June 2009. Ongoing costs associated with our former San Francisco facilities are included in our restructuring reserve, as discussed in Note 6 of the Notes to our Consolidated Financial Statements, included in Item 8 hereof. Our Colorado office occupies approximately 8,600 square feet in Littleton,

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Colorado pursuant to a lease that expires in August 2006. In addition, we maintain a research and development facility of approximately 6,500 square feet in Monterey, California pursuant to a lease that expires in November 2005. We have additional field sales and software development offices in the United States, Canada, the United Kingdom, and Australia.

We believe that our facilities are adequate and that, if required, we would be able to lease additional space to accommodate expansion.

Item 3. Legal Proceedings

In October 2002, The Client Server Factory Inc. filed a claim in the Superior Court for the County of San Francisco alleging causes of action for breach of fiduciary duty for misappropriation and theft of corporate opportunity, fraud, negligent misrepresentation, conspiracy and other similar claims. The claims relate to alleged activities of Wayne Williams, currently our Chief Technology Officer, and an entity in which Mr. Williams previously held an interest, EngineeringPerformance, Inc., prior to November 2000, when we acquired Engineering Performance and Mr. Williams joined the Company. The complaint names as defendants, in addition to Mr. Williams, Stonegate Insurance Company LTD, a company owned by Mr. Williams through which he held his interest in EngineeringPerformance; EngineeringPerformance Inc. and a related company, EngineeringPerformance, LLC; and the Company and Stephen Wong, the Company s President and Chief Executive Officer. Among other things, the complaint alleges that the defendants conspired together to deprive the plaintiff of its proprietary rights to software that the Company acquired from EngineeringPerformance, Inc., which is being used in a product that the Company is currently selling and marketing. The plaintiff is seeking damages of at least $10.0 million plus punitive damages, as well as restitution and disgorgement of certain earnings, profits, compensation and benefits.

In February 2004, Embarcadero, along with Mr. Wong, EngineeringPerformance Inc., and EngineeringPerformance, LLC, filed an amended cross-complaint against The Client Server Factory for fraud, negligent misrepresentation and violation of California s unfair competition law. These claims relate to contracts between Embarcadero and EngineeringPerformance, LLC, and, respectively, Client Server Factory and its then U.S. sales office. The cross-complaint seeks restitution, an unspecified amount of compensatory damages, and punitive damages. In August 2004, Embarcadero, along with Mr. Wong, EngineeringPerformance Inc., and EngineeringPerformance, LLC removed the lawsuit to federal court. In October 2004, the case was remanded back to state court. A trial date has been set for July 5, 2005. While management believes that the defenses to the claims are meritorious and the Company intends to continue to defend itself vigorously, no estimate can be made of the possible loss or possible range of loss associated with the resolution of this contingency and accordingly, the Company has not recorded a liability. As the litigation is uncertain, the Company is unable to predict an outcome at this time. An unfavorable outcome may have a material adverse effect on our financial position, results of operations or cash flows.

In November 2004, two putative class action lawsuits were filed against us and certain of our officers. Each of these lawsuits has been voluntarily dismissed without prejudice. The dismissal of the first lawsuit was filed and approved by the court on February 2, 2005, and the dismissal of the second lawsuit was filed and approved by the court on February 7, 2005.

There are no other known legal proceedings. However, from time to time, we may become a party to other legal proceedings arising in the normal course of our business. We may also be indirectly affected by administrative or court proceedings or actions in which we are not involved but which have general applicability to the software industry. Although occasional adverse opinions or settlements may occur, we believe that the final disposition of such matters will not have a material adverse effect on our financial position, results of operations or cash flows.

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

No matters were submitted to a vote of security holders during the fourth quarter of the year ended December 31, 2004.

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PART II

Item 5. Market for the Registrant s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities

Common Stock Market Price

Our common stock is traded on the NASDAQ National Market under the symbol EMBT. Our common stock began trading on NASDAQ on April 20, 2000, the date of our initial public offering. The following table presents, for the periods indicated, the high and low intra-day sale prices per share of our common stock during the fiscal quarters indicated, as reported on NASDAQ.

Fiscal 2003	High	Low
First Quarter	$ 8.50	$ 4.32
Second Quarter	7.88	5.53
Third Quarter	11.28	6.41
Fourth Quarter	16.62	9.83
Fiscal 2004	**High**	**Low**
First Quarter	$ 16.11	$ 12.01
Second Quarter	14.49	10.63
Third Quarter	12.45	5.79
Fourth Quarter	9.91	7.16

We had approximately 90 stockholders of record as of December 31, 2004. However, we believe there are significantly more beneficial holders of our common stock.

We have never declared or paid any cash dividends on our capital stock. We currently intend to retain future earnings, if any, for development of our business and do not anticipate that we will declare or pay cash dividends on our capital stock in the foreseeable future.

We made no unregistered sales of our securities during the year ended December 31, 2004.

Equity Compensation Plan Information

Plan category	Number of securities to be issued upon exercise of outstanding options,	Weighted average exercise price	Number of securities remaining available for future issuance under

	warrants and rights (a)	of outstanding options, warrants and rights (b)	equity compensation plans (excluding securities reflected in column (a)) (c)
Equity compensation plans approved by security holders	3,917,103	$ 7.12	1,667,124
Equity compensation plans not approved by security holders	443,817(1)	$ 13.63(1)	(1)
Total	4,360,920	$ 6.43	1,667,124

(1) In June 2003, the Board amended the Company s 1993 Stock Option Plan to (a) extend the expiration date from November 1, 2003 to the earlier of November 1, 2004 or the approval by the Company s stockholders of a new plan, (b) give the Company the ability to issue restricted stock under the plan and (c) increase the number of shares authorized for issuance by 1,000,000 shares on each of July 1, 2004, 2005, and 2006, unless the 1993 Stock Option Plan is earlier terminated or superseded by a new plan. These amendments to the 1993 Stock Option Plan were not

approved by the stockholders of the Company. In June 2004, the 2004 Equity Incentive Plan was approved by the Company s stockholders, and the remaining securities available for issuance under this plan were cancelled.

Pursuant to our publicly announced stock repurchase program approved by our Board of Directors in September 2001 and amended as of July 2002, July 2004 and October 2004, we are authorized to repurchase up to an aggregate of 4,230,000 shares of common stock. Under this stock repurchase program, depending on market conditions and other factors, we may make repurchases from time to time in the open market and in negotiated transactions, including block transactions. No purchases of equity securities were effected in the fourth quarter of 2004. As of December 31, 2004, 1,549,000 shares of our common stock remained available for repurchase under our stock repurchase program. This stock repurchase program may be terminated at any time.

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Item 6. Selected Consolidated Financial Data

The following selected condensed consolidated financial data should be read in conjunction with Item 7, Management s Discussion and Analysis of Financial Condition and Results of Operations , and Item 8, Consolidated Financial Statements and Supplementary Data, included in this Annual Report on Form 10-K. The amounts as of and for each of the four years ended in the period December 31, 2003 have been restated. See Note 13 to the Consolidated Financial Statements for further discussion on the impact of the restatement on 2002 and 2003. The restatements for 2000 and 2001 are related to the errors that were identified with respect to the accounting for the impact of foreign currencies and for income taxes described in Note 13. The impact of the restatements on 2000 and 2001 was to decrease net loss by $1.1 million and $816,000, respectively, and decrease net loss per share by $0.04 and $0.03, respectively.

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EMBARCADERO TECHNOLOGIES, INC.

CONDENSED CONSOLIDATED STATEMENT OF OPERATIONS

(In thousands, except per share data)

Year Ended December 31, (in thousands, except per share data)	Year ended December 31, 2004	2003 As restated	2002 As restated	2001 As restated	2000 As restated
Revenues:					
License (includes sales to affiliate of $1,962 in 2000)	$ 28,208	$ 27,151	$ 27,486	$ 32,018	$ 28,558
Maintenance	28,086	24,772	21,811	19,476	12,372
Total revenues	56,294	51,923	49,297	51,494	40,930
Cost of revenues:					
License	999	614	589	774	654
Amortization of acquired technology	2,105	2,223	1,684	808	115
Maintenance	2,362	2,286	2,245	2,228	1,378
Total cost of revenues	5,466	5,123	4,518	3,810	2,147
Gross profit	50,828	46,800	44,779	47,684	38,783
Operating expenses:					
Research and development	15,637	15,600	14,526	14,670	10,257
Purchased research and development			1,100		
Sales and marketing	21,077	18,977	19,317	21,142	16,205
General and administrative	8,777	5,238	5,432	6,572	9,255
Purchased in-process research and development					7,180
Amortization of goodwill and other intangible assets			1,321	5,502	794
Restructuring and impairment charges	4,032		160	1,490	
Total operating expenses	49,523	39,815	41,856	49,376	43,691
Income (loss) from operations	1,305	6,985	2,923	(1,692)	(4,908)
Other income, net	791	423	720	1,176	1,187
Expenses related to proposed public offering				(350)	
Income (loss) before provision for income taxes	2,096	7,408	3,643	(866)	(3,721)
Provision for income taxes	(108)	(2,695)	(906)	(479)	(2,736)
Income (loss) before share in loss of joint venture and affiliated company	1,988	4,713	2,737	(1,345)	(6,457)

Share in loss of joint venture and affiliated company, net			(448)	(579)	(230)
Net income (loss)	1,988	4,713	2,289	(1,924)	(6,687)
Deemed preferred stock dividend					(1,218)
Net income (loss) attributable to common stockholders	$ 1,988	$ 4,713	$ 2,289	$ (1,924)	$ (7,905)
Net income (loss) attributable to common stockholders per share:					
Basic	$ 0.07	$ 0.18	$ 0.08	$ (0.07)	$ (0.32)
Diluted	$ 0.07	$ 0.16	$ 0.08	$ (0.07)	$ (0.32)
Weighted average shares used in per share calculation:					
Basic	26,788	26,618	27,046	27,045	24,973
Diluted	28,502	28,654	28,879	27,045	24,973
Non-cash stock-based compensation included in the above expenses:					
Cost of revenues	$ 16	$	$ 2	$ 12	$ 34
Research and development	595	61	30	128	333
Sales and marketing	849	285	803	1,557	3,509
General and administrative	858	356	1,236	2,658	6,045
	$ 2,318	$ 702	$ 2,071	$ 4,355	$ 9,921

(1) Operating expenses for 2001 and 2000 included goodwill amortization of $ 2,740 and $404, respectively. In accordance with SFAS No. 142, effective January 1, 2002, we ceased amortization of goodwill.

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As of December 31,	2004	2003 As restated	2002 As restated	2001 As restated	(in thousands) 2000 As restated
Consolidated Balance Sheet Data:					
Cash, cash equivalent and short term investments	$ 59,907	$ 57,967	$ 43,763	$ 39,903	$ 34,745
Working capital	49,767	49,764	39,101	33,666	31,449
Total assets	90,123	90,005	78,262	76,157	68,637
Capital lease obligation	409				
Total stockholders equity	67,094	70,737	63,464	61,200	57,260

Item 7. Management s Discussion and Analysis of Financial Condition and Results of Operations

The following discussion and analysis of our financial condition and results of operations should be read in conjunction with our consolidated financial statements and related notes included in this Annual Report on Form 10-K. This report contains forward-looking statements that involve risks and uncertainties. All of these statements are based on information available to us as of the date hereof, and we assume no obligation to update any forward- looking statements. Our actual results could differ materially from those anticipated in the forward-looking statements as a result of certain risk factors including, but not limited to, those discussed under the heading Factors that May Affect Future Results.

Executive Overview

We provide data management solutions that help organizations cost-effectively build, optimize, test, and manage their critical data, database, and application infrastructures. We earn revenues from the world-wide sale of these software solutions and related maintenance and support services to corporations, government agencies, educational institutions, and other entities. IT budgets, as well as macroeconomic conditions, affect demand for our products. In addition, our sales are impacted by competitive conditions, market acceptance of our product offerings, and our execution against sales plans. We have historically derived a significant percentage of our revenues from our DBArtisan product line. This product line is expected to continue to account for a significant portion of our net revenues for the foreseeable future. As a result of this revenue concentration, our business could be harmed by a decline in demand for, or in the prices of, this product line resulting from any change in our pricing model, maturation in the market for this product, increased price competition, or a failure by us to keep up with technological change, among other factors.

We sell our software in the United States and Canada primarily through a direct sales force comprised of a telesales group and a field sales organization. In recent years, the field sales organization has accounted for an increasing portion of overall revenues. The field sales organization targets larger sales transactions and enterprise-wide implementations of our products. We have targeted these sales as part of our strategy to increase our revenues per customer and sell our products deeper onto our customers organizations. The sales cycle for these sales can range from two to twelve months. As a result, it is difficult to predict the period in which larger sales transactions will close and therefore adds additional risk to our quarterly revenue forecasts. We also anticipate continued growth from international sales to meet our revenue projections, although we cannot at this time provide reliable guidance regarding the magnitude of that growth. At the same time, we have experienced significant disruption (e.g. employee turnover and increased expenses) in our European subsidiary related to our 2004 restatement of financial results, which could negatively impact our business in the short-term.

In 2001, 2002, and the first half of 2003, global economic conditions had a negative impact on IT spending and affected sales of our products. However, we saw an improvement in license sales in the second half of 2003 as customers seemed more willing to spend money to bolster their IT infrastructures. Overall, 2004 proved to be a slightly better IT spending environment than the prior year and, coupled with better sales execution in the U.S. market and new product offerings, our total revenues increased to $14.5 million and $56.3 million for the three and twelve months ended December 31, 2004, respectively, as compared to $14.1 million and $51.9 million for the corresponding periods in 2003.

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Most of our operating expenses are related to personnel and related overhead costs, facilities, outside research and development contractors, and legal and other professional service costs. Our operating expenses for the three and twelve months ended December 31, 2004, were $13.4 million and $49.5 million, respectively, as compared to $9.9 million and $39.8 million for the three and twelve months ended December 31, 2003, respectively. We are involved in ongoing litigation and, depending on the activity in a given quarter, our litigation costs can vary materially from period to period.

Our revenues for the three and twelve months ended December 31, 2004 increased, as compared to the same periods in the prior year, by 3.0% and 8.4%, respectively, while operating expenses increased by 36.2% and 24.4%, respectively, for the same comparable periods.

Our cash flow from operations was approximately $12.2 million for the twelve months ended December 31, 2004. Cash, cash equivalents, and short-term investments were $59.9 million at December 31, 2004, which increased as compared to the December 31, 2003 balance of $58.0 million. Our license and maintenance revenues, results of operations, cash flows from operations, and financial condition could be adversely affected in the future by a renewed downturn in global economic conditions, increased competitive pressures and our own inability to execute our sales plans.

Restatements

Our Audit Committee recently completed an internal investigation focused on our revenue recognition practices related to transactions with certain distributors and resellers, principally those of our United Kingdom subsidiary, Embarcadero Europe, which resulted in the restatement of our financial results for the three months ended March 31, 2004 and June 30, 2004, and the six months ended June 30, 2004. Those restated financial statements were filed in Amended Quarterly Reports on Form 10-Q/A on January 18, 2005. The Audit Committee engaged independent legal and accounting experts to assist it in conducting the investigation. The cost of the investigation will be approximately $2.1 million to $2.3 million, of which $1.8 million was recorded in operating expenses in the three month period ended December 31, 2004. Approximately $300,000 to $500,000 of costs related to the investigation will be recorded in the three months ending March 31, 2005. We expect to incur additional costs as we implement the recommendations of our Audit Committee resulting from the investigation.

Our results of operations presented in this Annual Report on Form 10-K also includes restated financial information for fiscal years 2000 through 2003, as well as the quarters ended March 31, 2003 through September 2004, resulting from errors that were identified with respect to the accounting for the impacts of foreign currencies and for income taxes. More information regarding this restatement can be found in Note 13 to our Consolidated Financial Statements included in this Annual Report on Form 10-K. We expect to incur costs of approximately $250,000 to $300,000 in the three months ending March 31, 2005 related to our Restatement for Prior Years.

Critical Accounting Policies and Estimates

The discussion and analysis of our financial condition and results of operations is based upon our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America.

A detailed discussion of our significant accounting policies can be found in Note 1 to our consolidated financial statements. The impacts and risks associated with our accounting policies are discussed throughout this Annual

Report on Form 10-K and in the notes to our Consolidated Financial Statements. Critical accounting policies and estimates are those items that require significant judgment and/or estimates by management at the time that financial statements are prepared such that materially different results might have been reported if other assumptions had been made. Below is further discussion of the items that we consider to be our critical accounting policies and estimates.

Revenue Recognition. Our revenues are principally derived from software license sales and related maintenance and support contracts. Customers that license our software products also generally purchase maintenance and support contracts that provide software updates and technical support over a stated term, usually one year. Revenues from maintenance and support contracts are paid for in advance and are recognized ratably over the contract term. We primarily sell packaged software products that generally do not require us to perform any special installation or integration services.

We recognize revenues in accordance with Statement of Position (SOP) 97-2, Software Revenue Recognition, as amended by SOP 98-4 and SOP 98-9. We recognize revenues when all of the following criteria are met: persuasive evidence of an arrangement exists; delivery of the product has occurred, typically upon shipment, when terms are F.O.B. shipping point; no significant implementation obligations by us remain; the fee is fixed and determinable; and collectibility is probable.

We use a purchase order, a pre-payment via check, wire or credit card, a signed license agreement, or other persuasive evidence as substantiation of an arrangement.

When processing a sales transaction, we assess whether the fee associated with the transaction is fixed and determinable and whether or not collection is probable. We assess whether the fee is fixed and determinable based on the payment terms associated with the transaction. If a significant portion of a fee is due after our normal payment terms, which are typically 30 days from invoice date but in some cases may be 45 or 60 days, we account for the fee as not being fixed and determinable. In these cases, we recognize revenue as the fees become due. We assess collectibility based on a number of factors, including past transaction history with the customer and the credit-worthiness of the customer. We do not request collateral from our customers. If we determine that collection of a fee is not probable, we defer the fee and recognize revenue at the time collection becomes probable, which is generally upon receipt of cash. Most customers are granted payment terms, but some payments are collected via check, wire, or credit card at the time an order is placed.

For arrangements with multiple elements (e.g., undelivered maintenance and support contracts and consulting and training services bundled with licenses), we allocate revenue to the delivered elements of the arrangement using the residual value method. Under the residual value method, the fair value of the undelivered elements is deferred and the remaining portion of the arrangement fee is recognized as revenue. The vendor specific objective evidence of fair value for the ongoing maintenance and support obligations for the licenses is based upon the prices paid for separate renewal of those services by similar customers. Vendor specific objective evidence (VSOE) of fair value for other services, primarily consulting and training services, is based upon separate sales of such services.

Deferred maintenance and support revenue is recognized ratably over the maintenance term, typically one year. Deferred revenue, which consists primarily of maintenance and support services that customers have contracted for in advance but for which revenue has not been recognized, is recognized as services are rendered or as other requirements requiring deferral under SOP 97-2 are satisfied.

Our products are sold under a perpetual license model. Updates and upgrades to our products are made available to customers who have purchased maintenance and support contracts. We do not recognize revenues for refundable fees or agreements with cancellation rights until such rights to refund or cancellation have expired.

Our products may be sold through distributors or resellers in the United States and certain international markets. Revenues from software license fees sold through distributors or resellers are recognized on the sell-through basis. Maintenance revenue sold through distributors and resellers is recognized ratably over the contractual post contract service (PCS) period. Distributors and resellers purchase products to fulfill specific customer orders and generally do not hold inventory of our products. We also enter into arrangements with OEMs that provide for license fees based on inclusion of our products in their products. These arrangements often provide for non-refundable and upfront minimum royalty payments which are recognized as revenue either immediately or on a sell-through basis when due, assuming all other revenue recognition criteria are met. The OEM arrangements usually include maintenance and support contracts. We allocate revenues to the delivered elements of the arrangements using the residual value method based on the VSOE for undelivered items. We intend to continue to expand our international sales activities in an effort to increase revenues from foreign sales.

We sell our software and related maintenance services directly through our telesales and field sales organizations in North America, the United Kingdom and Australia and indirectly through our distribution partners worldwide.

Significant management judgment and estimates must be made in connection with the determination of the revenue to be recognized in any accounting period. If we made different judgments or utilized different estimates for any period, material differences in the amount and timing of revenue recognized could result

Allowance for Doubtful Accounts and Returns.

We establish allowances for doubtful accounts, returns and discounts based on our review of credit profiles of our customers, contractual terms and conditions, current economic trends and historical payment, return and discount experience. We reassess the allowances for doubtful accounts, returns and discounts each period. Historically, our actual losses and credits have been consistent with these provisions. However, unexpected events or significant future changes in trends could result in a material impact to our future statements of operations and of cash flows. If we made different judgments or utilized different estimates for any period, material differences in the amount and timing of revenue or bad debt expense recognized could result. Our allowances for doubtful accounts, returns and discounts as a percentage of net revenues were 0.1%, 0.2% and 0.7% in fiscal years 2004, 2003 and 2002, respectively. See Note 5 to our Consolidated Financial Statements for a summary of activities during the years reported. Based on our results for the year ended December 31, 2004, a one-percentage point deviation in our allowances for doubtful accounts, returns and discounts as a percentage of net revenues would have resulted in an increase or decrease in revenue and/or expense of approximately $563,000.

Capitalized Research and Development Costs. Capitalized research and development costs include certain costs associated with acquiring and developing technology used in our licensed products.

Research and development costs are capitalized in accordance with the provisions of Statement of Financial Accounting Standards (SFAS) No. 86, Accounting for Costs of Computer Software to be Sold, Leased or Otherwise Marketed, which requires capitalization of research and development costs once technological feasibility has been established through such time as the related product is generally available for sale. We consider technological feasibility to have been established when a working model that includes all significant planned features and functionality exists. Accordingly, purchased technology is capitalized if it has reached technological feasibility at the time of acquisition; costs of developed technology are capitalized after technological feasibility is reached.

Costs of purchased and developed technology are capitalized and amortized on a product-by-product basis over their remaining estimated useful lives at the greater of straight-line or the ratio that current gross revenues for a product bear to the total of current and anticipated future gross revenues for that product. Amortization begins when technology is available for sale. Estimated useful lives of capitalized technology are generally three years.

Our capitalized software costs were $1.5 million, net at December 31, 2004. A discussion of our policies related to capitalized software can be found in Note 1 to our Consolidated Financial Statements under the heading Capitalized software development costs and further detail can be found in Note 5 to our Consolidated Financial Statements.

Lease Related Impairment Loss. As discussed in Note 6 to our Consolidated Financial Statements, in 2001 we recorded a restructuring charge in connection with our abandonment of certain operating leases as part of a program to restructure our operations and related facilities. Lease abandonment costs were estimated to include the impairment of leasehold improvements, remaining net present value of the Company s future contractual lease obligations, net of any sublease income and brokerage fees. In 2002, based on changes in the commercial real estate market in San Francisco, we recorded an additional impairment charges to cover lower than estimated sublease

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income. Further, in 2004, we recorded a second restructuring and impairment charge of $4.0 million related to the consolidation of our office leases in San Francisco. The restructuring charge is primarily based on the net present value of the Company s future contractual lease obligations net of any sublease income and any incidental expenses related to restructuring. Estimates related to sublease costs and income are based on assumptions about the time period required to locate and contract with suitable sub-lessees as well as the sublease rates that can be achieved, as determined by market trend information analyses provided by a commercial real estate brokerage we retained. We will continue to review these estimates each reporting period. To the extent that these assumptions change due to unfavorable market conditions, the ultimate restructuring expenses for these abandoned facilities could increase.

Accounting for Income Taxes. In conjunction with preparing our consolidated financial statements, we must estimate our income taxes in each of the jurisdictions in which we operate. This process involves estimating our actual current tax expense as well as assessing temporary differences resulting from differing treatment of items, such as depreciation and amortization, for financial reporting and tax reporting purposes. These differences result in deferred tax assets and liabilities, which are included in our consolidated balance sheet. We must then assess the likelihood that our deferred tax assets will be recovered from future taxable income and to the extent we believe that recovery is not likely, we must establish a valuation allowance against our U.S. net deferred tax assets. To the extent we establish a valuation allowance or increase this allowance in a given period, we must increase the tax provision in the statement of operations.

Significant management judgment is required in determining our provision for income taxes, our deferred tax assets and liabilities, and any valuation allowance recorded against our net deferred tax assets. At December 31, 2004, we had gross deferred tax assets of $5.5 million. Due to uncertainties related to our ability to utilize some of our deferred tax assets, consisting of Colorado net operating loss carry forwards, we established a valuation allowance of approximately $15,000. The valuation allowance is based on our estimates of current and future taxable income by jurisdiction in which we operate and the period over which our deferred tax assets will be recoverable. In the event that actual results differ from these estimates or we adjust these estimates in future periods, we may need to establish an additional valuation allowance which could materially impact our financial position and results of operations. A detailed discussion of our income tax provision and the components of our deferred tax assets and liabilities can be found in Note 7 to our Consolidated Financial Statements.

Accounting for Deferred Stock-Based Compensation. Our stock-based employee compensation plans are described more fully in Note 10 to our Consolidated Financial Statements. We account for those plans under the recognition and measurement principles of Accounting Principles Board (APB) Opinion No. 25 and related interpretations. Deferred stock-based compensation cost is reflected in net income (loss), as some options and stock awards granted under those plans had an exercise price less than the fair value of the underlying common stock on the date of grant, which is described more fully in Note 10 to our Consolidated Financial Statements.

We amortize stock-based compensation using the multiple option method over the remaining vesting periods of the related options and stock awards, which are generally four years. Pro forma information regarding net income (loss) and earnings per share is required in order to show our net income (loss) as if we had accounted for employee stock options and awards under the fair value method of SFAS No. 123, as amended by SFAS No. 148, and is contained in Note 1 to our consolidated financial statements.

The fair value of options and stock awards issued pursuant to the option plans at the grant date were estimated using the Black-Scholes model. The Black-Scholes option-pricing model was developed for use in estimating the fair value of traded options that have no vesting restrictions and are fully transferable. In addition, option-pricing models require the input of highly subjective assumptions including the expected stock price volatility. We use projected volatility rates, which are based upon historical volatility rates trended into future years. Because our employee stock options have characteristics significantly different from those of traded options, and because changes in the subjective input assumptions can materially affect the fair value estimate, in management s opinion, the existing models do not necessarily provide a reliable single measure of the fair value of our options.

The effects of applying pro forma disclosures of net income (loss) and earnings per share are not likely to be representative of the pro forma effects on net income (loss) and earnings per share in the future years for the

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following reasons: 1) the number of future shares to be issued under these plans is not known and 2) the assumptions used to determine the fair value can vary significantly.

In December 2004, FASB issued Statement of Financial Accounting Standards (SFAS) No. 123(R), *Share-Based Payment*. The new pronouncement replaces the existing requirements under SFAS No.123 and APB 25. According to SFAS No. 123 (R), all forms of share-based payments to employees, including employee stock options and employee stock purchase plans, would be treated the same as any other form of compensation by recognizing the related cost in the Statement of Operations. This pronouncement eliminates the ability to account for stock-based compensation transactions using APB No. 25 and generally would require instead that such transactions be accounted for using a fair-value based method. FASB concluded that for public companies SFAS No. 123 (R) is effective for awards and stock options granted, modified or settled in cash in annual periods beginning after June 15, 2005. SFAS No. 123 (R) provides transition alternatives for public companies to restate prior interim periods or prior years. The Company expects the adoption of SFAS 123 (R) will have a material adverse impact on our net income and net income per share. The Company is currently in the process of evaluating the extent of such impact.

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RESULTS OF OPERATIONS

The following condensed table sets forth, for the periods indicated, the percentage relationship of certain items from our consolidated statements of operations to total revenues:

Year Ended December 31,	2004	2003 As restated (see Note 13)	2002 As restated (see Note 13)
Revenues:			
License	50.1%	52.3%	55.8%
Maintenance	49.9	47.7	44.2
Total revenues	100.0	100.0	100.0
Cost of revenues:			
License	1.8	1.2	1.2
Amortization of acquired technology	3.7	4.3	3.4
Maintenance	4.2	4.4	4.6
Total cost of revenues	9.7	9.9	9.2
Gross profit	90.3	90.1	90.8
Operating expenses:			
Research and development	27.8	30.0	29.5
Purchased research and development			2.2
Sales and marketing	37.4	36.5	39.2
General and administrative	15.6	10.1	11.0
Amortization of goodwill and other intangible assets			2.7
Restructuring and impairment charges	7.2		0.3
Total operating expenses	88.0	76.6	84.9
Income from operations	2.3	13.5	5.9
Other income, net	1.4	0.8	1.4
Income before provision for income taxes	3.7	14.3	7.3
Provision for income taxes	(0.2)	(5.2)	(1.8)
Income before share in loss of joint venture	3.5	9.1	5.5
Share in loss of joint venture, net			(0.9)
Net income	3.5%	9.1%	4.6%

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Years Ended December 31, 2004, 2003, and 2002

Revenues

Total revenues and year over year changes are as follows (in thousands, except for percentages):

Year ended December 31,	2004	2003	Change Amount	Change Percent	2002	Change Amount	Change Percent
Revenues:							
License	$ 28,208	$ 27,151	$ 1,057	3.9%	$ 27,486	$ (335)	(1.2)%
Maintenance	28,086	24,772	3,314	13.4	21,811	2,961	13.6
Total revenues	$ 56,294	$ 51,923	$ 4,371	8.4%	$ 49,297	$ 2,626	5.3%

Total Revenues. Total revenues increased 8.4% for fiscal year 2004 compared to fiscal year 2003, primarily due to a general increase in information technology spending and better sales execution in North America. Total revenues increased from 2002 to 2003 and is attributable to the growth in maintenance revenue related to the growth in our installed base.

License. License revenue increased 3.9% in 2004 compared to 2003. The increase was primarily due to a generally better information technology spending environment and increased license revenue generated in our North American region. See Note 12 to our Consolidated Financial Statements for further detail on total revenue by region. License revenue decreased 1.2% in 2003 compared to 2002, largely due to the global economic slowdown during that period and resulting reduction in information technology spending. We expect that license revenues will remain relatively constant as a percentage of total revenue in 2005.

Maintenance. Maintenance revenue increased 13.4% in 2004 compared to 2003, primarily due to the increase in the cumulative number of licenses sold, a growing installed base, and constant maintenance renewals. Maintenance revenue increased 13.6% in 2003 compared to 2002, primarily as a result of additional maintenance revenue related to the growth in our installed base. We expect that maintenance revenue will remain relatively constant as a percentage of total revenue in 2005.

Cost of Revenues

Total Cost of Revenues. Total cost of revenues and year over year changes are as follows (in thousands, except percentages):

	Change		Change

Year ended December 31,	2004	2003	Amount	Percent	2002	Amount	Percent
Cost of revenues:							
License	$ 999	$ 614	$ 385	62.7%	$ 589	$ 25	4.2%
Amortization of acquired technology	2,105	2,223	(118)	(5.3)	1,684	539	32.0
Maintenance	2,362	2,286	76	3.3	2,245	41	1.8
Total cost of revenues	$ 5,466	$ 5,123	$ 343	6.7%	$ 4,518	$ 605	13.4%

License. Cost of license revenues consists primarily of amortization of capitalized research and development expenses, royalties, credit card merchant fees, product media and packaging and shipping. Cost of license revenues were $1.0 million, $614,000, and $589,000 for 2004, 2003 and 2002, respectively. The absolute dollar and percentage of total revenues increased from 2003 to 2004 were primarily due to an increase of approximately $300,000 in amortization expense related to capitalized research and development expenses, and an increase of approximately $135,000 for royalties, offset by a decrease of approximately $17,000 related to lower product media and packaging costs. Amortization expense for capitalized research and development costs is expected to be approximately $540,000 in 2005. The absolute dollar increase from 2002 to 2003 was due primarily to a $61,000 increase in amortization expense related to capitalized research and development expenses for a product that came to market in 2003. This increase was partially offset by a $28,000 reduction in product media and packaging.

Amortization of acquired technology. Amortization of acquired technology expense was $2.1 million, $2.2 million and $1.7 million in 2004, 2003, and 2002, respectively. The expense is primarily related to technology acquired in

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the acquisition of Advanced Software Technologies, Inc. in 2000 and additional technology acquisitions in 2001 and 2002. The increase from 2002 to 2003 was due to a full year of amortization for the technology put into service in 2002. The decrease in 2004 was due to the completion of amortization in the fourth quarter of 2004. We expect there to be no amortization of acquired technology expense in 2005.

Maintenance. Cost of maintenance revenues consists primarily of customer support personnel and related expenses, including payroll, employee benefits, and allocated overhead. The decrease in cost of maintenance as a percentage of revenues from 2002 to 2003 to 2004 was due primarily to the increase in maintenance revenues from period to period while the number of related personnel remained flat, allowing us to realize economies of scale through increased utilization of our customer support personnel. We expect to hire more support personnel to support our expanding product line and customer base. When we hire such personnel, we expect cost of maintenance revenues to increase in absolute dollars and potentially to increase as a percentage of maintenance revenues if the additional personnel are hired in advance of an increase in the related revenues.

Operating Expenses

Total Operating Expense. Total operating expenses were $49.5 million, $39.8 million, and $41.9 million for 2004, 2003, and 2002, respectively, representing an increase of 24.4% from 2003 to 2004 and a decrease of 4.9% from 2002 to 2003.

			Change			**Change**	
Year ended December 31,	**2004**	**2003**	**Amount**	**Percent**	**2002**	**Amount**	**Percent**
Operating expenses:							
Research and development	$ 15,637	$ 15,600	$ 37	0.2%	$ 14,526	$ 1,074	7.4%
Purchased research and development					$ 1,100	$ (1,100)	(100.0)
Sales and marketing	21,077	18,977	2,100	11.1	19,317	(340)	(1.8)
General and administrative	8,777	5,238	3,539	67.6	5,432	(194)	(3.6)
Amortization of other intangible assets					1,321	(1,321)	(100.0)
Restructuring and impairment charges	4,032		4,032		160	(160)	(100.0)
Total operating expenses	$ 49,523	$ 39,815	$ 9,708	24.4%	$ 41,856	$ (2,041)	(4.9)%

Research and Development. Research and development expenses consist primarily of personnel and related expenses, including payroll, employee benefits, allocated overhead, and non-cash stock-based compensation, as well as expenses related to outside software development contractors. Domestic costs decreased $320,000 due to lower headcount and a reduced overhead expense allocation based on our restructuring in Q2 2004. Canadian development lab costs increased $369,000 due to increased operating costs including an unfavorable currency exchange cost of $135,000. We anticipate that we will continue to invest significant resources into research and development activities in order to develop new product and advance the technology of our existing products. We expect to continue to benefit from cost efficiencies related to expanding the research and development activities of our Canadian subsidiary. The absolute dollar increase from 2002 to 2003 was primarily due to an increase of $750,000 related to increased headcount in our Canadian development lab, which led to higher personnel expenses, overhead costs, bonus payments, as well as an unfavorable currency exchange rate impact of $295,000. There was also an increase of approximately $60,000 in recruiting fees and approximately $50,000 in increased software maintenance expense. We believe that continued investment in research and development is critical to attaining our strategic objectives and, as such, we expect that spending on research and development in 2005 will be consistent in absolute dollars with 2004.

Purchased Research and Development. Purchased research and development consists of technology purchased from third parties. From time to time, we may purchase technology to supplement our research and development efforts and to leverage the resources available to us. Such purchases are for the rights, titles, and interest in the technology. If we determine that the purchased software has not reached technological feasibility, we expense the cost of the technology in the year of the purchase (see Capitalized software development costs in Note 1 to our Consolidated Financial Statements for a discussion of when purchased technology is expensed versus capitalized).

In 2002, we spent $1.1 million to purchase technology that had not reached technological feasibility. The technology was subsequently integrated into our products in 2002, and there are no related contractual obligations for future purchases of technology. No comparable expense was incurred in 2004 or 2003. We may choose to purchase additional technology in the future based on our development needs and our decisions to internally build technology versus purchase technology from third parties. Our past purchases and integration of research and development did not create a material strain on our financial or personnel resources. However, if we choose to purchase additional research and development in the future, such purchases may have a material effect on our financial and/or personnel resources.

Sales and Marketing. Sales and marketing expenses consist primarily of personnel and related expenses, commissions earned by sales personnel, non-cash stock-based compensation, trade shows, travel, and other marketing communication costs, such as advertising and other marketing programs. The increase in absolute dollars from 2003 to 2004 was primarily due to a $1.2 million increase in wages and related costs, including $564,000 increase in non-cash stock based compensation. International sales and marketing costs attributable to the UK and Australia increased $990,000 due to increased headcount and unfavorable currency exchange rates.

Excluding stock-based compensation, the absolute dollar increase from 2002 to 2003 was primarily due to a $238,000 increase in expense in our European subsidiary as a result of an increase in the average exchange rate for the Pound Sterling. In 2003, we reduced marketing expenses, both personnel related and discretionary marketing expenses, which was offset by higher personnel related expenses for sales resulting primarily from increased wages and commissions. We intend to selectively increase staff in our sales organization and to create select marketing programs and, accordingly, expect that sales and marketing expenditures will increase in absolute dollars in 2005.

General and Administrative. General and administrative expenses consist primarily of salaries and related personnel expenses, general operating expenses, and non-cash stock-based compensation. The increase in absolute dollars from 2003 to 2004 was primarily due to $1.8 million related to the costs of the Audit Committee investigation that led to a restatement of our financial results for the three months ended March 31, 2004 and the three and six months ended June 30, 2004, an increase in non-cash stock based compensation of approximately $500,000, a $500,000 increase in litigation expense, and $250,000 in professional services related to Sarbanes-Oxley compliance requirements. International general and administrative expenses increased by $385,000 related to professional services fees for accounting, tax services, and personnel recruitment. Excluding stock-based compensation, the absolute dollar increase from 2002 to 2003 was due to a $715,000 increase in legal fees primarily attributable to the legal matter discussed in Item 3. Legal Proceedings, a $213,000 increase in personnel related expenses, and a $132,000 increase in professional service and insurance expenses, partially offset by a $219,000 decrease in expenses for our European subsidiary, primarily due to lower personnel related costs, and a $228,000 decrease in bad debt expense.

We anticipate that general and administrative expenses will increase in the near future, as we continue to incur costs to comply with the additional rules and regulations promulgated by the Sarbanes-Oxley Act, the Securities and Exchange Commission, and the NASDAQ National Market. These increased costs will include the hiring of additional personnel, as well as costs associated with outside legal counsel, accounting and advisory services. Further, we expect to incur additional costs as we continue to implement the recommendations of our Audit Committee resulting from the investigations related to our recent financial restatements. We are also involved in ongoing litigation and, depending on the activity in a given quarter, our litigation costs can vary materially from period to period. In addition, we expect to incur additional costs of approximately $300,000 to $500,000 related to the Audit Committee investigation and approximately $250,000 to $300,000 in the three months ending March 31, 2005 related to our Restatement of Prior Years. See Note 13.

Amortization of Other Intangible Assets. In connection with the acquisitions of Advanced Software Technologies, Inc., EngineeringPerformance, Inc., and the remaining 56% of Embarcadero Europe Ltd., we recorded $21.4 million of goodwill and other intangible assets in the fourth quarter of 2000. Relating to non-technology intangible assets acquired, we recorded $1.3 million of amortization expense in 2002 as an operating expense. These assets were fully amortized as of December 31, 2002. We ceased amortization of goodwill when we adopted Statement of Financial Accounting Standards (SFAS) No. 142 effective January 1, 2002 (see Goodwill in Note 1 to our Consolidated Financial Statements). We performed our annual goodwill impairment test on September 1, 2004. The results of the analysis showed that goodwill was not impaired. Going forward, we will test our goodwill for impairment on an annual basis or in the event of a significant change in our business. If, in the future, we determine that this goodwill

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is impaired, we will be required to take a charge at the date of impairment to write down this asset. The dollar amount of such potential future charge, if any, cannot currently be estimated.

Restructuring and impairment charges. In 2001, we recorded an impairment loss of $1.5 million related to office leases in San Francisco and Boston when we decided to abandon and sublease these office spaces in order to streamline operations. The impairment loss consists of approximately $1.0 million in contractual obligations under the facilities leases, net of estimated sublease income from the projected date of abandonment to the end of the lease term. The remaining $500,000 consists of write-downs to leasehold improvements and other assets attributable to the abandoned space, as well as other expenses related to securing the sublease arrangements. When we recorded the lease related impairment loss, we made estimates about sublease costs and income. In 2002, based on changes in the commercial real estate market in San Francisco, we recorded an additional $160,000 in impairment loss to cover lower than expected sublease income. At December 31, 2003, we had a balance of $413,000 in accrued restructuring costs for future facilities lease charges. In April 2004, we entered into a non-cancelable five-year operating lease agreement for our headquarters in San Francisco, California. The objectives of entering into this new lease agreement were to consolidate our two offices in San Francisco, eliminate excess office space within San Francisco and improve our operating efficiencies. In conjunction with the execution of the new lease, we subleased our other San Francisco long-term lease contract. The sublease agreements co-terminate along with the master lease to which they are subject in July 2008. As a result, we recorded restructuring and impairment charges of $4.0 million during the year ended December 31, 2004. The charges were comprised of three elements: the net present value of approximately $2.8 million relating to the future contractual lease obligation, an impairment loss of approximately $680,000 relating to abandoned leasehold improvements; and approximately $566,000 related to other contractual restructuring expenses, including tenant improvement allowances and brokerage and legal fees. If our subtenants were to stop paying the sublease income, we could be required to record another restructuring charge. The amount of that charge cannot be estimated at this time.

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

	Facility Leases, Net of Sublease Income	Write Down of Leasehold Improvements	Other Restructuring Expenses	Total
Initial loss	$ 1,043	$ 343	$ 104	$ 1,490
Charged to accrual	160			160
Non-cash expenses	(408)	(343)	$ (104)	(855)
Accrual as of December 31, 2002	$ 795	$	$	$ 795
Net cash payments	(382)		$	(382)
Accrual as of December 31, 2003	$ 413	$	$	$ 413
Restructuring and impairment charges during the three months ended June 30, 2004	2,822	680	566	4,068
Non-cash reductions of accrual		(680)	(36)	(716)
Net cash payments during the year ended December 31, 2004	(807)		(499)	(1,306)