EMBARCADERO TECHNOLOGIES INC
Form 10-Q
August 08, 2005
Table of Contents

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-Q

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

For the quarterly period ended June 30, 2005.

¨ **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 of incorporation or organization)	**(I.R.S. Employer Identification No.)**

100 CALIFORNIA STREET, SUITE 1200

SAN FRANCISCO, CA 94111

(415) 834-3131

(Address of principal executive offices, including zip code and telephone number, including area code)

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

The number of shares outstanding of the Registrant s Common Stock as of July 29, 2005 was 26,052,609.

Table of Contents

EMBARCADERO TECHNOLOGIES, INC.

INDEX

Table of Contents

PART I- FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

EMBARCADERO TECHNOLOGIES, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS

(in thousands)

	June 30, 2005	December 31, 2004 (1)
	(unaudited)	
ASSETS		
Current assets:		
Cash and cash equivalents	$ 9,867	$ 7,422
Short-term investments	53,210	52,485
Trade accounts receivable, net	6,788	8,339
Prepaid expenses and other current assets	1,999	1,634
Deferred income taxes	732	732
Total current assets	72,596	70,612
Property and equipment, net	2,271	2,922
Goodwill	10,739	10,950
Deferred income taxes	3,967	3,967
Other assets, net	735	1,672
Total assets	$ 90,308	$ 90,123
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 481	$ 1,004
Accrued liabilities	5,427	5,167
Capital lease obligations	166	171
Deferred revenue	15,708	14,503
Total current liabilities	21,782	20,845
Long-term deferred revenue	197	199
Long-term capital lease obligations	165	238
Long-term restructuring accrual	1,407	1,747
Total liabilities	23,551	23,029
Commitments and contingencies (Note 10)		
Stockholders Equity:		
Common stock: $0.001 par value	26	26
Treasury stock	(19,545)	(17,467)

Additional paid-in capital	85,284	85,462
Accumulated other comprehensive income	517	825
Deferred stock-based compensation	(665)	(2,130)
Retained earnings	1,140	378
Stockholders equity	66,757	67,094
Total liabilities and stockholders equity	$ 90,308	$ 90,123

(1) The balance sheet as of December 31, 2004 has been derived from the audited consolidated financial statements at that date but does not include all of the information and footnotes required by accounting principles generally accepted in the United States of America for complete financial statements.

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

Table of Contents

EMBARCADERO TECHNOLOGIES, INC.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(in thousands, except per share data)

(unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2005	2004 (as restated)	2005	2004 (as restated)
Revenues:				
License	$ 6,478	$ 6,260	$ 12,601	$ 13,467
Maintenance	7,498	7,227	14,554	14,264
Total revenues	13,976	13,487	27,155	27,731
Cost of revenues:				
License	216	213	464	422
Amortization of acquired technology	192	556	564	1,111
Maintenance	504	620	1,062	1,242
Total cost of revenues	912	1,389	2,090	2,775
Gross profit	13,064	12,098	25,065	24,956
Operating expenses:				
Research and development	3,840	3,906	7,782	7,680
Sales and marketing	5,513	5,096	11,261	10,207
General and administrative	2,221	1,543	4,874	2,756
Restructuring and impairment charges		4,068		4,068
Litigation settlement charge	573		573	
Total operating expenses	12,147	14,613	24,490	24,711
Income (loss) from operations	917	(2,515)	575	245
Other income, net	294	143	572	355
Income (loss) before provision for income taxes	1,211	(2,372)	1,147	600
Benefit from (provision for) income taxes	(408)	1,132	(385)	208
Net income (loss)	$ 803	$ (1,240)	$ 762	$ 808
Net income (loss) per share basic	$ 0.03	$ (0.05)	$ 0.03	$ 0.03
Net income (loss) per share diluted	$ 0.03	$ (0.05)	$ 0.03	$ 0.03

Weighted average shares outstanding basic	26,200	27,394	26,091	27,260
Weighted average shares outstanding diluted	27,482	27,394	27,509	28,251
Non-cash stock-based compensation included in the above expense:				
Cost of revenues	$ 3	$ 2	$ 7	$ 2
Research and development	(16)	55	258	55
Sales and marketing	126	181	346	330
General and administrative	210	171	389	317
	$ 323	$ 409	$ 1,000	$ 704

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

Table of Contents

EMBARCADERO TECHNOLOGIES, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands)

(unaudited)

	Six Months Ended June 30,	
	2005	**2004 (as restated)**
Cash from operating activities:		
Net income	$ 762	$ 808
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	760	940
Provision for (reduction in) doubtful accounts	33	(24)
Impairment charges		680
Amortization of acquired technology and capitalized software	962	977
Amortization of other intangible assets		404
Amortization of deferred stock-based compensation	990	646
Issuance of options in exchange for services	10	58
Changes in operating assets and liabilities:		
Trade accounts receivable	1,441	957
Prepaid expenses and other assets	(262)	(574)
Accounts payable and accrued liabilities	(684)	1,538
Deferred revenue	1,324	258
Net cash provided by operating activities	5,336	6,668
Cash from investing activities:		
Purchases of investments	(59,165)	(49,262)
Sales and maturities of investments	58,440	40,484
Purchases of property and equipment	(120)	(870)
Technology acquired and developed		(15)
Net cash used in investing activities	(845)	(9,663)
Cash from financing activities:		
Repurchase of common stock	(2,076)	(588)
Payments of principal under capital lease obligation	(81)	(15)
Proceeds from exercise of stock options	242	2,422
Net cash (used in) provided by financing activities	(1,915)	1,819
Effect of exchange rate changes on cash and cash equivalents	(131)	175
Net increase (decrease) in cash and cash equivalents	2,445	(1,001)
Cash and cash equivalents at beginning of period	7,422	11,427

Cash and cash equivalents at end of period	$ 9,867	$ 10,426

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

Table of Contents

EMBARCADERO TECHNOLOGIES, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(unaudited)

NOTE 1 THE COMPANY AND BASIS OF PRESENTATION

Embarcadero Technologies, Inc. (with its subsidiaries, collectively referred to as the Company) was incorporated in California on July 23, 1993, and reincorporated in Delaware on February 15, 2000. The Company provides software products that enable organizations to effectively manage their database infrastructure and manage the underlying data housed within that infrastructure. The Company is headquartered in San Francisco, California and has international operations in Toronto, Canada, Maidenhead, United Kingdom and Melbourne, Australia.

The Company markets its software and related maintenance services directly through telesales and field sales organizations in the United States, the United Kingdom and Australia, and indirectly through independent distributors and resellers worldwide.

The accompanying unaudited condensed consolidated financial statements reflect all adjustments, which, in the opinion of the Company, are necessary for a fair statement of the results for the interim periods presented. All such adjustments are normal recurring adjustments. These financial statements have been prepared in accordance with generally accepted accounting principles related to interim financial statements and the applicable rules of the Securities and Exchange Commission. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. The balance sheet at December 31, 2004, was derived from the audited financial statements, but it does not include all disclosures required by accounting principles generally accepted in the United States of America for complete financial statements.

The financial statements and related disclosures have been prepared with the presumption that users of the interim financial information have read or have access to the audited financial statements for the preceding fiscal year. Accordingly, these financial statements should be read in conjunction with the audited financial statements and the related notes thereto contained in the Company s Annual Report on Form 10-K/A for the year ended December 31, 2004, filed with Securities and Exchange Commission on April 25, 2005.

Operating results for the three and six months ended June 30, 2005, are not necessarily indicative of the results that may be expected for the full year ending December 31, 2005 or for any future period. Further, the preparation of condensed consolidated financial statements requires management to make estimates and assumptions that affect the recorded amounts reported therein. A change in facts or circumstances surrounding the estimates could result in a change to the estimates and impact future operating results.

NOTE 2 SIGNIFICANT ACCOUNTING POLICIES

Reclassifications

In connection with the preparation of its December 31, 2004 financial statements, the Company has reclassified auction rate securities from cash and cash equivalents to short-term investments. The resulting impact of this reclassification on the statement of cash flows for the six months ended June 30, 2004 was to increase the purchase of investments by $37.8 million, increase maturities of investments by $30.8 million and decrease cash and cash equivalents at the beginning of the period and the end of the period by $33.6 million and $40.7 million, respectively.

Stock-Based Compensation

Pursuant to SFAS No. 123, *Accounting for Stock-Based Compensation* , the Company accounts for employee stock options under Accounting Principles Board Opinion (APB) No. 25, Accounting for Stock Issued to Employees, and follows the disclosure-only provisions of SFAS No. 123. Under APB No. 25, compensation expense is based on the difference, if any, on the date of the grant, between the estimated fair value of the Company s common stock and the exercise price of options to purchase that stock. For purposes of estimating the compensation cost of the Company s option grants in accordance with SFAS No. 123, the fair value of each option grant is estimated on the date of grant using the Black-Scholes option-pricing model. If the Company had determined its compensation cost for the Company s stock-based compensation plan based on the fair value at the grant dates for the awards under a method prescribed by SFAS No. 123, the Company s net income (loss) would have been changed to the pro forma net income (loss) indicated below (in thousands, except per share amounts):

6

Table of Contents

	Three Months Ended June 30,		Six Months Ended June 30,	
	2005	2004 (as restated)	2005	2004 (as restated)
	(unaudited)		(unaudited)	
Net income (loss) as reported	$ 803	$ (1,240)	$ 762	$ 808
Add: Total stock-based employee compensation expense included in reported net income (loss), net of related tax effects	214	242	623	383
Deduct: Total stock-based employee compensation expense determined under fair value method for all awards, net of related tax effects	(434)	(930)	(1,363)	(1,598)
Net income (loss) pro forma	$ 583	$ (1,928)	$ 22	$ (407)
Net income (loss) per share - basic as reported	$ 0.03	$ (0.05)	$ 0.03	$ (0.03)
Net income (loss) per share - basic pro forma	$ 0.02	$ (0.07)	$ 0.00	$ (0.01)
Net income (loss) per share - diluted as reported	$ 0.03	$ (0.05)	$ 0.03	$ (0.03)
Net income (loss) per share - diluted pro forma	$ 0.02	$ (0.07)	$ 0.00	$ (0.01)

The fair value of each option grant is estimated on the date of grant using the fair value method with the following weighted average assumptions:

	Three months ended June 30,		Six months ended June 30,	
	2005	2004	2005	2004
	(unaudited)		(unaudited)	
Risk free interest rate	3.78%	3.02% 3.78%	3.89%	2.40% 3.78%
Expected life	3	4	3	4
Expected dividends				
Volatility	70	99	70	99

Recent Accounting Pronouncements

In December 2004, FASB Staff Position No. FAS 109-2, Accounting and Disclosure Guidance for the Foreign Earnings Repatriation Provision within the American Jobs Creation Act of 2004 (FSP FAS 109-2) was issued and immediately effective, providing guidance under SFAS 109, Accounting for Income Taxes for recording the potential impact of the repatriation provisions of the American Jobs Creation Act of 2004 (Jobs Act), enacted on October 22, 2004. FSP FAS 109-2 allows time beyond the financial reporting period of enactment to evaluate the effects of the Jobs Act before applying the requirements of FSP FAS 109-2. Accordingly, we are evaluating the potential effects of the Jobs Act and have not adjusted our tax expense or deferred tax liability as of June 30, 2005. We will complete our evaluation by the end of 2005.

Table of Contents

In December 2004, the FASB revised SFAS No. 123 (SFAS 123(R)), *Share-Based Payment*, which requires companies to expense the estimated fair value of employee stock options and similar awards. On April 14, 2005, the SEC adopted a new rule amending the compliance dates for SFAS 123(R). In accordance with the new rule, the accounting provisions of SFAS 123(R) will be effective for the Company beginning on January 1, 2006. The Company will adopt the provisions of SFAS 123(R) using a modified prospective application. Under a modified prospective application, SFAS 123(R) will apply to new awards and to awards that are outstanding on the effective date and are subsequently modified or cancelled. Compensation expense for outstanding awards for which the requisite service had not been rendered as of the effective date will be recognized over the remaining service period using the compensation cost calculated for pro forma disclosure purposes under SFAS 123. The Company is in the process of determining how the new method of valuing stock-based compensation as prescribed in SFAS 123(R) will be applied to valuing stock-based awards granted after the effective date and the impact the recognition of compensation expense related to such awards will have on its financial statements. The Company expects the adoption of SFAS 123(R) will have a material adverse impact on the Company s net income and net income per share.

In March 2005, the SEC staff issued guidance on SFAS 123(R). Staff Accounting Bulletin No. 107 (SAB 107) was issued to assist preparers by simplifying some of the implementation challenges of SFAS 123(R) while enhancing the information that investors receive. SAB 107 creates a framework that is premised on two overarching themes: (a) considerable judgment will be required by preparers to successfully implement SFAS 123(R), specifically when valuing employee stock options; and (b) reasonable individuals, acting in good faith, may conclude differently on the fair value of employee stock options. Key topics covered by SAB 107 include: (a) valuation models SAB 107 reinforces the flexibility allowed by SFAS 123(R) to choose an option-pricing model that meets the standard s fair value measurement objective; (b) expected volatility SAB 107 provides guidance on when it would be appropriate to rely exclusively on either historical or implied volatility in estimating expected volatility; and (c) expected term the new guidance includes examples and some simplified approaches to determining the expected term under certain circumstances. The Company will apply the principles of SAB 107 in conjunction with its adoption of SFAS 123(R).

In March 2005, the FASB issued FIN 47, Accounting for Conditional Asset Retirement Obligations, an interpretation of FASB Statement No. 143 (FIN 47), which requires an entity to recognize a liability for the fair value of a conditional asset retirement obligation when incurred if the liability s fair value can be reasonably estimated. FIN 47 is effective for fiscal years ending after December 15, 2005. The Company is currently evaluating the effect that the adoption of FIN 47 will have on its consolidated results of operations and financial condition but does not expect it to have a material impact.

In May 2005, the FASB issued SFAS No. 154, Accounting Changes and Error Corrections (SFAS 154) which replaces Accounting Principles Board Opinions No. 20 Accounting Changes and SFAS No. 3, Reporting Accounting Changes in Interim Financial Statements An Amendment of APB Opinion No. 28. SFAS 154 provides guidance on the accounting for and reporting of accounting changes and error corrections. It establishes retrospective application, or the latest practicable date, as the required method for reporting a change in accounting principle and the reporting of a correction of an error. SFAS 154 is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005 and is required to be adopted by the Company in the first quarter of fiscal 2006. The Company is currently evaluating the effect that the adoption of SFAS 154 will have on its consolidated results of operations and financial condition but does not expect it to have a material impact.

NOTE 3 OTHER COMPREHENSIVE INCOME (LOSS)

Other comprehensive income (loss) consists of unrealized gain (loss) on available-for-sale investments and foreign currency translation adjustments during the period.

The components of comprehensive income (loss) are as follows (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2005	2004 (as restated)	2005	2004 (as restated)
	(unaudited)		(unaudited)	
Net income (loss)	$ 803	$ (1,240)	$ 762	$ 808
Unrealized loss on available-for-sale investments	(2)	(11)	(5)	(7)
Foreign currency translation adjustments	(155)	(79)	(303)	(239)
Comprehensive income (loss)	$ 646	$ (1,330)	$ 454	$ 562

Table of Contents

NOTE 4 EARNINGS PER SHARE

Basic net income (loss) per share excludes the effect of the potentially dilutive securities and is computed by dividing net income (loss) by the weighted average number of common shares outstanding for the period. Diluted net income (loss) per share reflects the potential dilution of securities by adding dilutive common stock options and shares subject to repurchase to the weighted average number of common shares outstanding for the period.

A reconciliation of the numerator and denominator used in the calculation of basic and diluted net income (loss) per share is as follows (in thousands, except per share data):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2005	2004 (as restated)	2005	2004 (as restated)
	(unaudited)		(unaudited)	
Calculation of basic net income (loss) per share:				
Net income (loss)	$ 803	$ (1,240)	$ 762	$ 808
Weighted average common shares outstanding-basic	26,200	27,394	26,091	27,260
Net income (loss) per share	$ 0.03	$ (0.05)	$ 0.03	$ 0.03
Calculation of diluted net income (loss):				
Net income (loss)	$ 803	$ (1,240)	$ 762	$ 808
Weighted average shares of common stock outstanding	26,200	27,394	26,091	27,260
Add: Dilutive securities common stock options and non- vested restricted common stock	1,282		1,418	1,864
Weighted average common shares outstanding and potentially dilutive common shares	27,482	27,394	27,509	24,620
Net income (loss) per share	$ 0.03	$ (0.05)	$ 0.03	$ 0.03
Anti-dilutive common stock options and non-vested restricted common stock, not included in net income (loss) per share	2,744	4,408	4,418	695

NOTE 5 ACCOUNTING FOR GOODWILL

The Company s goodwill balance as of June 30, 2005 is $10.7 million compared to $11.0 as of December 31, 2004. The change was due to foreign currency translation. The Company performed its last goodwill impairment test in September 2004 and determined that there had been no impairment to its goodwill. There can be no assurance, however, that a material impairment charge will not be recorded in the future.

Table of Contents

NOTE 6 CAPITALIZED SOFTWARE DEVELOPMENT COSTS

The Company accounts for certain software development costs, including purchased software, in accordance with SFAS No. 86, Accounting for Costs of Computer Software to be Sold, Leased or Otherwise Marketed. In the six months ended June 30, 2005 and 2004, the Company capitalized $0 and $15,000, respectively. Capitalized software is typically amortized over a period of 36 months. The remaining lives of the capitalized software at June 30, 2005 are between 12 months and 30 months. The capitalized software development costs are as follows (in thousands):

	As of June 30, 2005 (unaudited)			As of December 31, 2004		
	Gross Amortization Carrying Amount	Accumulated Amortization	Net Carrying Amount	Gross Amortization Carrying Amount	Accumulated Amortization	Net Carrying Amount
Capitalized software	$ 6,283	$ 5,571	$ 712	$ 6,283	$ 4,735	$ 1,548

The net capitalized software costs are included in long-term Other assets on the Company s balance sheet.

NOTE 7 RESTRUCTURING AND IMPAIRMENT LOSS

During the year ended December 31, 2004, the Company recorded a restructuring and impairment charge of $4.0 million related to the consolidation of our office leases in San Francisco. The restructuring charge included a $2.8 million charge, which represented the net present value of the Company s future contractual lease obligations net of any sublease income and $566,000 of other expenses, principally lease commissions, legal fees and other subtenant allowances.

In addition to the restructuring provision, the Company abandoned approximately $680,000 of leasehold improvements and excess furniture and fixtures.

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

	Facility Leases, Net of Sublease Income	Write down of Leashold Improvements	Other Restructuring Expenses	Total
Balance 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)
Balance as of December 31, 2004	$ 2,428	$	$ 31	$ 2,459
Net cash payments during the six months ended June 30, 2005	$ (378)		$ (27)	$ (405)
Balance as of June 30, 2005	$ 2,050	$	$ 4	$ 2,054

As of June 30, 2005, approximately $1.4 million of the restructuring accrual is recorded as long-term liabilities.

Table of Contents

NOTE 8 TREASURY STOCK

In September 2001, the Company s Board of Directors authorized an initial stock repurchase program of up to 1,000,000 shares of its common stock. In July 2002, the Board of Directors amended the Company s stock repurchase program to increase the number of shares authorized for repurchase by an additional 1,230,000 shares. In both July and October 2004, the Board of Directors further amended the Company s stock repurchase program to increase the number of shares authorized for repurchase by an additional 1,000,000 shares. Depending on market conditions and other factors, repurchases can be made from time to time in the open market and in negotiated transactions, including block transactions, and this program may be discontinued at any time. Authorizations and repurchases by year are as follows:

	Number of Shares (thousands)	Cost of Repurchase (thousands)	Average Cost
Initial repurchase program authorized in September 2001	1,000		
Increased in repurchase program authorized in July 2002	1,230		
Increased in repurchase program authorized in July 2004	1,000		
Increased in repurchase program authorized in October 2004	1,000		
Total authorized for repurchase	4,230		
Shares repurchased in 2001	219	$ 1,781	$ 8.13
Shares repurchased in 2002	712	3,335	4.68
Shares repurchased in 2003	231	1,171	5.07
Shares repurchased in 2004	1,519	11,182	7.36
Shares repurchased in 2005	356	2,076	5.83
Total shares repurchased	3,037	$ 19,545	$ 6.44
Remaining shares available for repurchase at June 30, 2005	1,193		

NOTE 9 SEGMENT AND GEOGRAPHIC REPORTING

Operating segments are components of a business enterprise that its chief operating decision maker applies his decisions to allocate the resources to its different segments and to make assessments on their performances. By this definition, Embarcadero operates only in one reportable operating segment; the design, development, marketing, sales and support of software for database and application development and management.

The Company s geographic sales data is based on customer location as defined by the following regions: North America, United Kingdom and Other. The Company s wholly owned subsidiary, Embarcadero Europe Ltd., transacts all sales in Europe, the Middle East, Australia and Africa. Various distributors and resellers handle sales in regions outside Europe, the Middle East, Australia, Africa and North America.

Revenues and long-lived assets by geographic regions are as follows (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2005	2004 (as restated)	2005	2004 (as restated)
	(unaudited)		(unaudited)	
Revenues:				
North America (1)	$ 11,133	$ 10,378	$ 22,019	$ 21,548
United Kingdom	1,157	1,095	1,931	2,255
Other	1,686	2,014	3,205	3,928
Total	$ 13,976	$ 13,487	$ 27,155	$ 27,731

(1) Includes gross revenues related to Canada of $525,000 and $799,000 for the three months ended June 30, 2005 and 2004, respectively, and $1,123,000 and $1,703,000 for the six months ended June 30, 2005 and 2004, respectively.

Table of Contents

Long-lived assets by geographic regions are as follows (in thousands):

	As of June 30, 2005 (unaudited)	As of December 31, 2004
Long lived assets:		
North America (2)	$ 2,052	$ 2,625
United Kingdom	195	268
Australia	24	29
Total	$ 2,271	$ 2,922

(2) Includes long lived assets related to Canada of $191,000 and $269,000 at June 30, 2005 and December 31, 2004, respectively.

NOTE 10 COMMITMENTS AND CONTINGENCIES

Bank Credit Facility

A financial institution issued an irrevocable standby letter of credit for approximately $120,000 in relation to a real estate lease agreement executed in April 2004. The standby letter of credit will expire on June 1, 2006.

Leases

The Company leases office space and equipment under non-cancelable operating lease agreements that expire at various dates through 2009. The Company recognizes rent expense on a straight-line basis over the lease period and has accrued for rent expense incurred but not paid. Some of the lease agreements have renewal options ranging from one to five years. In April 2004, the Company announced a restructuring plan. As a part of that plan, the Company entered into a new five-year lease commitment and subleased the remainder of its long-term San Francisco office leases. The lease and subleases were executed in April 2004. The subleases will expire in July 2008. The Company s net contractual sublease income over the remaining duration of the subleases is $829,000 receivable as $134,000 in 2005, $269,000 per year in years 2006 and 2007 and $157,000 in 2008.

The Company entered into a three-year capital lease agreement in June 2004, for approximately $499,000 to finance the acquisition of certain furniture and fixtures and computer equipment. The capital lease agreement bears an interest rate of 6.1% per annum and has a $1 buyout option at its expiration in June 2007.

Gross lease payment obligations under the non-cancelable operating and capital lease are as follows (in thousands):

	Capital Lease	Operating Leases	Bank Letter of Credit	Total
2005	$ 91	$ 802	$	$ 893
2006	182	1,395	120	1,697
2007	76	1,213		1,289
2008		707		707
2009		303		303
Total minimum payments	349	$ 4,420	$ 120	$ 4,889
Less: amount representing interest	18			
Present value of net minimum lease payments	$ 331			

Table of Contents

Contingencies

In May 2005, the Company entered into a settlement agreement with the other parties in the litigation against the Company and its President and Chief Executive Officer and other parties by The Client Server Factory Inc. filed in October 2002. Pursuant to the settlement agreement, none of the parties made any admission regarding fault or liability and all outstanding issues among the parties were resolved. The Company s share of the payments made pursuant to the settlement was $573,000 and has been recorded in the statement of operations for the three months ended June 30, 2005. The case was dismissed with prejudice on June 30, 2005.

There are no other known legal proceedings. However, the Company may, from time to time, become a party to other legal proceedings arising in the normal course of business. The Company may also be indirectly affected by administrative or court proceedings or actions in which the Company is not involved but which have general applicability to the software industry.

The Company provides general indemnification provisions in its license agreements. In these agreements, the Company states that it will defend or settle, at its own expense, any claim against the customer asserting a patent, copyright, trademark, trade secret or proprietary right violation related to any products that the Company has licensed to the customer. The Company agrees to indemnify its customers against any loss, expense or liability, including reasonable attorney s fees, from any damages alleged against the customer in its course of using products sold by the Company. The Company has not received any claims under this indemnification and does not know of any instances in which such a claim may be brought against the Company in the future. The Company believes that the fair value of these agreements is minimal and has not recorded any liabilities in connection with them.

NOTE 11 RESTATEMENT OF FINANCIAL STATEMENTS

The Company restated its consolidated financial statements for the years ended December 31, 2000 through 2003 and for each of the quarters in 2003 and the first three quarters of 2004 (Restatement for Prior Years) to correct errors in accounting for the impact of foreign currencies and income taxes.

The foreign currency errors related to both transaction and translation gains and losses. The foreign currency transaction error resulted from the foreign currency translation effects related to intercompany balances being recorded as a component of the cumulative translation adjustment within stockholders equity (and a component of comprehensive income), rather than in the statement of operations. The foreign currency translation error resulted from the failure to record certain foreign currency translation adjustments, mainly related to goodwill, which should have been recorded as a component of the cumulative translation adjustment within stockholders equity (and a component of comprehensive income). The income tax errors related principally to (1) the failure to record deferred tax assets totalling approximately $475,000 in 2000 related to two acquisitions which resulted in an overstatement of goodwill and (2) the impact of stock-based compensation associated with stock options issued prior to the Company s initial public offering in 2000. The Company did not record deferred tax assets associated with the amortization of stock-based compensation related to non-qualified stock options that are deductible for tax purposes. The Company had instead recognized the tax benefit associated with the exercise of these options at the date of exercise, to the extent of stock-based compensation recognized, and recorded any excess benefits to additional paid-in capital. The impact of these adjustments was reflected in the Annual Report on Form 10-K/A for the year ended December 31, 2004 filed with the Securities and Exchange Commission on April 25, 2005.

The Restatement for Prior Years is separate from, and in addition to, the restatement of our financial results for the first and second quarters of 2004, which resulted from an internal investigation into revenue recognition practices related to transactions with certain distributors and resellers, principally those of the Company s United Kingdom subsidiary, Embarcadero Europe Ltd. (the 2004 Restatement). The effects of the

2004 Restatement were reflected in the amended Quarterly Reports on Form 10-Q/A filed with the Securities and Exchange Commission on January 18, 2005.

ITEM 2. 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 condensed consolidated financial statements and related notes included in this Form 10-Q, and with our management s discussion and analysis included in the Company s Annual Report on Form 10-K/A for the year ended December 31, 2004, filed on April 25, 2005.

This report contains 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. Suc statements are only predictions. Risks and uncertainties and the occurrence of other events could cause actual results to differ materially from these predictions. The factors discussed below under Factors That May Affect Future Results should be considered carefully in evaluating Embarcadero and its 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 conform these statements to actual results.

Overview

We provide 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. We earn revenues from the worldwide sale of these software solutions and related maintenance and support services to corporations, government agencies, educational institutions, and other entities. Information technology (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 ability to execute our sales plans successfully. We have historically derived a significant percentage of our revenues from our DBArtisan product line. For the three and six months ended June 30, 2005, DBArtisan and DBArtisan add-on products accounted for more than 34% of our license revenues. 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 this product or its related product line.

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

Our key products and their 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

Table of Contents

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. In 2004, we continued to see improvements on the fundamentals of our market and broader acceptance of our core and new products, as our total revenues increased 8.4% to $56.3 million. In the first quarter of 2005, primarily due to an unexpected slowdown in closure rates of sales transactions in the United States that may have been Company specific or a result of macroeconomic changes, and also due to the organizational disruption in our U.K. subsidiary related to our Audit Committee investigation, we did not meet our revenue projections and total revenues decreased to $13.2 million for the three months ended March 31, 2005. However, with the stabilization of our U.K. operation in the second quarter, total revenue increased to $14.0 million.

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. Over the past 12 months, our general and administrative costs have increased significantly due to increased costs associated with new compliance requirements for public companies, increased costs associated with the restatement of our financials for prior periods, and increased legal costs associated with litigation and general legal services. We expect general and administrative costs will generally remain higher relative to prior periods as we incur ongoing incremental costs in order to comply with the Sarbanes-Oxley Act of 2002 and the additional rules and regulations promulgated by the SEC and NASDAQ National Market. These increased costs include the hiring of additional personnel, as well as costs related to outside legal, accounting and advisory services.

Our license and maintenance revenues, results of operations, cash flows from operations, and financial condition could be adversely affected in future periods by a renewed downturn in global economic conditions, increased competitive pressures and our own inability to execute on our sales plans.

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.

The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts in our consolidated financial statements. We evaluate our estimates on an on-going basis, including those related to revenue recognition, allowances for doubtful accounts and returns, capitalized research and development costs, lease related impairment loss, goodwill impairment, accounting for income taxes, and accounting for deferred stock-based compensation. We base our estimates on historical experience and on various other assumptions that we believe reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities. Although actual results have historically been reasonably consistent with management s expectations, the actual results may differ from these estimates or our estimates may be affected by different assumptions or conditions.

We believe there have been no significant changes during the six months ended June 30, 2005 to the items that we disclosed as our critical accounting policies and estimates in Management s Discussion and Analysis of Financial Condition and Results of Operations in our Annual Report on Form 10-K/A for the fiscal year ended December 31, 2004, filed with Securities and Exchange Commission on April 25, 2005.

Table of Contents

RESULTS OF OPERATIONS

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

	Three months ended June 30,		Six months ended June 30,	
	2005	2004 (as restated)	2005	2004 (as restated)
	(unaudited)		(unaudited)	
Revenues:				
License	46.4%	46.4%	46.4%	48.6%
Maintenance	53.6	53.6	53.6	51.4
Total revenues	100.0	100.0	100.0	100.0
Cost of revenues:				
License	1.5	1.6	1.7	1.5
Amortization of acquired technology	1.4	4.1	2.1	4.0
Maintenance	3.6	4.6	3.9	4.5
Total cost of revenues	6.5	10.3	7.7	10.0
Gross profit	93.5	89.7	92.3	90.0
Operating expenses:				
Research and development	27.5	29.0	28.7	27.7
Sales and marketing	39.4	37.8	41.5	36.8
General and administrative	15.9	11.4	17.9	9.9
Restructuring and impairment charges	0.0	30.2	0.0	14.7
Litigation settlement charge	4.1	0.0	2.1	0.0
Total operating expenses	86.9	108.4	90.2	89.1
Income (loss) from operations	6.6	(18.7)	2.1	0.9
Other income, net	2.1	1.1	2.1	1.3
Income (loss) before provision for income taxes	8.7	(17.6)	4.2	2.2
Provision for income taxes	(2.9)	8.4	(1.4)	0.8
Net income (loss)	5.8%	(9.2)%	2.8%	3.0%

Revenues (in thousands):

	Three months ended June 30,			Six months ended June 30,		
	2005	2004(as restated)	Percent change	2005	2004(as restated)	Percent change
		(unaudited)			(unaudited)	
Revenues:						
License	$ 6,478	$ 6,260	3.5%	$ 12,601	$ 13,467	(6.4)%
Maintenance	7,498	7,227	3.7	14,554	14,264	2.0
Total revenues	$ 13,976	$ 13,487	3.6%	$ 27,155	$ 27,731	(2.1)%

Total Revenues. Total revenues were $14.0 million for the three months ended June 30, 2005, an increase of 3.6% over the $13.5 million reported for the comparable period in 2004. The increase in total revenues was primarily due to an increase in total revenues generated by our U.K. subsidiary and increase in overall maintenance revenues. Total revenues were $27.2 million for the six months ended June 30, 2005, a decrease of 2.1% from $27.7 million reported for the comparable period in 2004. The decrease is mainly attributable to lower sales generated from the U.K. subsidiary in the first quarter of 2005.

Table of Contents

License. License revenues were $6.5 million for the three months ended June 30, 2005, representing a 3.5% increase from the $6.3 million reported for the comparable period in 2004. The increase in license revenues was attributable to higher international revenues generated through our U.K. subsidiary. License revenues were $12.6 million for the six months ended June 30, 2005, a decrease of 6.4% from the $13.5 million reported for the comparable period in 2004. The decrease was due to a significant decrease in license revenues generated by our U.K. subsidiary in the first quarter of 2005 and also to a lesser extent, due to lower sales closure rates in our North American sales operations during the first quarter of 2005. Future license revenues cannot be predicted and will vary based on IT spending, competitive conditions, varying revenue contribution from our international operations, and changes in the sales closure rates in North America.

Maintenance. Maintenance revenues were $7.5 million for the three months ended June 30, 2005, representing a 3.7% increase over the $7.2 million reported for the comparable period in 2004. Maintenance revenues increased 2.0% for the six months ended June 30, 2005 compared to the same period in 2004. Maintenance revenues vary with license revenue growth and maintenance renewal rates. Maintenance revenues increased primarily due to the consistent maintenance renewal rates among our customer base and increase in professional service revenues. We expect that maintenance revenue will remain consistent as a percentage of revenues or decline slightly as a percentage of total revenues, if license revenues increase.

Cost of Revenues (in thousands):

	Three months ended June 30,			Six months ended June 30,		
	2005	2004 (as restated)	Percent change	2005	2004 (as restated)	Percent change
		(unaudited)			(unaudited)	
Cost of revenues						
License	$ 216	$ 213	1.4%	$ 464	$ 422	10.0%
Amortization of acquired technology	192	556	(65.5)	564	1,111	(49.2)
Maintenance	504	620	(18.7)	1,062	1,242	(14.5)
	$ 912	$ 1,389	(34.3)%	$ 2,090	$ 2,775	(24.7)%

License. Cost of license revenues consists primarily of royalties, credit card processing fees and product media and packaging. Cost of license revenues was $216,000 for the three months ended June 30, 2005, as compared to $213,000 for the comparable period in 2004. The slight increase in dollars for the three months ended June 30, 2005, from the comparable period in 2004, was primarily due to increases in royalty fess and product media, packaging and shipping costs. Cost of license revenues was $464,000 for the six months ended June 30, 2005, as compared to $422,000 for the comparable period in 2004. The increase is attributable to higher royalty fees.

Amortization of acquired technology. This amortization relates to licensed technologies acquired from third parties that were deemed to have reached technological feasibility at the date of acquisition and therefore capitalized. The amortization of acquired technology was $192,000 and $556,000 for the three months ended June 30, 2005 and 2004, respectively. The amortization of acquired technology was $564,000 and $1,111,000 for the six months ended June 30, 2005 and 2004, respectively. In the second quarter of 2005, certain of our intangible assets became fully amortized, resulting in a decrease in amortization expense for the second quarter of 2005.

Maintenance. Cost of maintenance revenues primarily consists of customer support personnel and related expenses, including payroll, employee benefits and allocated overhead. Cost of maintenance revenues was $504,000 for the three months ended June 30, 2005 as compared to $620,000 for the comparable period in 2004. Cost of maintenance revenues was $1,062,000 for

17

the six months ended June 30, 2005 as compared to $1,242,000 for the comparable period in 2004. The decrease was primarily due to decreases in headcount and related wages and related expenses. We expect to hire additional support personnel to support our expanding product line and customer base, the cost of maintenance revenues may increase in the future.

Operating Expenses (in thousands):

	Three months ended June 30,			Six months ended June 30,		
	2005	2004 (as restated)	Percent change	2005	2004 (as restated)	Percent change
		(unaudited)			(unaudited)	
Operating expenses:						
Research and development	$ 3,840	$ 3,906	(1.7)%	$ 7,782	$ 7,680	1.3%
Sales and marketing	5,513	5,096	8.2	11,261	10,207	10.3
General and administrative	2,221	1,543	43.9	4,874	2,756	76.9
Restructuring charges		4,068	(100.0)		4,068	(100.0)
Litigation settlement charge	573		100.0	573		100.0
Total operating expenses	$ 12,147	$ 14,613	(16.9)%	$ 24,490	$ 24,711	(0.9)%

Research and Development. Research and development expenses primarily consist of personnel and related expenses, including payroll and employee benefits, allocated overhead, non-cash stock-based compensation, as well as expenses related to third party development services. Research and development expenses were $3.8 million for the three months ended June 30, 2005 and $3.9 million for the comparable period in 2004. The decrease was primarily due to a decrease in consulting services and third party development costs. Research and development expenses were $7.8 million for the six months ended June 30, 2005 and $7.7 million for the comparable period in 2004. The slight increase is due to the increases in third party development costs. We anticipate that we will continue to invest significant resources into research and development activities in order to develop new products, advance the technology in our existing products and to develop new business opportunities.

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, including advertising and other marketing programs. Sales and marketing expenses were $5.5 million for the three months ended June 30, 2005 and $5.1 million for the comparable period in 2004. For the six months ended June 30, 2005, sales and marketing expenses were $11.3 million compared to $10.2 million for the six months ended June 30, 2004. The increase was mainly due to the establishment of our enterprise and commercial sales force, which resulted in higher wages and related costs, higher commission compensation and sales related travel and entertainment expenses. We intend to selectively increase staff in our sales organization and to create select marketing programs and, accordingly, expect that future sales and marketing expenditures will increase slightly.

General and Administrative. General and administrative expenses primarily consist of personnel and related expenses, general operating expenses and non-cash stock-based compensation. General and administrative expenses were $2.2 million for the three months ended June 30, 2005 and were $1.5 million for the comparable period in 2004. General and administrative expenses were $4.9 million for the six months period ended June 30, 2005 and were $2.8 million for the comparable period in 2004. The increase in absolute dollars and as a percentage of revenues was mainly due to a $1.1 million increase in professional fees due to compliance with the Sarbanes-Oxley Act of 2002 and additional rules and regulations promulgated by the SEC and NASDAQ National Market, our Audit Committee investigation and financial restatement, $47,000 in recruitment fees associated with enhancing our accounting and finance capabilities and international management team, and a $126,000 increase in wage related expenses. We expect general and administrative costs to decrease as compared to 2004 as we complete implementation of measures to comply with new rules and regulations.

Provision for Income Taxes. Under SFAS No. 109, *Accounting for Income Taxes* (SFAS No. 109), deferred tax assets and liabilities are determined based on differences between the financial reporting and tax basis of assets and liabilities and are measured using enacted tax rates and laws that will be in effect when the differences are expected to reverse. SFAS No. 109 provides for the recognition of deferred tax assets if realization of such assets is more likely than not. The provision for income taxes was a tax expense of $408,000 for the three months ended June 30, 2005 and a tax benefit of $1,132,000 for the three months ended June 30, 2004. The estimated effective tax rate provision and benefit rates for the three months ended June 30, 2005 and 2004 was 34% and 48%, respectively. The provision for income taxes was a tax expense of $385,000 for the six months ended June 30, 2005 and a tax benefit of $208,000 for the six months ended June 30, 2004. The estimated effective tax provision rate for the six months ended June 30, 2005 was 34%. A tax benefit was recorded for the six months ended June 30, 2004. The tax benefit for the three and six months ended June 30, 2004 is primarily due to restructuring and impairment charges of $4.1 million recorded during the three months ended June 30, 2004 and the exercise of stock options, which typically creates disqualifying disposition which benefits the overall corporate tax rate. It is impossible to forecast the exercise of our outstanding common stock options or the disqualifying dispositions associated with them. The benefits received from the disqualifying dispositions can only be considered in calculating a tax rate in the period in which they are realized. In the past, our effective tax rate has declined due to occurrence of such disqualifying dispositions. There were no disqualifying dispositions during the three months ended March 31, 2005. There were disqualifying dispositions of $13,000 during the three months ended June 30, 2005.

We will continue to evaluate our ability to realize deferred tax assets on a quarterly basis. Significant management judgment is required in determining our provision for income taxes and our deferred tax assets and liabilities. In the event that actual results differ from these estimates or we adjust these estimates in future periods, we may need to adjust the effective rate for the current year.

We are currently under Internal Revenue Service (the IRS) audit of our United States federal income tax return for the fiscal year ended 2003. As of June 30, 2005, the IRS had not issued any proposed adjustments to the amounts reflected by us on our return. However, the calculation of our tax liabilities involves dealing with uncertainties in the application of complex tax regulations. If the IRS audit results in assessment of additional taxes due, there would be a material adverse impact on the results in operations for the period in which the matter is ultimately resolved or an unfavorable outcome becomes probable and reasonably estimable.

RECENT ACCOUNTING PRONOUNCEMENTS

In December 2004, FASB Staff Position No. FAS 109-2, Accounting and Disclosure Guidance for the Foreign Earnings Repatriation Provision within the American Jobs Creation Act of 2004 (FSP FAS 109-2) was issued, providing guidance under SFAS 109, Accounting for Income Taxes for recording the potential impact of the repatriation provisions of the American Jobs Creation Act of 2004 (Jobs Act), enacted on October 22, 2004. FSP FAS 109-2 allows time beyond the financial reporting period of enactment to evaluate the effects of the Jobs Act before applying the requirements of FSP FAS 109-2. Accordingly, we are evaluating the potential effects of the Jobs Act and have not adjusted our tax expense or deferred tax liability as of June 30, 2005. We will complete our evaluation by the end of 2005.

In December 2004, the FASB revised SFAS No. 123 (SFAS 123(R)), *Share-Based Payment,* which requires companies to expense the estimated fair value of employee stock options and similar awards. On April 14, 2005, the SEC adopted a new rule amending the compliance dates for SFAS 123(R). In accordance with the new rule, the accounting provisions of SFAS 123(R) will be effective for the Company beginning on January 1, 2006. The Company will adopt the provisions of SFAS 123(R) using a modified prospective application. Under a modified prospective application, SFAS 123(R) will apply to new awards and to awards that are outstanding on the effective date and are subsequently modified or cancelled. Compensation expense for outstanding awards for which the requisite service had not been rendered as of the effective date will be recognized over the remaining service period using the compensation cost calculated for pro forma disclosure purposes under SFAS 123. The Company is in the process of determining how the new method of valuing stock-based compensation as prescribed in SFAS 123(R) will be applied to valuing stock-based awards granted after the effective date and the impact the recognition of compensation expense related to such awards will have on its financial statements. The Company expects the adoption of SFAS 123(R) will have a material adverse impact on the Company s net income and net income per share.

Table of Contents

In March 2005, the SEC staff issued guidance on SFAS 123(R). Staff Accounting Bulletin No. 107 (SAB 107) was issued to assist preparers by simplifying some of the implementation challenges of SFAS 123(R) while enhancing the information that investors receive. SAB 107 creates a framework that is premised on two overarching themes: (a) considerable judgment will be required by preparers to successfully implement SFAS 123(R), specifically when valuing employee stock options; and (b) reasonable individuals, acting in good faith, may conclude differently on the fair value of employee stock options. Key topics covered by SAB 107 include: (a) valuation models SAB 107 reinforces the flexibility allowed by SFAS 123(R) to choose an option-pricing model that meets the standard s fair value measurement objective; (b) expected volatility SAB 107 provides guidance on when it would be appropriate to rely exclusively on either historical or implied volatility in estimating expected volatility; and (c) expected term the new guidance includes examples and some simplified approaches to determining the expected term under certain circumstances. The Company will apply the principles of SAB 107 in conjunction with its adoption of SFAS 123(R).

In March 2005, the FASB issued FIN 47, Accounting for Conditional Asset Retirement Obligations, an interpretation of FASB Statement No. 143 (FIN 47), which requires an entity to recognize a liability for the fair value of a conditional asset retirement obligation when incurred if the liability s fair value can be reasonably estimated. FIN 47 is effective for fiscal years ending after December 15, 2005. The Company is currently evaluating the effect that the adoption of FIN 47 will have on its consolidated results of operations and financial condition but does not expect it to have a material impact.

In May 2005, the FASB issued SFAS No. 154, Accounting Changes and Error Corrections (SFAS 154) which replaces Accounting Principles Board Opinions No. 20 Accounting Changes and SFAS No. 3, Reporting Accounting Changes in Interim Financial Statements An Amendment of APB Opinion No. 28. SFAS 154 provides guidance on the accounting for and reporting of accounting changes and error corrections. It establishes retrospective application, or the latest practicable date, as the required method for reporting a change in accounting principle and the reporting of a correction of an error. SFAS 154 is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005 and are required to be adopted by the Company in the first quarter of fiscal 2006. The Company is currently evaluating the effect that the adoption of SFAS 154 will have on its consolidated results of operations and financial condition but does not expect it to have a material impact.

LIQUIDITY AND CAPITAL RESOURCES

We have funded our business to date from cash generated by our operations and financings. In April 2000, we completed our initial public offering of common stock, generating net proceeds to us of approximately $43.0 million. As of June 30, 2005, we had cash, cash equivalents and short-term investments of $63.1 million.

Operating Activities

The table below aggregates certain line items from the cash flow statement to present the key items affecting our operating activities (in thousands):

	Six months ended June 30,	
	2005	**2004**

		(as restated)
	(unaudited)	
Net income	$ 762	$ 808
Non-cash adjustments	2,755	3,681
Increase in operating assets	1,179	383
Increase in operating liabilities	640	1,796
Net cash provided by operating activities	$ 5,336	6,668

Our primary source of operating cash flows is the collection of accounts receivable from our customers. We measure the effectiveness of our collections efforts by an analysis of average accounts receivable daily sales outstanding (DSO). Collection of accounts receivable and related DSO could fluctuate in the future periods due to timing and amount of our revenues and the effectiveness of our collection efforts. In the future, collections could also fluctuate based upon the payment terms we extend to our customers. In the past, our payment terms have typically been net thirty days. Our DSO for the six months ended June 30, 2005 and 2004 were 45 days and 48 days, respectively.

The non-cash adjustments include depreciation and amortization of property and equipment and intangible assets, as well as amortization of deferred stock-based compensation and options issued in exchange for services. These non-cash adjustments may increase or decrease and, as a result, positively or negatively impact our future operating results, but they will not have a corresponding impact on our cash flows. The decrease in non-cash adjustments were mainly due to a decrease of $680,000 in impairment charges, and a decrease of $404,000 in amortization of other intangible assets offset by an increase of $344,000 in non-cash stock based compensation amortization.

The increase in operating assets during the six months ended June 30, 2005 compared to the six months ended June 30, 2004 was primarily due to an increase in accounts receivable of $484,000 and a decrease of $312,000 in prepaid expenses and other assets. The decrease in operating liabilities during the six months ended June 30, 2005 compared to the six months ended June 30, 2004 was primarily due to an increase of $1,066,000 in deferred revenue, offset by a decrease in accounts payable and accrued liabilities of $2,222,000.

Our operating cash flows may be impacted in the future by the timing of payments to our vendors for accounts payable. We typically pay our vendors and service providers in accordance with their invoice terms and conditions. The timing of cash payments in future periods will be impacted by the nature of accounts payable arrangements and management s assessment of our cash inflows.

Investing Activities

The table below aggregates certain line items from the cash flow statement to present the key items affecting our investing activities (in thousands):

	Six months ended June 30,	
	2005	**2004**
	(unaudited)	
Proceeds from sales or maturities of investments	$ 58,440	$ 40,484
Purchase of investments	(59,165)	(49,262)
Purchase of property and equipment	(120)	(870)
Technology acquired and developed		(15)
Net cash used in investing activities	$ (845)	$ (9,663)

Table of Contents

The main use of cash used in investing activities during the six months ended June 30, 2005 is the purchase of marketable securities for investment purposes, which were converted from cash equivalents. We intend to be consistent with our historical investment practices and invest in high quality short-term investments. We expect to continue to acquire such investments in the future and receive proceeds from them as they mature or are sold.

Included in cash used in investing activities were purchases of property and equipment. For the six months ended June 30, 2005 and 2004, purchases of property and equipment were $120,000 and $870,000, respectively.

Financing Activities

The table below presents the key items affecting our financing activities (in thousands):

	Six months ended June 30,	
	2005	2004
	(unaudited)	
Repurchase of common stock	$ (2,076)	$ (588)
Payments of principal under capital lease obligation	(81)	(15)
Proceeds from exercise of stock options	242	2,422
Net cash provided by (used in) financing activities	$ (1,915)	$ 1,819

The primary source of cash in financing activities during the six months ended June 30, 2005 was the exercise of approximately 66,000 stock options for $242,000. The main use of cash in financing activities during the six months ended June 30, 2005 was the Company s repurchase of 356,000 shares of common stock as part of its stock repurchase program for $2.1 million. Our future liquidity and capital resources could be impacted by the cash proceeds we receive upon exercise of employee stock options. We cannot estimate the amount of such proceeds in the future. In addition, we currently have approximately 1.2 million shares authorized for repurchase. The timing of future repurchases and the price paid for the shares could have a material impact on our liquidity.

In June 2004, we entered into a $499,000 three-year capital lease agreement with a financial institution to finance acquisition of certain furniture and fixtures and computer equipment. The capital lease agreement bears interest of 6.1% per annum and has a $1 buyout at its expiration in June 2007. It is likely we will enter into additional capital lease arrangements as long as interest rates remain attractive.

In August 2004, we terminated our $3.0 million revolving credit facility with a financial institution. We did not intend to utilize this line of credit due to our liquidity position. The financial institution issued an irrevocable standby letter of credit for approximately $120,000 in relation to a real estate lease agreement executed in April 2004. The standby letter of credit expires on June 1, 2006.

We had net deferred tax assets totaling $4.7 million as of June 30, 2005 and December 31, 2004. We believe that these net assets will be realizable in the future. In addition, as of December 31, 2004, the Company had federal and state net operating loss carry forwards (NOLs) of approximately $5.0 million and $7.1 million, respectively. These NOLs can be carried forward to offset future taxable income, if any. The federal and state NOLs expire in 2006 through 2021, if not utilized. As of December 31, 2004, the Company had federal, state and foreign research and development credits of approximately $1.6 million, $234,000 and $592,000, respectively. The federal credits expire in 2020 through 2023. The foreign credits expire in 2011 through 2013. The state credits do not expire. Pursuant to the provisions of Section 382 of the Internal Revenue Code, the amount of benefits from NOLs available to the Company may be limited.

Our contractual obligations consist of facility lease commitments, operating leases for office equipment, and capital leases for property and equipment. In April 2004, we announced a restructuring plan, and, as a part of that plan, we entered in to a new five-year lease commitment and subleased the remainder of our long-term San Francisco office leases. Gross lease payment obligations under the non-cancelable operating and capital leases are as follows (in thousands):

Year Ending December 31,	Capital Lease	Operating Leases	Bank Letter Of Credit	Total
Remainder of 2005	$ 91	$ 802	$	$ 893
2006	182	1,395	120	1,697
2007	76	1,213		1,289
2008		707		707
2009		303		303
Total minimum lease payments	349	$ 4,420	$ 120	$ 4,889
Less: amount representing interest	18			
Present value of net minimum lease payments	$ 331			

We believe that our existing cash, cash equivalents, short-term investments and cash generated from operations will be sufficient to finance our operations through at least the next 18 months. If we fail to generate cash flow from operations in the future due to an unexpected decline in revenues or due to a sustained increase in cash expenditures in excess of revenues generated, our cash balances may not be sufficient to fund continuing operations without obtaining additional financing. If additional financing is needed, there can be no assurance that such financing will be available to us on reasonable business terms, or at all.

FACTORS THAT MAY AFFECT FUTURE RESULTS

In addition to other information in this report, the following factors should be considered carefully in evaluating the Company. The risks and uncertainties described below are not the only ones we face. Additional risks and uncertainties that we are unaware of or currently deem immaterial may also become important factors that may harm our business.

We have restated our previously issued financial statements and have material weaknesses in our internal control over financial reporting that require remediation. Pursuant to Section 404 of the Sarbanes-Oxley Act, we have concluded that our internal control over financial reporting was not effective as of December 31, 2004.

Our Annual Report on Form 10-K included restated consolidated financial information for fiscal years 2000 through 2003, as well as for the first three quarters of 2004. The restatement of financial information results from errors that were identified with respect to the accounting for the impact of foreign currencies and for income taxes. We concluded that these errors constituted material weaknesses in our internal control over financial reporting. The existence of material weaknesses precluded us from concluding that our internal control over financial reporting was effective as of December 31, 2004.

In addition, following the third quarter of 2004, our Audit Committee conducted 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. Upon completion of this investigation, we concluded that it was necessary to restate our financial statements to properly reflect sales to certain distributors and resellers on a sell-through basis, which is consistent with our revenue recognition policy, for the quarters ended March 31 and June 30, 2004. This restatement resulted from a material weakness in our internal control over financial reporting with respect to the reporting of transactions principally conducted by Embarcadero Europe. Following discovery of the material weakness, we have taken steps, including replacing certain employees of our U.K. subsidiary and appointing a new international controller as of March 2005, a new corporate controller with worldwide responsibilities in April 2005 and a compliance manager in June 2005, to strengthen our internal controls over financial reporting to prevent the recurrence of the circumstances that resulted in our determination to restate prior period financial statements.

Because we concluded that our internal control over financial reporting was not effective at December 31, 2004, we could be subject to regulatory sanctions and a loss of public confidence in our internal controls. In addition, any failure to implement required new or improved controls, or difficulties encountered in their implementation, could harm our operating results or cause us to fail to timely meet our regulatory reporting obligations. Any of these failures could have a negative effect on the trading price of our stock. Further, implementation of remediation procedures related to the material weaknesses will consume management s attention and result in increased general and administrative expenses.

We must meet ongoing stringent requirements of NASDAQ to maintain the listing of our common stock in the NASDAQ National Market.

The NASDAQ Stock Market notified us on November 17, 2004 that our securities were subject to delisting from the NASDAQ National Market due to our failure to timely file a Form 10-Q for the third quarter of 2004. We requested an oral hearing before a NASDAQ Listing Qualifications Panel (the NASDAQ Panel) to appeal the delisting proceedings and request additional time to file the Form 10-Q. This oral hearing occurred on December 21, 2004. The NASDAQ Panel took no action at that time. We filed the required Form 10-Q for the third quarter of 2004, along with Forms 10-Q/A for the quarters ended March 31, 2004 and June 30, 2004, all on January 18, 2005. By letter dated January 26, 2005, we received the determination of the Panel granting our request for continued listing in the NASDAQ National Market, subject to the condition that we timely file all required periodic reports for all reporting periods ending on or before December 31, 2005. Our failure to timely file our Annual Report on Form 10-K for the year ended December 31, 2004 resulted in non-compliance with the determination of the NASDAQ Panel. By letter dated April 19, 2005, the NASDAQ Stock Market notified us that our failure to timely file our Annual Report was an additional deficiency that would be considered by the NASDAQ Panel in its determination regarding our continued listing on the NASDAQ National Market. By letter dated May 5, 2005, we received a determination of the Panel granting our request for continued listing on the NASDAQ National Market, subject to continued monitoring of our periodic reports for the periods ending on or before December 31, 2005. If we fail to comply with NASDAQ s requirements for continued listing, we could be subject to immediate delisting. The delisting of our common stock would significantly affect the ability of investors to trade our securities and would significantly negatively affect the value and liquidity of our common stock.

Our quarterly operating results may fluctuate in future periods, and, as a result, our stock price may fluctuate or decline.

Our operating results have fluctuated from quarter to quarter. We believe that quarter-to-quarter comparisons of our historical results of operations are not indicative of our future performance. Our revenues and operating results may continue to vary significantly from quarter to quarter due to a number of factors, including the factors discussed below. Seasonal variations in orders for our products also contribute to fluctuations in our quarterly operating results. These fluctuations are likely to cause corresponding volatility in our stock price, particularly if our operating results vary from analysts expectations.

Increased costs associated with corporate governance compliance and our Audit Committee investigation may significantly impact the results of our operations.

Changing laws, regulations and standards relating to corporate governance, public disclosure and compliance practices, including the Sarbanes-Oxley Act of 2002, new SEC regulations and NASDAQ National Market rules, are creating uncertainty for companies such as ours in understanding and complying with these laws, regulations and standards. As a result of this uncertainty and other factors, devoting the necessary resources to comply with evolving corporate governance and public disclosure standards has resulted in increased general and administrative expenses and a diversion of management time and attention to compliance activities. We also expect these developments to continue to increase our legal compliance and financial reporting costs. In addition, these developments may make it more difficult and more expensive for us to obtain director and officer liability insurance, and we may be required to accept reduced coverage or incur substantially higher costs to obtain such coverage. Moreover, we may not be able to comply with these new rules and regulations on a timely basis. These developments could make it more difficult for us to attract and retain qualified members of our board of directors or qualified executive officers.

Additionally, we have incurred significant legal, accounting and consulting costs in connection with our Audit Committee investigation completed in January 2005. The costs of the investigation totaled $2.0 million, of which $189,000 was recorded in operating expenses in the six month period ended June 30, 2005. As a result, our results of operations for the six months ended

Table of Contents

June 30, 2005 were adversely affected. In addition, we expect to continue to incur higher general and administrative expenses as a result of the new personnel added to our finance organization as we continue to remediate the material weaknesses identified in our internal control over financial reporting.

If sales of DBArtisan fall, our revenues and income may decline.

A significant portion of our revenues is derived from sales of our DBArtisan product. For the three and six months ended June 30, 2005, DBArtisan and DBArtisan add-on products accounted for more than 34% of our license revenues, which is consistent with similar percentages of our license revenues in 2004 and 2003. We expect that sales of DBArtisan will continue to represent a substantial portion of our license revenues for the foreseeable future. In addition, many of our customers initiate a relationship with us by purchasing DBArtisan. If demand for DBArtisan declines due to competition, technological change or other factors, our revenues and income may decline significantly.

If our products do not perform as expected, we may lose customers, our costs will increase and revenues may be delayed or lost.

Computer software such as ours often contains undetected errors and may contain design flaws. Errors may be found in current versions, new versions, or enhancements of our products after we make commercial shipments. If our software contains undetected errors, performs unreliably, or if we otherwise fail to meet our customers expectations, we may suffer:

- loss of revenues, market share or customers;
- negative publicity and harm to our reputation;
- diversion of research and development and management resources;
- increased maintenance and warranty costs;
- legal actions by customers against us; and
- increased insurance costs.

If we do not generate new business from our existing customers and add new customers from our new or existing products, we will not be able to sustain or increase our revenues.

Our license arrangements generally do not provide for substantial ongoing license or maintenance payments. Therefore, our future revenue growth depends on our success in expanding our relationships with existing customers and attracting new customers. Our ability to expand our relationships with existing customers and attract new customers will depend on a variety of factors, including the performance, quality, breadth, and depth of our current and future products and maintenance. Our failure to expand relationships with existing customers or to add new customers would reduce our future license and maintenance revenues. In addition, if our existing customers do not renew their support contracts, our future maintenance revenues will be adversely affected.

Our operating results would be harmed if the recovery of information technology spending does not continue.

The markets into which we sell our products are cyclical and are subject to general economic conditions. Although the information technology market has recovered in second half of 2003 and was generally better in 2004, economic conditions remain uncertain and the recovery may not be sustained. During the first six months of 2005, we experienced a slowdown in sales closure rates in the United States that may have been Company specific or a result of macroeconomic changes. Any slowdown in the database market or in general economic conditions would likely result in a reduction in demand for our products and our results of operations would be harmed.

If we are not able to attract and retain qualified personnel, our business will not be able to grow.

Our success depends on the continued service of our executive officers and other key administrative, sales and marketing, research and development, and support personnel. None of our executive officers or key employees is bound by an employment agreement for any specific term, and we do not maintain any key person life insurance policies.

We have added, and we continue to recruit, new personnel for our finance and sales organization. We have enhanced our accounting and finance capabilities by appointing new worldwide controller and international controllers. In addition, we have recently appointed new vice presidents of international sales and product development. Our business will not be able to grow if we cannot continue to fill these positions and attract, retain, and motivate other qualified personnel. Competition for qualified employees remains intense and we may not be able to attract, assimilate, or retain highly qualified personnel in the future. There has been in the past and there may also be in the future a shortage of personnel that possess the technical background necessary to sell, support, and develop our products effectively. It has also become more difficult to recruit qualified financial personnel since the implementation of the new laws, regulations and standards relating to corporate governance, public disclosure and financial reporting. Some of our current employees and those that we seek to hire may be subject to non-competition or non-solicitation covenants that could further limit our ability to attract or retain qualified personnel.

Our financial statements have been and could again be impacted by unauthorized and improper actions of our personnel.

As we have experienced with our recent restatements, our financial statements can be adversely impacted by our employees errant or improper actions. For instance, revenue recognition depends on, among other criteria, the terms negotiated in our contracts with our customers. Our personnel may act outside of their authority and negotiate additional terms without our knowledge which could impact our ability to recognize revenue in a timely manner. For instance, in the event that our sales personnel have negotiated terms that do not appear in the contract and of which we are unaware, whether the additional terms are written or oral, we could be prevented from recognizing revenue in accordance with our policy. Furthermore, depending on when we learn of unauthorized actions and the size of transactions involved, we may have to restate our financial statements for a previously reported period, which could seriously harm our business, operating results and financial condition. We have implemented new controls to prevent such conduct, but we cannot be certain that these new controls will be effective.

We invest heavily in research and development with no guarantee of return from the investments that we make.

We have invested significant resources in the development of new products. If our new products are not accepted in the marketplace, we may not achieve future revenue growth and may have limited return on the investments that we have made. In addition, we plan to continue to invest in research and development and could fail to achieve expected returns from future investments.

If we are not able to enhance our existing products to adapt to rapid technological change, or we introduce new products that do not achieve market acceptance, our revenues and earnings may suffer and we may experience loss of market share.

The market for our products is characterized by rapid technological change, frequent product introductions and enhancements, uncertain product lifecycles, and changes in customer demands and industry standards. Our success depends on our ability to continue to:

- enhance our current products;
- introduce new products that keep pace with technological developments and market conditions;
- satisfy increasingly complicated customer requirements;
- integrate our products with multiple database platforms; and
- modify our products as database platforms change.

However, due to the nature of computing environments, new products and product enhancements could require longer development and testing periods than we currently anticipate. Moreover, if we develop new products that do not achieve market acceptance, we may not be able to recoup development and marketing expenses, which could harm our operating results.

The introduction of new technologies and the emergence of new industry standards may render our existing products obsolete and unmarketable. Delays in the general availability of new releases or problems in the installation or implementation of new releases could harm our business and operating results. We may not be successful in developing and marketing, on a timely and cost-effective basis, new products or new product enhancements that respond to technological change, evolving industry standards, or customer requirements. Our failure to do so would render our products obsolete and could harm our ability to compete. In addition, our products and product enhancements may not achieve market acceptance.

Table of Contents

Large sales of our products and maintenance involve a lengthy sales cycle, which could cause delays in recognizing revenue or the failure to obtain revenue.

Our field sales focus on large sales of our products where the product packages are larger with higher starting prices and longer evaluation periods than our traditional products. These large sales typically involve sales cycles between six and twelve months. This lengthy sales cycle is due to the need to educate and convince prospective customers of the value of our products and to gain approval from more constituencies within a prospective account, including key management personnel.

The timing of our revenues has become more difficult to forecast because of this lengthy sales cycle for large sales. We may expend substantial time and resources to negotiate transactions with prospective customers but then be delayed in concluding, or be unable to conclude, sales of our products and maintenance. Any delay in, or failure to complete, sales in a particular period would reduce our revenues in that period as well as in subsequent periods over which revenues for the sale may be recognized. If we were to experience a delay on one or more large orders, it could harm our ability to meet our forecasts for a given period. If our sales cycle unexpectedly lengthens in general or for one or more large sales, it could negatively affect the timing of our revenues and may cause our revenues and operating results to vary significantly from period to period.

Our high fixed operating expenses might adversely affect our profitability if future revenue expectations are not met.

The majority of our operating expenses consist of personnel and related expenses and facility related costs. These costs are relatively fixed in the short-term, and our operating decisions such as when to hire additional personnel and when to expand our facilities and infrastructure are based in large part on expectations about expected future revenues. If we hire personnel and enter into facilities contracts based on our expectations about future revenues, and then fail to meet those revenue expectations, we would likely have lower than expected earnings per share, which would negatively affect our stock price.

We may have future non-recurring charges in the event of goodwill impairment.

We adopted SFAS No. 142 on January 1, 2002, and, as a result, we ceased to amortize goodwill. We now test our goodwill for impairment on an annual basis or in the event of a significant change in our business. We performed our last impairment test in September 2004 and determined that there had been no impairment to our goodwill. As of June 30, 2005, our goodwill balance was $10.7 million. In the future, if we determine that this goodwill has been impaired, we will be required to take a non-recurring charge to write down this asset, which would adversely affect our earnings and book value.

The expansion of our international operations exposes us to risks.

We expect to continue to expand our international sales and research and development operations. As a result, we could face a number of risks from our expanding international operations:

- staffing and managing foreign operations;

complying with increased financial accounting and reporting complexities, including implementing effective internal controls across international operations;

complying with foreign redundancy notification and severance payment obligations;

potentially adverse tax consequences;

the loss of revenues and net income resulting from currency fluctuations;

compliance with a wide variety of complex foreign laws and treaties;

the impact of war or terrorist activities;

reduced protection for intellectual property rights in some countries;

licenses, tariffs and other trade barriers;

longer sales and payment cycles; and

costs and difficulties of customizing products for foreign countries.

Further expansion of our international operations may require significant management attention and financial resources and may place burdens on our management, administrative, operational and financial infrastructure. Our possible investments to establish facilities in other countries may not produce desired levels of revenues or profitability, which would negatively affect our stock price.

We may lose market share and be required to reduce prices as a result of competition from our existing competitors and other independent software vendors and developers of software.

The market for our products is highly competitive, dynamic, and subject to rapidly changing technology. Pricing pressure in the market has increased as competitors have lowered prices and engaged in more aggressive discounting. If such pricing pressure continues, it could have an adverse effect on our margins.

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 products also compete with products offered by database software manufacturers, including Oracle, Microsoft, Sybase and IBM. Some of these competing products are provided at no charge to their 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 technical, financial, marketing and distribution resources in those efforts. We may not be able to compete effectively with those products or efforts, which could significantly harm our business and operating results.

There has been consolidation in our industry, such as IBM s acquisition of Rational Software and Borland Software Corporation s acquisition of Togethersoft. These and any future acquisitions may have the effect of improving the competitive positions of the acquired companies and weakening our competitive situation. To effectively compete as the industry consolidates, we may need to seek alliances with other companies in order to gain better acceptance of our products. We may not be able to enter into such alliances on terms favorable to us or at all.

In addition, if the market for application and data lifecycle management products grows, some of our competitors may increase their focus on offering software directly competitive with ours, whether by internal development, external development, or acquisition. Our competitors may also attempt to keep us from integrating our software with theirs, making it more difficult for our customers to adopt our software. If such increased competition were to result in resistance to integration of our software with the software of these competitors, we may have difficulty entering markets where our competitors have strong market positions.

Further, if a single database platform were to gain a considerably larger share of the database market than other database platforms, we would lose our multi-platform competitive advantage and our sales would suffer. Many of our competitors have longer operating histories, substantially greater financial, technical, marketing and other resources, and greater name recognition than we do. They also may be able to respond more quickly than we can to changes in technology or customer requirements. Competition could seriously impede our ability to sell additional products on acceptable terms. Our competitors may pursue the following actions:

- develop and market new technologies that render our products obsolete, unmarketable or otherwise less competitive;
- make strategic acquisitions or establish cooperative relationships among themselves or with other companies, thereby enhancing the functionality of their products; or

establish or strengthen cooperative relationships with channel or strategic partners which limit our ability to sell or to co-market products through these channels.

Competitive pressures could reduce our market share, reduce customer orders, reduce gross margins, or require us to reduce our prices, any of which would harm our operating results.

International political instability may increase our cost of doing business and disrupt our business.

Continued international political instability, evidenced by the threat or occurrence of terrorist attacks, enhanced national security measures, sustained military action in Afghanistan and Iraq, strained international relations with foreign governments and other international conflicts, may halt or hinder our ability to do business, may increase our costs, and may adversely affect our stock price. This continued instability may, for example, negatively impact the reliability and cost of transportation, negatively affect the desire of our employees and customers to travel, adversely affect our ability to obtain adequate insurance at reasonable rates, or require us to take extra security precautions for our domestic and international operations. In addition, this international political instability has had and may continue to have negative effects on financial markets, including significant price and volume fluctuations in securities markets. If this international political instability continues or escalates, our business and results of operations could be harmed and the market price of our common stock could decline.

Our proprietary rights may be inadequately protected and infringement claims or independent development of competing technologies could harm our competitive position.

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. Despite such precautions, unauthorized third parties may be able to copy aspects of our products or obtain and use information that we consider as proprietary.

We license our software products primarily under shrink-wrap licenses delivered electronically with our software products. Shrink-wrap licenses are not negotiated with or signed by individual licensees and purport to take effect upon installation of the product or downloading of the product from the Internet. These measures afford only limited protection. Policing unauthorized use of our products is difficult and we are unable to determine the extent to which piracy of our software exists. In addition, the laws of some foreign countries do not protect our proprietary rights as well as the laws of the United States. 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. Litigation is generally very expensive and can divert the attention of management from daily operations. Accordingly, any intellectual property litigation could disrupt our operations and harm our operating results. Further, the cost we may need to incur in connection with the defense of such lawsuits, if significant, could harm our financial condition.

We are not aware of any case in which we are infringing the proprietary rights of others. However, third parties may bring infringement claims against us. Any such claim is likely to be time consuming and costly to defend, could cause product delays and could force us to enter into unfavorable royalty or license agreements with third parties. A successful infringement claim against us could require us to enter into a license or royalty agreement with the claimant or develop alternative technology. However, we may not be able to negotiate favorable license or royalty agreements, if any, in connection with such claims and we may fail to develop alternative technology on a timely basis. Accordingly, a successful product infringement claim against us could harm our business and operating results.

Acquisitions of companies or technologies may result in disruptions to our business.

We may make strategic acquisitions of companies, products, or technologies as necessary in order to implement our business strategy. If we make acquisitions and are unable to successfully integrate them with our existing operations, we may not receive the intended benefits of such acquisitions and the revenues and operating results of the combined company may decline. Any acquisition may temporarily disrupt our operations and divert management s attention from day-to-day operations.

In addition, acquisitions may subject us to unanticipated liabilities or risks, including litigation and the costs and uncertainties related to legal proceedings. For example, we recently settled litigation related to our acquisition of Engineering Performance, Inc, in November 2000, incurring litigation settlement costs of approximately $573,000 in the six months ended June 30, 2005.

While we have financed our acquisitions to date primarily through our working capital, we may incur debt or issue equity securities to finance future acquisitions. The issuance of equity securities for any acquisition could be substantially dilutive to our stockholders. In addition, our profitability may suffer due to acquisition-related expenses.

We are susceptible to business interruptions that could harm our business.

Our operations are vulnerable to damage or interruption from computer viruses, human errors, natural disasters, telecommunications failures, intentional acts of vandalism, and other similar events. In particular, our corporate headquarters are located in San Francisco, which is known for its seismic activities. Although we have a disaster recovery plan for critical data and business applications, this does not provide assurance that we would not suffer a business interruption. A significant business interruption would result to losses or damages to our operation and harm our business. Our business interruption insurance may not be adequate to compensate us for losses that might occur, which would result in increased expenses and harm our operating results.

Table of Contents

Certain persons have substantial control over us, which could impede stockholder approval of certain transactions.

Our executive officers and directors, in the aggregate, beneficially held 24% of our outstanding common stock as of June 30, 2005. These stockholders, if acting together, can significantly influence all matters requiring approval by our stockholders, including the approval of equity compensation plans, the election of directors and the approval of mergers or other business combination transactions.

We expect the price of our common stock to remain volatile, making it difficult for our stockholders to predict the return on their investment.

Since our initial public offering, the market price of our common stock has fluctuated significantly in response to a number of factors, including:

- market reactions to our announcement of the restatements of our financial statements for the years 2000, 2001, 2002 and 2003, the inability of the investing public to rely on our previously issued financial information for those years and the quarters ended March 31, June 30, and September 30, 2004 and 2003, and the delayed filing of the Form 10-K for 2004;
- market reaction to our announcement of the delayed filing of our Form 10-Q for the quarter ended September 30, 2004, and the inability of the investing public to rely on our previously issued financial statements for the quarters ended March 31 and June 30, 2004;
- changes in market valuation of software and technology companies;
- quarterly variations in our operating results;
- global and domestic economic and political conditions;
- changes in financial estimates by securities analysts;
- announcements that we or our competitors make related to significant contracts, acquisitions, capital commitments, strategic partnerships or product introductions or enhancements;
- additions or departures of key personnel;
- stock market price and volume fluctuations, which are particularly volatile among securities of software and Internet companies; and
- sales of significant amounts of our common stock or other securities in the open market.

Provisions of our charter and bylaws and Delaware law could deter takeover attempts that might be beneficial to our stockholders.

Provisions of our amended and restated certificate of incorporation and bylaws as well as Delaware law could make it more difficult for a third party to acquire us, even if doing so would be beneficial to our stockholders. We are subject to the provisions of Delaware law that restrict business combinations with interested stockholders, which may have the effect of inhibiting a non-negotiated merger or other business combinations.

An unfavorable government review of our tax returns or changes in our effective tax rates could adversely affect our operating results.

Our operations are subject to income and transaction taxes in the United States and in multiple foreign jurisdictions. Our tax filings are subject to review or audit by the Internal Revenue Service and state, local and foreign taxing authorities. We exercise judgment in determining our worldwide provision for income taxes and, in the ordinary course of our business, there may be transactions and calculations where the ultimate tax determination is uncertain.

Table of Contents

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Interest Rate Risk

Our exposure to market risk for changes in interest rates primarily relates to our investment portfolio, which at June 30, 2005 included auction rate securities with a fair value of approximately $53.2 million. The primary objective of our investment activities is to preserve principal while at the same time maximizing the income we receive from our investments without significantly increasing risk. From time to time, some of the securities in which we invest may be subject to market risk. This means that a change in prevailing interest rates may cause the principal amount of the investment to fluctuate. For example, if we hold a security that was issued with an interest rate fixed at the then-prevailing rate and the prevailing interest rate later rises, the principal amount of our investment will probably decline. To minimize this risk in the future, we intend to maintain our portfolio of cash equivalents, marketable securities in money market funds, tax-exempt municipal auction rate securities and tax exempt municipal bonds. The risk associated with fluctuating interest rates is limited to our investment portfolio. Based on our portfolio as of June 30, 2005, if interest rates were to change by 10%, interest income could be impacted positively or negatively by approximately $23,000 on an annualized basis. There would be no material impact on the fair market value of the portfolio. As of June 30, 2005, all of our investments were in tax-exempt municipal auction rate securities.

Foreign Exchange Risk

Our operations are conducted primarily in the United States and are denominated in United States dollars. A small but growing portion of our sales originate through our European subsidiary and are denominated in Pounds Sterling. With respect to such sales, revenues are collected and operating expenses are generally paid in Pounds Sterling. Accordingly, we are exposed to volatility in sales and earnings within Europe due to fluctuations in foreign exchange rates.

Our exposure to foreign exchange risk is related to the magnitude of foreign net profits and losses denominated in Pound Sterling, as well as our net position of monetary assets and monetary liabilities in Pound Sterling. These exposures have the potential to produce either gains or losses within our consolidated results.

In addition, our European operations in some instances act as a natural hedge because both operating expenses and sales are denominated in local currency. In these instances, although an unfavorable change in the exchange rate of Pound Sterling against the U.S. dollar will result in lower sales when translated to U.S. dollars, operating expenses will also be lower.

We believe an immediate increase of 10% in the exchange rates of the U.S. dollar to Pound Sterling may have a material impact on our operating results or cash flows. For example, in 2004 the Pound Sterling exchange rate strengthened by approximately 12% over 2003, which improved earnings per share by approximately $0.01.

Our international business is subject to risks, including, but not limited to changing economic conditions, changes in political climate, differing tax structures, other regulations and restrictions, and foreign exchange rate volatility when compared to the United States. Accordingly, our future results could be materially adversely impacted by changes in these or other factors.

ITEM 4. CONTROLS AND PROCEDURES

(a) Evaluation of Disclosure Controls and Procedures

Our Chief Executive Officer and Chief Financial Officer evaluated the effectiveness of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities and Exchange Act of 1934) as of the end of the period covered by this report. Based upon this evaluation, our Chief Executive Officer and Chief Financial Officer have concluded that our disclosure controls and procedures were not effective as of June 30, 2005 due to the material weaknesses in our internal controls over financial reporting previously reported in our Annual Report on Form 10-K/A filed on April 25, 2005.

(b) Changes in Internal Controls over Financial Reporting

During the quarter ended June 30, 2005, in addition to the steps disclosed in our 10-Q for the quarter ended March 31, 2005, we continued to take steps to strengthen our internal controls over financial reporting. These steps have included the following:

- We continued to enhance the corporate finance oversight and controls over key financial activities for foreign subsidiaries, such as cash management, manual journal entries and daily sales postings.

Table of Contents

We continued to improve our policies requiring corporate finance approval before granting credit to and accepting returns from distributors and resellers and end users.

We continued to recruit new personnel to our finance organization to enhance our oversight of international operations and improve our internal control function. We appointed a corporate controller with worldwide responsibilities in April 2005 and a compliance manager in June 2005.

We continue to strengthen our internal controls in the area of tax preparation, primarily by engaging external tax advisors to assist in the preparation and review of our income tax calculations.

We have enhanced our capabilities in the area of accounting for foreign currency translation and foreign currency transactions by hiring a new corporate and international controller with expertise in these areas.

While we believe we have enhanced, and will continue to enhance, our controls over financial reporting with the steps above and by implementing other previously disclosed measures, as of June 30, 2005, we cannot conclude that these new internal controls are effective until they operate for a sufficient period of time and are tested with satisfactory results.

PART II

OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

Information with respect to this item is incorporated by reference to Note 10 of the Notes to the Condensed Consolidated Financial Statements included herein on page 12 of this Quarterly Report on Form 10-Q.

ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

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. This stock repurchase program may be terminated at any time. The following table sets forth information on the Company s common stock repurchase program activity for the quarter ended June 30, 2005 (amounts in thousands, except average price paid per share):

	Number of Shares Purchased	Average Price Paid Per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Maximum Number of Shares that may yet be Purchased under Plans or Programs

April 1 April 30, 2005		$	2,692	1,538
May 1 May 31, 2005	131	$ 5.71	2,823	1,407
June 1 June 30, 2005	214	$ 5.84	3,037	1,193
Total:	345	$ 5.79	3,037	1,193

ITEM 5. OTHER INFORMATION

On July 13, 2005, the Compensation Committee of our Board of Directors approved an increase to the annual base salary of Raj P. Sabhlok, the Company s Chief Financial Officer and Senior Vice President of Corporate Development, after a review of his performance and competitive market data. Mr. Sabhlok s new annual base salary is $225,000.

32

Table of Contents

ITEM 6. EXHIBITS

(a) Exhibits:

The following documents are furnished as Exhibits to this Report:

31.1	Certification of Stephen Wong pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification of Raj Sabhlok pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	Certification of Stephen Wong pursuant to Rule 13a-14(b) of the Securities Exchange Act of 1934 and 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
32.2	Certification of Raj Sabhlok pursuant to Rule 13a-14(b) of the Securities Exchange Act of 1934 and 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

SIGNATURE

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

EMBARCADERO TECHNOLOGIES , INC .

By: /s/ Raj P. Sabhlok

Raj P. Sabhlok

Chief Financial Officer and Senior Vice President

of Corporate Development

Date: August 8, 2005