CHORDIANT SOFTWARE INC
Form 10-Q
April 29, 2005
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

for the quarterly period ended December 31, 2004

OR

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

For the transition period from ______ to ______

Commission File Number 000-29357

Chordiant Software, Inc.

(Exact name of Registrant as specified in its Charter)

Delaware	**93-1051328**
(State or Other Jurisdiction of Incorporation or Organization)	**(I.R.S. Employer Identification Number)**

20400 Stevens Creek Boulevard, Suite 400

Cupertino, CA 95014

(Address of Principal Executive Offices including Zip Code)

(408) 517-6100

(Registrant s Telephone Number, Including Area Code)

(Former name, former address and former fiscal year if changed since last report)

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

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

The number of shares of the Registrant s common stock outstanding as of March 31, 2005 was 77,008,337.

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CHORDIANT SOFTWARE, INC.

QUARTERLY REPORT ON FORM 10-Q FOR THE PERIOD ENDED DECEMBER 31, 2004

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PART I FINANCIAL INFORMATION

Item 1. Financial Statements (unaudited)

CHORDIANT SOFTWARE, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS

(In thousands, unaudited)

	December 31, 2004	September 30, 2004
		(Restated)
ASSETS		
Current assets:		
Cash and cash equivalents	$ 47,287	$ 55,748
Marketable securities	4,000	4,000
Restricted cash	1,780	279
Accounts receivable, net	17,928	20,161
Prepaid expenses and other current assets	3,841	3,097
Total current assets	74,836	83,285
Restricted cash	558	2,057
Property and equipment, net	3,172	3,237
Goodwill	32,028	24,874
Intangible assets, net	6,178	244
Other assets	2,419	1,643
Total assets	$ 119,191	$ 115,340
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 6,656	$ 6,394
Accrued expenses	13,981	11,681
Deferred revenue	18,582	18,459
Current portion of capital lease obligations	201	191
Total current liabilities	39,420	36,725
Deferred revenue, long-term	1,622	2,122
Long term portion of capital lease obligations	257	317
Total liabilities	41,299	39,164
Stockholders equity:		
Common stock	77	72
Additional paid-in capital	271,890	262,703
Deferred stock-based compensation	(4,391)	(339)

Accumulated deficit	(193,411)	(189,349)
Accumulated other comprehensive income	3,727	3,089
Total stockholders equity	77,892	76,176
Total liabilities and stockholders equity	$ 119,191	$ 115,340

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

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CHORDIANT SOFTWARE, INC.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE LOSS

(In thousands, except per share data, unaudited)

	Three Months Ended	
	December 31, 2004	December 31, 2003
Revenues:		
License	$ 8,842	$ 9,248
Service	12,835	10,352
Total revenues	21,677	19,600
Cost of revenues:		
License	166	574
Service	7,503	6,237
Stock based compensation	(56)	676
Amortization of intangible assets	131	794
Total cost of revenues	7,744	8,281
Gross profit	13,933	11,319
Operating expenses:		
Sales and marketing	7,215	5,695
Research and development	4,865	4,176
General and administrative	3,912	1,291
Stock based compensation	(105)	2,671
Amortization of intangible assets	24	96
Purchased in-process research and development	1,940	
Restructuring expense	(123)	1,028
Total operating expenses	17,728	14,957
Loss from operations	(3,795)	(3,638)
Interest income, net	210	17
Other income (expense), net	(397)	141
Net loss before income taxes	(3,982)	(3,480)
Provision for income taxes	80	457
Net loss	$ (4,062)	$ (3,937)
Other comprehensive income:		
Foreign currency translation gain	638	1,135
Comprehensive loss	$ (3,424)	$ (2,802)

Net loss per share basic and diluted	$ (0.06)	$ (0.06)
Weighted average shares used in computing basic and diluted loss per share	72,223	61,560

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

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CHORDIANT SOFTWARE, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands, unaudited)

	Three Months Ended	
	December 31, 2004	**December 31, 2003**
Cash flows from operating activities:		
Net loss	$ (4,062)	$ (3,937)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:		
Depreciation and amortization	372	539
Amortization of intangibles	155	890
Purchased in-process research and development	1,940	
Non-cash stock-based compensation expense	(161)	3,149
Provision for doubtful accounts	79	
Warrants issued to customers	(15)	95
Loss on disposal of assets		11
Other non-cash charges	105	
Changes in assets and liabilities net of effect of acquisitions:		
Accounts receivable	2,983	1,091
Prepaid expenses and other current assets	(637)	502
Other assets	(736)	139
Accounts payable	(2,094)	938
Accrued expenses	1,755	1,366
Deferred revenue	(1,487)	(1,215)
Other liabilities		(90)
Net cash provided by (used in) operating activities	(1,803)	3,478
Cash flows from investing activities:		
Property and equipment purchases, net	(196)	(173)
Proceeds from release of restricted cash	(3)	
Cash used for acquisitions, net of cash acquired	(7,869)	
Net cash used for investing activities	(8,068)	(173)
Cash flows from financing activities:		
Proceeds from exercise of stock options	135	617
Payment on capital leases	(50)	
Collection of notes receivable		400
Repayment of borrowings		(2,131)
Net cash provided by (used in) financing activities	85	(1,114)
Effect of exchange rate changes	1,325	1,933
Net increase (decrease) in cash and cash equivalents	(8,461)	4,124
Cash and cash equivalents at beginning of period	55,748	32,094

Cash and cash equivalents at end of period	$ 47,287	$ 36,218

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

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CHORDIANT SOFTWARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(UNAUDITED)

NOTE 1 BASIS OF PRESENTATION

The accompanying unaudited condensed consolidated financial statements reflect all adjustments, consisting of only normal recurring adjustments, which in the opinion of management, are necessary to state fairly the financial position, results of operations and cash flows for the interim periods presented. The results of operations for interim periods are not necessarily indicative of the results expected for the full fiscal year or for any future period. These unaudited condensed financial statements should be read in conjunction with the audited consolidated financial statements and related notes included in our Transition Report on Form 10-K/T for the nine months ended September 30, 2004 filed with the Securities and Exchange Commission (SEC) on March 29, 2005 (2004 Form 10-K).

Change in year end

On December 29, 2004, Chordiant Software s Board of Directors approved a change in the Company s fiscal year end from December 31 to September 30. The three months ended December 31, 2004 reported by the Company in this Quarterly Report on Form 10-Q relate to the fiscal year ending September 30, 2005.

Restatement

The financial information as of September 30, 2004 is labeled restated as it has been revised from the amounts previously filed with the SEC. The restatement is further discussed in Note 2 and Note 18 of the Consolidated Financial Statements in our 2004 Form 10-K.

NOTE 2 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Reclassifications

Certain reclassifications have been made to prior year balances to conform to the current year presentation.

Principles of consolidation

The accompanying unaudited condensed consolidated financial statements include our accounts and the accounts of our wholly-owned subsidiaries. All significant intercompany transactions and balances have been eliminated in consolidation.

Use of estimates

The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires us to make estimates and assumptions that affect the reported amounts of assets and liabilities, disclosures of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting periods.

On an on-going basis, we evaluate the estimates, including those related to our allowance for doubtful accounts, valuation of goodwill and intangible assets, valuation of deferred tax assets, restructuring costs, contingencies and the estimates associated with the percentage-of-completion method of accounting for certain of our revenue contracts. We base our estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions.

Revenue recognition

We derive revenues from licenses of our software and related services, which include assistance in implementation, customization and integration, post-contract customer support, training and consulting. The amount and timing of our revenue is difficult to predict and any shortfall in revenue or delay in recognizing revenue could cause our operating results to vary significantly from quarter to quarter and could result in operating losses.

At the time of entering into a transaction, we assess whether any services included within the arrangement require us to

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perform significant implementation or customization essential to the functionality of our products. For contracts involving significant implementation or customization essential to the functionality of our products, we recognize the license and professional consulting services revenues using the percentage-of-completion method using labor hours incurred as the measure of progress towards completion as prescribed by Statement of Position (SOP) No. 81-1, Accounting for Performance of Construction-Type and Certain Product-Type Contracts. The progress toward completion is measured based on the go-live date. We define the go-live date as the date the essential product functionality has been delivered or the application enters into a production environment or the point at which no significant additional Chordiant supplied professional services resources are required. Estimates are updated when new information becomes available. We account for the change in estimate when the information becomes known in the period the change was identified. Provisions for estimated contract losses are recognized in the period in which the loss becomes probable and can be reasonably estimated. When we sell additional licenses related to the original licensing agreement, revenue is recognized either upon delivery if the project has reached the go-live date, or if the project has not reached the go-live date, revenue is recognized under the percentage-of-completion method. We classify revenues from these arrangements as license and service revenues based upon the estimated fair value of each element.

On contracts for products not involving significant implementation or customization essential to the product functionality, we recognize license revenues when there is persuasive evidence of an arrangement, the fee is fixed or determinable, collection of the fee is probable and delivery has occurred as prescribed by SOP No. 97-2, Software Revenue Recognition, as amended.

We assess collectibility based on a number of factors, including past transaction history with the customer and the credit-worthiness of the customer. We generally 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.

For arrangements with multiple elements, we recognize revenue for services and post-contract customer support based upon vendor specific objective evidence (VSOE) of fair value of the respective elements. VSOE of fair value for the services element is based upon the standard hourly rates we charge for the services when such services are sold separately. VSOE of fair value for annual post-contract customer support is established with the optional substantive stated future renewal rates included in the contracts. When contracts contain multiple elements, and VSOE of fair value exists for all undelivered elements, we account for the delivered elements, principally the license portion, based upon the residual method as prescribed by SOP No. 98-9, Modification of SOP No. 97-2 with Respect to Certain Transactions.

In situations in which we are obligated to provide unspecified additional software products in the future, we recognize revenue as a subscription ratably over the term of the commitment period.

For all sales we use either a signed license agreement or a binding purchase order as evidence of an arrangement. Sales through our third party systems integrators are evidenced by a master agreement governing the relationship together with binding purchase orders on a transaction-by-transaction basis. Revenues from reseller arrangements are recognized on the sell-through method, when the reseller reports to us the sale of our software products to end-users. Our agreements with customers and resellers do not contain product return rights.

We recognize revenue for post-contract customer support ratably over the support period which ranges from one to three years. Our training and consulting services revenues are recognized as such services are performed.

Restricted cash

At December 31, 2004 and September 30, 2004, we had interest bearing certificates of deposit aggregating $0.6 million classified as long-term restricted cash and $0.3 million classified as short-term restricted cash. These balances primarily relate to funds pledged as collateral for letters of credit against certain lease obligations. As of December 31, 2004 and September 30, 2004, we also had a balance of $1.5 million in the form of cash equivalents which is restricted from withdrawal. This balance serves as a security deposit in a long-term, post-contract customer support revenue transaction expiring on December 31, 2005 and accordingly, it has been reclassified from non-current to current assets as of December 31, 2004.

Stock-based compensation

We account for stock-based employee compensation arrangements in accordance with provisions of Accounting Principles Board Opinion (APB) No. 25, Accounting for Stock Issued to Employees, FASB Interpretation No. 44 (FIN 44),

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Accounting for Certain Transactions Involving Stock Based Compensation an Interpretation of APB No. 25, and related interpretations and comply with the disclosure provisions of SFAS No. 123, Accounting for Stock-Based Compensation. Under APB No. 25 and FIN 44, compensation expense is based on the difference, if any, on the date of the grant, between the fair value of our stock and the exercise price of the stock option being granted. Stock-based compensation is amortized in accordance with FIN 28 using the multiple option approach. SFAS No. 123 defines a fair value based method of accounting for an employee stock option or similar equity instrument.

We account for equity instruments issued to non-employees in accordance with the provisions of SFAS No. 123 and EITF Issue No. 96-18, Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling Goods or Services.

We have adopted the disclosure requirements of Statement of Financial Accounting Standards (SFAS) No. 148, Accounting for Stock-Based Compensation Transition and Disclosure during the quarter ended March 31, 2003. SFAS No. 148 amends SFAS No. 123 to provide alternative methods of transition for a voluntary change to the fair value based method of accounting for stock-based compensation and also amends the disclosure requirements of SFAS 123 to require prominent disclosures in both annual and interim financial statements about the methods of accounting for stock-based employee compensation and the effect of the method used on reported results. As permitted by SFAS 148 and SFAS 123, we continue to apply the accounting provisions of APB No. 25. We generally grant stock options at exercise prices equal to the fair market value of the underlying stock on the date of grant and, therefore, under APB No. 25, no compensation expense is recognized in the statements of operations. Had we recorded compensation expense based on the estimated grant date fair value, as defined by SFAS No. 123, for awards granted under our stock option plans and stock purchase plan, our net loss and loss per share would have been increased to the pro forma amounts below (in thousands, except per share amounts):

	Three Months Ended	
	December 31, 2004	December 31, 2003
Net loss as reported	$ (4,062)	$ (3,937)
Add: Stock-based compensation expense (benefit) included in reported net loss	(161)	3,149
Less: Stock-based compensation expense determined under fair value method	1,299	2,121
Net loss pro forma	$ (5,522)	$ (2,909)
Basic and diluted net loss per share as reported	$ (0.06)	$ (0.06)
Basic and diluted net loss per share pro forma	$ (0.08)	$ (0.05)

Under SFAS No. 123, the fair value of each option grant is estimated on the grant date using the following weighted average assumptions:

	Three Months Ended	
	December 31, 2004	December 31, 2003

Expected lives in years		
Stock options	2.4	3.1
Employee stock purchase plan	N/A	N/A
Risk free interest rates		
Stock options	2.9%	2.3%
Employee stock purchase plan	N/A	N/A
Volatility		
Stock options	88%	100%
Employee stock purchase plan	N/A	N/A
Dividend yield	0%	0%

The weighted average fair value of options granted during the three months ended December 31, 2004 and 2003 was $1.16 and $2.51, respectively.

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Because the determination of the fair value of all options granted after we became a public entity includes an expected volatility factor in addition to the other factors described in the table above and because additional option grants are expected to be made each year, the above pro forma disclosures are not representative of the pro forma effects of option grants on reported results for future years.

The related functional breakdown of total stock-based compensation is outlined below (in thousands):

	Three Months Ended	
	December 31, 2004	December 31, 2003
Stock-based compensation expense (benefit):		
Cost of revenues - service	$ (56)	$ 676
Sales and marketing	(14)	685
Research and development	(61)	860
General and administrative	(30)	1,126
Total stock-based compensation expense (benefit)	$ (161)	$ 3,347

On August 23, 2002, we implemented a stock option exchange program (the Program). Under the Program, holders of outstanding options with an exercise price of $3.00 or greater per share (the Eligible Options) were given the choice of retaining these options or canceling the options in exchange for (i) restricted shares of common stock (Restricted Stock) to be issued as soon as possible after the expiration of the Program period and/or (ii) replacement options issuable six (6) months and one (1) day following the cancellation of the Program (Replacement Options) at the closing market price on that date. The Program, as amended, also provided our Chief Executive Officer and former Chief Financial Officer of the Company, if they participated in the Program, with a Separate Restricted Stock Agreement (the CEO and CFO Agreement). There were 11,668,875 options subject to the Program, which closed on October 9, 2002.

Employees tendered 8,109,640 stock options and received 2,780,967 shares of Restricted Stock pursuant to the Program. In addition, employees tendered 672,948 stock options, which were cancelled and to the extent an employee was still employed by us were replaced six (6) months and one (1) day following the expiration of the Program. The tendered stock options represented approximately 59% of our total outstanding stock options as of the expiration date of the Program. In addition, in October 2002, we issued 3,706,745 shares of Restricted Stock to our employees residing in the United Kingdom, including to our Chief Executive Officer. The Restricted Stock issued to our Chief Executive Officer is subject to the CEO and CFO Agreement. In November 2003, our then acting Chief Financial Officer left our employ and, as a result, we are no longer subject to stock-based compensation expense related to the vesting of his restricted stock. In connection with his departure, we accelerated the vesting of 154,723 shares of restricted stock resulting in a compensation expense of $0.6 million during the fourth quarter of fiscal year 2003.

The Program has been accounted for under the guidance of Emerging Issues Task Force Issue No. 00-23, Issues Related to the Accounting for Stock Compensation under APB Opinion No. 25, and Interpretation No. 44, Accounting for Certain Transactions Involving Stock Compensation-an Interpretation of APB Opinion No. 25. Because we offered to cancel existing fixed stock options in exchange for a grant of restricted stock within six months of the cancellation date of the existing options, the Eligible Options became subject to variable accounting treatment at the commencement date of the Program. Variable accounting ceased upon cancellation of the tendered options. A total of 2,886,287 Eligible Options that were not tendered will remain subject to variable accounting. The remaining unearned stock-based compensation expense associated with the Eligible Options amounted to approximately $0.2 million at December 31, 2004. Due to the decline in our stock price, for the three months ended December 31, 2004, a credit of ($0.2) million was recorded as stock-based compensation expense. The compensation expense on variable options will be re-measured at the end of each operating period until the options are exercised, forfeited or have expired.

Depending upon the change in the market value of our common stock, this accounting treatment may result in significant additional stock-based compensation charges or credits in future periods.

As part of the Program implemented in 2002, we issued 499,068 replacement options at the current market value of $0.88 per share on April 11, 2003 to employees.

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In September 2001, we issued warrants to Accenture plc to purchase up to 600,000 shares of our common stock subject to performance-based vesting. No warrants have vested through December 31, 2004.

Concentrations of credit risk

Financial instruments that potentially subject us to concentrations of credit risk consist of cash and cash equivalents, marketable securities, restricted cash and accounts receivable. To date, we have invested excess funds in money market accounts and marketable securities consisting of auction rate securities. We have cash equivalents and investments with various high quality institutions domestically and internationally.

Our accounts receivable are derived from revenues earned from customers located in North America, Europe, and elsewhere in the world. We perform ongoing credit evaluations of our customers financial condition and, generally, require no collateral from our customers. We maintain an allowance for doubtful accounts when deemed necessary. To date, bad debts have not been material and have been within management expectation.

The following table summarizes the revenues from customers that accounted for 10% or more of total revenues:

	Three Months Ended	
	December 31, 2004	**December 31, 2003**
Barclays	26%	*
Capital One	19%	*
Canadian Imperial Bank of Commerce	*	16%
Signal Iduna	*	15%

* Represents less than 10% of revenue

At December 31, 2004, Capital One and Time Warner Cable accounted for approximately 30% and 18% of accounts receivable, respectively. At September 30, 2004, Time Warner Cable, Capital One and Canadian Imperial Bank of Commerce accounted for approximately 24%, 22% and 12% of accounts receivable, respectively.

Research and Development

Costs incurred in the research and development of new products and enhancements to existing products are charged to expense as incurred until the technological feasibility of the product or enhancement has been established. Technological feasibility of the product is determined after the completion of a detailed program design and a determination has been made that any uncertainties related to high-risk development issues have been resolved. If the process of developing the product does not include a detail program design, technological feasibility is determined only after completion of a working model. After establishing technological feasibility, additional development costs incurred through the date the product is available for general release to customers is capitalized and amortized over the estimated product life.

When technological feasibility is established through the completion of a working model the period of time between achieving technological feasibility and the general release of new products is generally short and software development costs qualifying for capitalization are insignificant. During the quarter ended September 30, 2004, technological feasibility for an acquired banking product was established through the completion of a detailed program design. As a result, as of December 31, 2004, costs aggregating $1.3 million associated with this product have been capitalized and included in Other Assets. No amortization expense relating to this product has been recorded as the product development was still in progress at December 31, 2004. Amortization in future periods will be calculated as the greater of (a) the ratio that current gross revenue for the product bears to the total of current and anticipated future gross revenue for the product or (b) the straight-line method over the remaining estimated economic life of the product.

Recent Accounting Pronouncements

In December 2004, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 123 (Revised 2004), *Share-Based Payment* (SFAS 123R). This standard requires expensing of stock options and other share-based payments and supersedes SFAS No. 123, which had allowed companies to choose between expensing stock options or showing pro forma disclosure only. On April 14, 2005, the standard was delayed to the

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first interim period after the Company s fiscal year, accordingly, effective October 1, 2005, the Company will be required to apply the standard to all awards granted, modified, cancelled or repurchased after that date as well as the unvested portion of prior awards. SFAS 123(R) permits public companies to adopt its requirements using one of two methods:

A modified prospective method in which compensation cost is recognized beginning with the effective date (a) based on the requirements of SFAS 123(R) for all share-based payments granted after the effective date and (b) based on the requirements of SFAS 123(R) for all awards granted to employees prior to the effective date of SFAS 123(R) that remain unvested on the effective date.

A prospective method which includes the requirements of the modified prospective method described above, but also permits entities to restate based on the amounts previously recognized under SFAS 123(R) for purposes of pro forma disclosures either (a) all prior periods presented or (b) prior interim periods of the year of adoption.

The Company expects the adoption to have a material adverse effect on its financial statements.

In December 2004, the FASB issued SFAS No. 153 (FAS 153), *Exchange of Nonmonetary Assets an amendment of APB Opinion No. 29,* which amends Opinion 29 to eliminate the exception for nonmonetary exchanges of similar productive assets and replaces it with a general exception for exchanges of nonmonetary assets that do not have commercial substance. FAS 153 defines a nonmonetary exchange as having commercial substance if the future cash flows of the entity are expected to change significantly as a result of the exchange. This Statement is effective for nonmonetary asset exchanges occurring in fiscal periods beginning after June 15, 2005 and shall be applied prospectively. The Company will adopt FAS 153 in fiscal 2005 and its adoption is not expected to have a material effect on the Company s financial position or financial statements.

In December 2004, the FASB issued FASB Staff Position No. FAS 109-2 (FAS 109-2), *Accounting and Disclosure Guidance for the Foreign Earnings Repatriation Provision within the American Jobs Creations Act of 2004.* FAS 109-2 provides guidance under FASB Statement No. 109, *Accounting for Income Taxes,* with respect to recording the potential impact of the repatriation provisions of the American Jobs Creation Act of 2004 (the Jobs Act) on enterprises income tax expense and deferred tax liability. The Jobs Act was enacted on October 22, 2004. FAS 109-2 states that an enterprise is allowed time beyond the financial reporting period of enactment to evaluate the effect of the Jobs Act on its plan for reinvestment or repatriation of foreign earnings for purposes of applying FASB Statement No. 109. The Company has not yet completed evaluating the impact of the repatriation provisions, however it does not anticipate the adoption will have a material impact on its consolidated financial statements. Accordingly, as provided for in FAS 109-2, we have not adjusted our tax expense or deferred tax liability to reflect the repatriation provisions of the Jobs Act.

In March 2004, the FASB issued EITF Issue No. 03-1 (EITF 03-1), *The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments,* which provided new guidance for assessing impairment losses on investments. Additionally, EITF 03-1 includes new disclosure requirements for investments that are deemed to be temporarily impaired. In September 2004, the FASB delayed the accounting provisions of EITF 03-1; however the disclosure requirements remain effective for annual periods ending after June 15, 2004. The Company will evaluate the impact of EITF 03-1 once final guidance is issued, however it does not anticipate the adoption will have a material impact on its financial statements.

NOTE 3 BALANCE SHEET COMPONENTS

The main components of accounts receivable, net are as follows (in thousands):

	December 31, 2004	September 30, 2004
		(Restated)
Accounts receivable, net:		
Accounts receivable	$ 18,143	$ 20,272
Less: allowances for doubtful accounts and credits	(215)	(111)
	$ 17,928	$ 20,161

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The main components of accrued expenses are as follows (in thousands):

	December 31, 2004	September 30, 2004
		(Restated)
Accrued expenses:		
Accrued payroll and related expenses	$ 6,338	$ 4,919
Accrued restructuring expenses	2,835	3,368
Other accrued liabilities	4,808	3,394
	$ 13,981	$ 11,681

The components of intangible assets, excluding goodwill, are as follows (in thousands):

	December 31, 2004			September 30, 2004 (Restated)		
	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
Intangible assets:						
Developed technologies	$ 6,904	$ (2,293)	$ 4,611	$ 2,374	$ (2,162)	$ 212
Purchased technologies	7,162	(7,162)		7,162	(7,162)	
Customer list	1,750	(183)	1,567	190	(158)	32
Tradenames	982	(982)		982	(982)	
	$ 16,798	$ (10,620)	$ 6,178	$ 10,708	$ (10,464)	$ 244

All of our acquired intangible assets, excluding goodwill, are subject to amortization and are carried at cost less accumulated amortization. Amortization is computed over the estimated useful lives which are as follows: developed technologies-one and one half to five years; purchased technologies-three years; tradenames-three years; customer list-three to five years. Aggregate amortization expense for intangible assets totaled $0.2 million and $0.9 million for the three months ended December 31, 2004 and 2003, respectively. We expect amortization expense on acquired intangible assets as of December 31, 2004 to be $1.1 million for the remaining nine months in fiscal 2005, $1.2 million in fiscal 2006, $1.2 million in fiscal 2007, $1.2 million in fiscal 2008, $1.2 million in fiscal 2009 and $0.3 million in fiscal 2010.

NOTE 4 ACQUISITION

On December 21, 2004, we acquired KiQ Limited, a privately held United Kingdom software company with branch offices in the Netherlands (KiQ), specializing in the development and sales of decision management systems. The aggregate purchase price was approximately $20

million, which was comprised of $9.7 million in cash, 4,352,084 shares of our common stock valued at $9.4 million and approximately $0.9 million in associated transaction costs. Through this transaction we acquired decision management system products and technology.

The acquisition has been accounted for as a business combination. Assets acquired and liabilities assumed were recorded at their fair values as of December 21, 2004. The table below summarizes the total purchase price for the acquisition (in thousands, except share and per share data,):

Acquisition date	**December 21, 2004**
Shares issued	4,352,084
Average per share value used to value the share consideration	$ 2.17
Purchase price:	
Value of shares issued	$ 9,444
Cash in consideration of cancelled options	1,049
Cash	8,604
Direct acquisition costs	935
Total purchase price	$ 20,032

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The value of the shares issued was determined based on the weighted average value of our stock s market price, two days before, the day of, and two days after the date the terms of the acquisition were agreed upon and announced.

The total purchase price has been allocated to the fair value of assets acquired and liabilities assumed as follows (in thousands):

Fair value of assets acquired and liabilities assumed (net)	$ 586
In-process research and development	1,940
Deferred compensation	4,262
Developed technology	4,530
Customer list	1,150
Tradename	410
Goodwill	7,154
Total purchase price	$ 20,032

Assets acquired principally include cash and cash equivalents, accounts receivable, fixed assets and other assets. Liabilities assumed principally include accounts payable and accrued expenses. The excess of the purchase price over the identified tangible and intangible assets was recorded as goodwill and amounted to approximately $7.2 million. In accordance with SFAS No. 142 (SFAS 142), *Goodwill and Other Intangible Assets,* the goodwill will not be amortized but instead tested for impairment in accordance with the provisions of SFAS 142 at least annually and more frequently upon the occurrence of certain events. For income tax purposes the Company does not believe the goodwill balances will be deductible.

The value of the purchased in-process research and development was determined by estimating the projected net cash flows related to products under development, based upon our estimates of costs to complete the development of the technology, and the future revenue to be earned upon commercialization of the related products. The estimated stage of completion (expressed as a percentage of completion) was calculated and then applied to the net cash flow for these products. A discount rate of 25% was then applied to the projected cash flows associated with the in-process research and development to determine the net present value. KiQ s in-process research and development efforts consisted of developing a new product module based on an improved architecture to allow for more power, functionality, improved performance, as well as enhancing the product s scalability and increasing automation to existing modules. Also included were development efforts to complete a new user interface and various optimized data preparation projects. The estimated state of completion for all projects was approximately 80%. In accordance with application of SFAS 141, the value attributed to in-process research and development was charged to expense in the period we completed the acquisition.

It is anticipated that the two principal sellers, in addition to other employees of KiQ, will remain our employees. We issued 1,964,279 shares of our common stock to the two principal sellers, which we are allowed to buy back from them at a price of $.001 per share if their employment is terminated under certain circumstances. Our right to repurchase these shares diminishes on a monthly basis in accordance with a 30 month vesting schedule which begins on the acquisition date. We are recognizing the $4.3 million deferred compensation as stock-based compensation expense over the period of the vesting schedule.

The value of the developed, core technology was determined by estimating the projected net cash flows related to products which are or anticipated to be commercialized based on this technology, less any estimated cost to complete commercialization. A discount rate of 20% was then applied to the projected cash flows associated with the developed, core technology to determine the net present value. We plan to amortize the intangible asset related to the developed, core technology over a period of five years.

The value of the customer list was determined by estimating the projected net cash flows associated with existing customers and applying estimated attrition rates for these customers of from 5% to 95% over future periods. A discount rate of 22.5% was then applied to the projected cash flows associated with the customer relationships to determine the net present value. The value of the tradename was determined by estimating what the projected net cash flows associated with royalties derived from licensing KiQ s trade name would be over future periods if a third party were using the name. A discount rate of 22.5% was then applied to the projected cash flows associated with the tradename to determine the net present value. We are amortizing the intangible assets related to the customer list and tradename over a period of five years.

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The operating results of KiQ have been included in the condensed consolidated financial statements since the acquisition date. The following unaudited pro forma condensed consolidated financial information reflects the results of operations for the three months ended December 31, 2004, and December 31, 2003 as if the acquisition of KiQ had occurred on October 1, 2003, after giving effect to purchase accounting adjustments. The purchased in-process research and development of $1.9 million has not been included in the pro forma results of operations for the three months ended December 31, 2004 because it is considered a non-recurring charge. These pro forma results have been prepared for comparative purposes only, do not purport to be indicative of what operating results would have been had the acquisition actually taken place at the beginning of each period, and may not be indicative of future operating results (in thousands, except per share data):

	Three Months Ended December 31, 2004	Three Months Ended December 31, 2003
Pro forma adjusted total revenue	$ 22,571	$ 19,877
Pro forma adjusted net loss	$ (2,586)	$ (4,793)
Pro forma adjusted net loss per share basic and diluted	$ (0.03)	$ (0.07)
Pro forma weighted average shares basic and diluted	76,575	65,912

NOTE 5 RESTRUCTURING

Restructuring Costs

During the quarter ended September 30, 2004, we announced plans to reallocate staff between our North American and European operations in order to better support our growth in North America. This restructuring plan included a reduction in workforce.

During fiscal years 2003 and 2002, based upon our continued evaluation of economic conditions in the information technology industry and our expectations regarding revenue levels, we restructured several areas of the Company to reduce expenses and improve our revenue per employee. This restructuring program included a worldwide workforce reduction and consolidation of excess facilities and certain business functions. We believe that these reductions and realignments have resulted and will continue to result in a more responsive management structure.

As part of the fiscal year 2003 restructuring, we entered into an agreement with Ness Technologies Inc., Ness Global Services, Inc. and Ness Technologies India, Ltd. (collectively, Ness), effective December 15, 2003 wherein Ness will provide our customers with technical product support through a worldwide 24x7 help desk facility, a sustaining engineering function which serves as the interface between technical product support and our internal engineering organization, product testing services, and product development services (collectively, the Services). The agreement has an initial term of three years and may be extended for additional one year terms at our discretion. Under the terms of the agreement, we pay for services rendered on a monthly fee basis, including the requirement to reimburse Ness for approved out-of-pocket expenses. The agreement may be terminated for convenience by the Company, subject to the payment of a termination fee that declines over time. At December 31, 2004 the estimated fee was $0.5 million. The maximum termination fee is initially equal to three months of fees, declining to zero after 30 months.

Severance costs associated with the fourth quarter of fiscal year 2003 employee reductions were accounted for in accordance with SFAS No. 112, Employers Accounting for Post-Employment Benefits. Other one-time benefit arrangements are accounted for in accordance with SFAS

No. 146, Accounting for Costs Associated with Exit or Disposal Activities.

Workforce reductions

The prior period restructuring programs resulted in the reduction of 74 regular employees and 108 regular employees during the years ended December 31, 2003 and 2002, respectively. All areas of the Company were affected by this restructuring.

Consolidation of excess facilities

Included in accrued restructuring as of December 31, 2004 are the estimated future obligations for non-cancelable lease payments for the consolidation of excess facilities relating to lease terminations and non-cancelable lease costs. These costs

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are offset by estimated sub-lease income based on current comparable rates for leases in the respective markets. If facilities rental rates decrease in these markets or if it takes longer than expected to sublease these facilities, the maximum amount by which the actual loss could exceed the original estimate is approximately $0.9 million.

A summary of the activity of accrued restructuring for the three months ended December 31, 2004 is as follows (in thousands):

	Facilities	Severance and Benefits	Total
Reserve balance at September 30, 2004	$ 2,781	$ 587	$ 3,368
Provision adjustments (1)		(123)	(123)
Non-cash		9	9
Cash paid	(71)	(348)	(419)
Reserve balance at December 31, 2004	$ 2,710	$ 125	$ 2,835

(1) Provision adjustments relate to a change in estimates.

As of December 31, 2004, $2.8 million related to the restructuring reserve is included in accrued expenses on the balance sheet. Amounts related to net lease expenses due to the consolidation of facilities will be paid over the lease terms through fiscal 2011. However, management will seek ways to exit the facilities earlier if economically feasible. The remaining accrual primarily relates to the termination and/or sublease of our excess facilities and to severance and other benefits for impacted employees.

NOTE 6 BORROWINGS

Revolving line of credit

Our two-year line of credit with Comerica Bank, effective from March 28, 2003 and extended to May 27, 2005, is comprised of a $5.0 million accounts receivable line and a $2.5 million equipment line. The terms of the line of credit require us to maintain a minimum quick ratio of 2.00 to 1.00, a tangible net worth of at least $15.0 million plus 60% of the proceeds of any equity offerings and subordinated debt issuances subsequent to the effective date of the line of credit agreement, and certain other covenants. All assets of the Company have been pledged as collateral on the credit facility. As of December 31, 2004, the Company was in compliance with the respective debt covenants, with the exception of filing its 2004 Form 10-K and its quarter ended December 31, 2004 Form 10-Q within time periods prescribed by the bank. Subsequently, the Company filed its 2004 Form 10-K on March 29, 2005 and obtained a waiver from the bank related to the filing of its quarter ended December 31, 2004 Form 10-Q until May 16, 2005.

The accounts receivable line of credit contains a provision for a sub-limit of up to $2.0 million for issuances of standby commercial letters of credit. As of December 31, 2004, we had utilized $1.4 million of the $2.0 million standby commercial letter of credit limit of which $0.9 million serves as collateral for computer equipment leases for our outsourcing partner in India (See Note 5). The accounts receivable line of credit also contains a provision for a sub-limit of up to $2.0 million for issuance of foreign exchange forward contracts. As of December 31, 2004, we had not entered into any foreign exchange forward contracts.

Borrowings under the accounts receivable line of credit will bear interest at the lending bank s prime rate plus 0.5%. Advances are available on a non-formula basis up to $2.0 million (non-formula portion); however, if advances exceed $2.0 million, then subsequent advances cannot exceed 80% of eligible accounts receivable balances, and the bank would hold a security interest in those accounts receivable. As of December 31, 2004, there was no outstanding balance on our accounts receivable line of credit.

Borrowings under the $2.5 million equipment line bear interest at the lending bank s prime rate plus 1.0%, and the bank would hold a security interest in the equipment. As of December 31, 2004, there was no outstanding balance on our equipment line of credit and our ability to use the line to purchase equipment had expired.

NOTE 7 LITIGATION

Beginning in July 2001, we and certain of our officers and directors (Individuals) were named as defendants in a series of

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class action shareholder complaints filed in the United States District Court for the Southern District of New York, now consolidated under the caption, In re