EMBARCADERO TECHNOLOGIES INC
Form 10-Q
January 18, 2005
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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 September 30, 2004.

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

100 CALIFORNIA STREET, SUITE 1200

SAN FRANCISCO, CA 94111

(415) 834-3131

(Address of principal executive offices)

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

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

The number of shares outstanding of the Registrant s Common Stock as of December 31, 2004 was 26,326,813.

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PART I- FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

EMBARCADERO TECHNOLOGIES, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS

(in thousands, except par value)

(unaudited)

	September 30, 2004	December 31, 2003
ASSETS		
Current Assets:		
Cash and cash equivalents	$ 50,520	$ 45,066
Short-term investments	7,480	12,901
Trade accounts receivable, net	6,617	8,237
Prepaid expenses and other current assets	2,065	1,670
Deferred income taxes	415	465
Total current assets	67,097	68,339
Property and equipment, net	3,023	3,259
Goodwill	10,337	10,337
Other intangible assets, net	86	692
Deferred income taxes	3,777	3,711
Other assets, net	2,255	3,692
Total assets	$ 86,575	$ 90,030
LIABILITIES AND STOCKHOLDERS EQUITY		
Current Liabilities:		
Accounts payable	$ 490	$ 1,011
Accrued liabilities	5,492	5,098
Capital lease obligations	173	
Deferred revenue	13,320	13,219
Total current liabilities	19,475	19,328
Long-term deferred revenue	169	251
Long-term capital lease obligations	274	
Long-term restructuring accrual	1,906	203
Total liabilities	21,824	19,782
Stockholders Equity:		

Common stock at $0.001 par value	26	28
Treasury stock at cost	(17,469)	(6,287)
Additional paid-in capital	85,586	80,145
Accumulated other comprehensive income	439	374
Deferred stock-based compensation	(3,007)	(1,519)
Accumulated deficit	(824)	(2,493)
Total stockholders equity	64,751	70,248
Total liabilities and stockholders equity	$ 86,575	$ 90,030

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

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EMBARCADERO TECHNOLOGIES, INC.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(in thousands, except per share data)

(unaudited)

	Three months ended September 30,		Nine months ended September 30,	
	2004	**2003**	**2004**	**2003**
Revenues:				
License	$ 7,097	$ 6,864	$ 20,564	$ 19,632
Maintenance	6,928	6,290	21,192	18,175
Total revenues	14,025	13,154	41,756	37,807
Cost of revenues:				
License	283	168	705	373
Amortization of acquired technology	556	556	1,667	1,667
Maintenance	572	565	1,814	1,718
Total cost of revenues	1,411	1,289	4,186	3,758
Gross profit	12,614	11,865	37,570	34,049
Operating expenses:				
Research and development	3,915	3,987	11,595	11,793
Sales and marketing	5,204	4,602	15,411	14,341
General and administrative	2,260	1,263	5,016	3,873
Restructuring and impairment charges			4,068	
Total operating expenses	11,379	9,852	36,090	30,007
Income from operations	1,235	2,013	1,480	4,042
Other income, net	210	79	529	364
Income before provision for income taxes	1,445	2,092	2,009	4,406
Provision for income taxes	(692)	(607)	(340)	(1,278)
Net income	$ 753	$ 1,485	$ 1,669	$ 3,128
Net income per share:				
Basic	$ 0.03	$ 0.06	$ 0.06	$ 0.12
Diluted	$ 0.03	$ 0.05	$ 0.06	$ 0.11
Shares used in per share calculation:				

Basic	26,604	26,525	27,044	26,553
Diluted	28,078	28,458	28,778	28,289
Non-cash stock-based compensation included in the above expenses:				
Cost of revenues	$ 7	$	$ 9	$
Research and development	227	55	282	61
Sales and marketing	222	60	552	242
General and administrative	276	55	593	302
	$ 732	$ 170	$ 1,436	$ 605

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

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EMBARCADERO TECHNOLOGIES, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands)

(unaudited)

	Nine months ended September 30,	
	2004	**2003**
Cash from Operating Activities:		
Net income	$ 1,669	$ 3,128
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	1,360	1,582
Recovery of doubtful accounts	(53)	(66)
Deferred income taxes	(16)	
Impairment charges	680	
Amortization of developed technology	1,465	1,167
Amortization of other intangible assets	606	606
Amortization of deferred stock-based compensation	1,378	542
Issuance of options in exchange for services	58	63
Changes in assets and liabilities:		
Trade accounts receivable	1,816	(68)
Prepaid expenses and other assets	(434)	(229)
Accounts payable and accrued liabilities	1,801	1,180
Deferred revenue	(252)	1,405
Net cash provided by operating activities	10,078	9,310
Cash from Investing Activities:		
Purchase of investments	(11,393)	(13,496)
Maturities of investments	16,799	11,700
Sales of investments		17,717
Purchase of property and equipment	(1,300)	(817)
Technology acquired and developed	(45)	(275)
Net cash provided by investing activities	4,061	14,829
Cash from Financing Activities:		
Payments for repurchase of common stock	(11,182)	(1,171)
Payments of principal under capital lease obligation	(52)	
Proceeds from exercise of stock options	2,519	150
Net cash used in financing activities	(8,715)	(1,021)
Effect of exchange rate changes on cash and cash equivalents	30	92
Net increase in cash and cash equivalents	5,454	23,210
Cash and cash equivalents at the beginning of the period	45,066	15,870

Cash and cash equivalents at the end of the period	$ 50,520	$ 39,080

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

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EMBARCADERO TECHNOLOGIES, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(unaudited)

INTRODUCTION

The Audit Committee of our Board of Directors recently completed an investigation focused on our revenue recognition practices related to transactions with certain distributors and resellers, principally those of our United Kingdom subsidiary, Embarcadero Europe Ltd. (Embarcadero Europe). Upon completion of this investigation, we concluded that it was necessary to restate certain financial data to properly reflect sales to certain international 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. The financial statements presented in this report give effect to such restatement.

NOTE 1 - THE COMPANY AND BASIS OF PRESENTATION

Embarcadero Technologies, Inc. (with its subsidiaries, collectively referred to as Embarcadero or 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 Maidenhead, United Kingdom; Toronto, Canada; and Melbourne, Australia.

The Company markets its software and related maintenance services directly through telesales and field sales organizations in North America, the United Kingdom and Australia, and indirectly through original equipment manufacturers (OEMs) and 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, 2003 was derived from the audited financial statements, but it does not include all disclosures required by generally accepted accounting principles.

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 for the year ended December 31, 2003, filed on March 12, 2004.

Operating results for the three and nine months ended September 30, 2004 are not necessarily indicative of the results that may be expected for the full year ending December 31, 2004, 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.

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NOTE 2 - SIGNIFICANT ACCOUNTING POLICIES

Principles of Consolidation

The consolidated financial statements include the accounts of Embarcadero Technologies, Inc. and its wholly-owned subsidiaries: Embarcadero Europe Ltd., Embarcadero Canada Ltd. and Embarcadero Australia Ltd. The Company has eliminated all inter-company accounts and transactions.

Use of Estimates

The preparation of financial statements in conformity with generally accepted accounting principles (GAAP) requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amount of revenues and expenses during the reporting period.

Cash and Cash Equivalents

Cash and cash equivalents include all highly liquid investments with an original maturity of three months or less at the time of purchase. The Company s cash and other cash equivalents at September 30, 2004 and December 31, 2003 consisted of deposits in banks, money market funds and short-term securities.

Concentration of Credit Risk

Financial instruments, which potentially subject the Company to concentrations of credit risk, consist primarily of cash and cash equivalents and trade accounts receivable. The Company maintains its cash and cash equivalents with high quality financial institutions and invests in highly rated short-term securities.

The Company maintains an allowance for doubtful accounts resulting from the inability of our customers to make required payments. The allowance was $81,000 at September 30, 2004. The amount of our allowance is based on historical experience and an analysis of the current accounts receivable. Credit losses to date have been within management s expectations. However, actual results could differ from such estimates. As of September 30, 2004 and December 31, 2003 there were no customer balances in excess of 10% of aggregate accounts receivable.

Property and Equipment

Property and equipments are stated at cost less accumulated depreciation, computed using the straight-line method based on the estimated useful lives of the assets, generally ranging from three to five years. Depreciation commences upon placing the asset in service. Capital leases are recorded at the lesser of the fair value of the leased asset at the inception of the lease or the present value of the minimum lease payments as of the beginning of the lease term. Leased assets are amortized on a straight-line basis over the estimated useful life of the asset or the lease term. Leasehold improvements are amortized over the shorter of the useful life or the remaining lease term. The Company reviews its property and equipment for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable.

Impairment of Long-Lived Assets

The Company reviews its long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable or that the useful lives of the assets are no longer appropriate. Factors considered important which could trigger an impairment review include, but are not limited to, significant underperformance relative to expected historical or projected future operating results and significant changes in the manner of use of the acquired assets or the strategy for the Company s overall business. When the Company determines that the carrying value of long-lived assets may not be recoverable based upon the existence of one or more of the above indicators of impairment, then it measures any impairment based on a projected discounted cash flow method using a discount rate commensurate with the risk inherent in the Company s current business model.

Accounting for Goodwill

Goodwill represents the excess of the purchase price over the fair value of net assets acquired in business combination. In July 2001, the Financial Accounting Standards Board (FASB) approved the issuance of SFAS No. 142, *Goodwill and Other Intangible Assets*. SFAS No. 142 provides guidance on how to account for goodwill and

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certain intangible assets after an acquisition is completed. The most substantive change is that goodwill and other indefinite life intangible assets can no longer be amortized but instead should be periodically tested for impairment. Embarcadero adopted SFAS No. 142 on January 1, 2002 and has ceased amortization of goodwill and will evaluate it for impairment in accordance with its policies.

Revenue Recognition

The Company s revenues are primarily derived from software license fees and related maintenance and support contracts. Revenues from software license fees are recognized upon shipment, when terms of the contracts are Freight on Board (F.O.B.) shipping point, provided that evidence of an arrangement exists, the fee is fixed or determinable and collection of the resulting receivable is probable. Maintenance and support contracts generally cover a one-year term and are paid for in advance. Revenues from maintenance and support contracts are recognized ratably over the term of the contract. License revenues include the nominal shipping and handling charges associated with most of the license orders. The actual shipping costs that we incur are included in the cost of revenues.

The Company uses purchase orders, signed contracts and pre-payments via check, wire or credit card as persuasive evidence for substantiation of an arrangement. For arrangements with multiple obligations (e.g., undelivered maintenance and support contracts and consulting and training services bundled with licenses), the Company allocates revenues to the delivered elements of the arrangement using the residual value method based on the vendor specific objective evidence (VSOE) for the undelivered items. The VSOE for post contract services (PCS) is determined based upon prices paid by the customers for the separate renewal or sale of such services. If the Company cannot determine the VSOE for PCS, then the entire arrangement fee is recognized ratably over the contractual PCS period (explicit rights to PCS) or the period during which PCS is expected to be provided (implicit rights to PCS).

The Company typically grants its customers net 30 payment terms, but some payments are collected in advance via check, wire or credit card upon receipt of an order.

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

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

The Company does not have a return or refund policy and its practice is to enforce the terms of the contracts and not allow its customers to return their software products, and as such past sales returns have not been material. However, the Company has allowed a small number of its customers to return their software products, and therefore has recorded a reserve of $25,000 as of September 30, 2004.

Foreign Currency Translation

The functional currencies of the Company s foreign subsidiaries are their respective local currencies. The Company translates the assets and liabilities of international subsidiaries into the U.S. Dollar at the current rates of exchange in effect during each period. Revenues and expenses are translated using rates that approximate the average of those in effect during the period. Gains and losses from translation adjustments are included in stockholders equity in the consolidated balance sheet caption Accumulated other comprehensive income .

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Deferred Revenue

Deferred revenue represents amounts received from customers under certain maintenance and service contracts for which the revenue earnings process has not been completed. The revenue will be recognized ratably over the life of the contract or when the service is rendered.

Income Taxes

The Company uses the asset and liability method of accounting for income taxes based on Statement of Financial Accounting Standards (SFAS) No. 109, *Accounting for Income Taxes*. Under the asset and liability method, deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between financial statement carrying amounts and the tax basis of existing assets and liabilities. The Company records a valuation allowance to reduce tax assets to an amount for which realization is more likely than not. There are certain charges that are not deductible for tax purposes. The Company recorded a restructuring charge of $4.1 million during the three months ended June 30, 2004, and a significant portion of this amount may not be deductible for tax purposes in the current year. Thus, the statutory income tax rate used for determination of tax liability will likely differ from the effective income tax rate used for the calculation of income tax provision for financial reporting purposes.

Stock-based Compensation

The Company has adopted stock-based compensation plans that provide for the grant of options and restricted stock to employees and directors of the Company. All options granted under these plans typically vest over terms of three to four years. The restricted stock is subject to transfer restrictions that lapse over time, typically one to two years.

The Company accounts for stock-based employee compensation using the intrinsic value method in accordance with Accounting Principles Board (APB) Opinion No. 25 and related interpretations, which generally requires that the amount of compensation cost that must be recognized, if any, is the quoted market price of the stock at the measurement date, which is generally the grant date, less the amount the grantee is required to pay to acquire the stock.

Alternatively, Statement of Financial Accounting Standards (SFAS) No. 123, *Accounting for Stock-Based Compensation*, employs fair value-based measurement and generally results in the recognition of compensation expense for all stock-based awards to employees. SFAS No. 123 does not require an entity to adopt those provisions, but rather, permits continued application of APB Opinion No. 25. The Company has elected not to adopt the recognition and measurement provisions of SFAS No. 123 and continues to account for its stock-based employee compensation plans under APB Opinion No. 25 and related interpretations. In accordance with APB Opinion No. 25, deferred compensation is generally recorded for stock-based employee compensation grants based on the excess of the market value of the common stock on the measurement date over the exercise price. The deferred compensation is amortized to expense over the vesting period of each unit of stock-based employee compensation granted. If the exercise price of the stock-based compensation is equal to or exceeds the market price of the Company s common stock on the date of grant, no compensation expense is recorded.

For the three and nine months ended September 30, 2004, the Company issued restricted stock grants with an associated deferred compensation expense of $918,000 and $3.7 million, respectively. The deferred compensation expense will be amortized to expense over the period that the transfer restrictions are in effect. For the three and nine months ended September 30, 2004, the Company recorded compensation expense related to restricted stock grants of $732,000 and $1.4 million, respectively. For the three and nine months ended September 30, 2003, the Company did not record any compensation expense related to restricted stock grants.

The compensation expense recorded for restricted stock grants under the intrinsic value method is consistent with the expense that would be recorded under the fair value-based method. Had the compensation cost for the Company s employee stock option grants been determined based on the grant date fair values of awards estimated using the Black-Scholes option pricing model, which is consistent with the method described in SFAS No. 123, the

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Company s reported net income and net income per share would have been reduced to the following pro forma amounts (in thousands, except per share amounts):

	Three months ended September 30,		Nine months ended September 30,	
	2004	2003	2004	2003
	(unaudited)		(unaudited)	
Net income, as reported	$ 753	$ 1,485	$ 1,669	$ 3,128
Employee stock-based compensation expense included in reported net income, net of tax	434	87	817	451
Total employee stock-based compensation expense determined under fair value, net of tax	(1,048)	(438)	(2,646)	(1,980)
Pro forma net income (loss)	$ 139	$ 1,134	$ (160)	$ 1,599
Basic net income (loss) per share:				
As reported	$ 0.03	$ 0.06	$ 0.06	$ 0.12
Pro forma	$ 0.01	$ 0.04	$ (0.01)	$ 0.06
Diluted net income (loss) per share:				
As reported	$ 0.03	$ 0.05	$ 0.06	$ 0.11
Pro forma	$ 0.00	$ 0.04	$ (0.01)	$ 0.06

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 September 30,		Nine months ended September 30,	
	2004	2003	2004	2003
	(unaudited)		(unaudited)	
Risk free interest rate	3.02-3.78%	2.33-6.65%	2.40-3.78%	2.33-6.65%
Expected life	4	4	4	4
Expected dividends	$	$	$	$
Volatility	99%	113%	99%	113%

In connection with the financial restatement discussed in Note 12 below, and as a result of the delayed filing of its Quarterly Report on Form 10-Q for the quarter ended September 30, 2004, the Company suspended all exercises of stock options under each of its equity compensation plans from November 16, 2004 through the filing date of this report. This suspension was required because the Company s periodic reports are incorporated by reference into the registration statements for the securities issuable under each such equity compensation plan. The Company has extended the exercisability of all options that would otherwise have terminated during that period for a period of time equal to that during which the options were not exercisable due to the suspension. Accordingly, the Company will record a stock-based compensation charge in the quarter ending December 31, 2004 to record the intrinsic benefit received by the optionees for the extension of time to exercise their options

New Accounting Pronouncements

In May 2003, the FASB issued SFAS No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*. SFAS No. 150 establishes standards for how an issuer classifies and measures in its statement of financial position certain financial instruments with characteristics of both liabilities and equity. It requires an issuer to classify a financial instrument that is within its scope as a liability (or an asset in some circumstances) because that financial instrument embodies an obligation of the issuer. In November 2003, the FASB issued FASB Staff Position No.150-3 which deferred the effective date for instruments that are mandatorily redeemable on fixed dates for amounts that either are fixed or are determined by reference to an interest rate index, currency index or another external index by one year, so that, for those instruments, the provisions of SFAS No. 150 are effective for fiscal periods beginning after December 15, 2004, and for all other financial instruments that are mandatorily redeemable, the classification, measurement and disclosure provisions of SFAS No. 150 are deferred indefinitely, pending further FASB action. The FASB, at this time, is reconsidering the implementation issues, as well as, perhaps, classification or measurement guidance for those non-controlling interests during the deferral period. To date, the effective provisions of SFAS No. 150 did not have an impact on the financial position or the results of operations of the Company. Although the effective date of certain elements of SFAS No. 150 has been deferred, the adoption of SFAS No. 150, once finalized, is not expected to have an impact on the Company s financial position or the results of operations since the Company does not currently have any financial instrument that has been impacted by the standard.

In March 2004, the FASB issued EITF Issue No. 03-01 (EITF 03-01), *The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments*, which provides new guidance for assessing impairment losses on investments. Additionally, EITF 03-01 includes new disclosure requirements for investments that are deemed to be temporarily impaired. In September 2004, the FASB delayed the accounting provisions of EITF 03-01; however, the disclosure requirements remain effective for annual periods ending after June 15, 2004. The Company will evaluate the impact of EITF 03-01 once the final guidance is issued.

In October, 2004, the President signed the American Jobs Creation Act of 2004 (the Act). The Act creates a temporary incentive for U.S corporations to repatriate accumulated income earned abroad by providing an 85 percent dividends received deduction for certain dividends from controlled foreign corporations. The deduction is subject to a number of limitations and, as of today, uncertainty remains as to how to interpret numerous provisions in the Act.

In December 2004, FASB issued Statement of Financial Accounting Standards (SFAS) No. 123 (Revised 2004), *Share-Based Payment*. The new pronouncement replaces the existing requirements under SFAS No.123 and APB 25. According to SFAS No. 123 (R), all forms of share-based payments to employees, including employee stock options and employee stock purchase plans, would be treated the same as any other form of compensation by recognizing the related cost in the Statement of Operations. This pronouncement eliminates the ability to account for stock-based compensation transactions using APB No. 25 and generally would require instead that such transactions be accounted for using a fair-value based method, with a binomial or lattice model preferred to the Black-Scholes valuation model. The lattice model can explicitly capture expected changes in dividends and stock volatility over the expected life of the options, in contrast to the Black-Scholes option-pricing model, which uses weighted average assumptions about option pricing. FASB concluded that for public companies SFAS No. 123 (R) is effective for awards and stock options granted, modified or settled in cash in interim or annual periods beginning after June 15, 2005. SFAS No. 123 (R) provides transition alternatives for public companies to restate prior interim periods or prior years. The Company is in the process of evaluating the impact of this standard on its statement of operation.

NOTE 3 - OTHER COMPREHENSIVE INCOME

Other comprehensive income consists of unrealized loss on available-for-sale investments reported at fair value and foreign currency translation adjustments during the period.

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

	Three months ended September 30,		Nine months ended September 30,	
	2004	**2003**	**2004**	**2003**
	(unaudited)		(unaudited)	
Net income, as reported	$ 753	$ 1,485	$ 1,669	$ 3,128
Unrealized loss on available-for-sale investments	(3)		(10)	(112)
Foreign currency translation adjustments	92	9	26	39
Comprehensive income	$ 842	$ 1,494	$ 1,685	$ 3,055

NOTE 4 - EARNINGS PER SHARE

Basic net income per share excludes the effect of potentially dilutive securities and is computed by dividing net income by the weighted average number of common shares outstanding for the period. Diluted net income 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 per share is as follows (in thousands, except per share data):

	Three months ended September 30,		Nine months ended September 30,	
	2004	**2003**	**2004**	**2003**
	(unaudited)		(unaudited)	
Calculation of basic net income per share:				
Net income	$ 753	$ 1,485	$ 1,669	$ 3,128
Weighted average common shares outstanding	26,604	26,525	27,044	26,553
Net income per share, basic	$ 0.03	$ 0.06	$ 0.06	$ 0.12
Calculation of diluted net income per share:				
Net income	$ 753	$ 1,485	$ 1,669	$ 3,128
Weighted average - common shares outstanding	26,604	26,525	27,044	26,553
Dilutive securities - common stock options and shares subject to repurchase	1,474	1,933	1,734	1,736
Weighted average - common shares outstanding and potentially dilutive common shares	28,078	28,458	28,778	28,289
Net income per share, diluted	$ 0.03	$ 0.05	$ 0.06	$ 0.11
	1,928	1,055	1,169	1,227

Anti-dilutive common stock options and non-vested common stock, not included in net income (loss) per share calculation				

NOTE 5 - ACCOUNTING FOR GOODWILL AND OTHER INTANGIBLE ASSETS

Between January 1, 2004 and September 30, 2004, there were no changes to the Company s goodwill balance of $10.3 million. The Company performed its last 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.

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Other intangible assets subject to amortization consist of acquired technology that is being amortized over a period of four years as follows (in thousands):

	As of September 30, 2004			As of December 31, 2003		
	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
		(unaudited)			(unaudited)	
Other intangible assets:						
Acquired technology	$ 3,230	$ 3,144	$ 86	$ 3,230	$ 2,538	$ 692

The other intangible assets will be fully amortized during the three months ending December 31, 2004.

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*. For the three and nine months ended September 30, 2004, the Company capitalized $30,000 and $45,000 of software development costs. For the comparable periods in 2003, the Company capitalized $0 and $275,000, respectively. Capitalized software costs subject to amortization consist of technology that is being amortized over a period of 36 months. The capitalized software at September 30, 2004 will be fully amortized within 1 and 2 years. The software development costs are as follows (in thousands):

	As of September 30, 2004			As of December 31, 2003		
	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
		(unaudited)				
Capitalized software	$ 6,268	$ 4,247	$ 2,021	$ 6,223	$ 2,783	$ 3,440

The net capitalized software costs are classified as Other assets on the Company s balance sheet.

NOTE 7 - RESTRUCTURING AND IMPAIRMENT LOSS

During the three months ended June 30, 2004, the Company recorded a restructuring and impairment charge of $4.1 million related to the consolidation of our office leases in San Francisco. The restructuring charge is based on net present value of the Company s future contractual lease obligations net of any sublease income and any incidental expenses related to restructuring.

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 Leasehold Improvements	Other Restructuring Expenses	Total
		(unaudited)		
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 reduction of accrual		(680)		(680)
Net cash payments during the nine months ended September 30, 2004	(502)		(499)	(1,001)
Accrual balance as of September 30, 2004	$ 2,733	$	$ 67	$ 2,800

As of September 30, 2004, approximately $1.9 million of the restructuring accrual is recorded as long-term liabilities.

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 July 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. During the nine months ended September 30, 2004, the Company repurchased approximately 1,519,000 shares at a cost of approximately $11.2 million. In calendar year ended December 31, 2003, the Company repurchased approximately 231,000 shares at a cost of approximately $1.2 million.

	Number of Shares (thousands)	Cost of Repurchase	Average Cost
		(unaudited)	
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		
Total authorized for repurchase	3,230		
Shares repurchased in 2001	218	$ 1,781	$ 8.17
Shares repurchased in 2002	713	3,335	4.68
Shares repurchased in 2003	231	1,171	5.07
Shares repurchased during the three months ended June 30, 2004	52	588	11.31
Shares repurchased during the three months ended September 30, 2004	1,467	10,594	7.22
Total shares repurchased	2,681	$ 17,469	$ 6.52

Remaining shares available for repurchase at September 30, 2004	549		

In October 2004, the Board of Directors amended the Company s stock repurchase program to increase the number of shares authorized to repurchase by an additional 1,000,000 shares.

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NOTE 9 - GEOGRAPHIC AND SEGMENT REPORTING

Operating segments are components of a business enterprise that its chief operating decision maker considers when allocating resources to its different segments and making assessments on their performances. By this definition, the Company 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 by geographic regions are as follows (in thousands):

	Three months ended September 30,		Nine months ended September 30,	
	2004	2003	2004	2003
	(unaudited)		(unaudited)	
Revenues:				
North America	$ 11,537	$ 10,612	$ 33,103	$ 30,265
United Kingdom	992	915	3,246	2,486
Other	1,496	1,627	5,407	5,056
Total	$ 14,025	$ 13,154	$ 41,756	$ 37,807

Long-lived assets by geographic regions are as follows:

	As of September 30, 2004	As of December 31, 2003
	(unaudited)	
Long lived assets:		
North America	$ 2,729	$ 3,059
United Kingdom	263	183
Other	31	17
Total	$ 3,023	$ 3,259

NOTE 10 - COMMITMENTS AND CONTINGENCIES

Bank Credit Facility

On August 31, 2004, the Company terminated its $3.0 million revolving 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, 2005.

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 duration of the subleases is $962,000 payable as follows: years 2005 through 2007, $269,000 per year and $155,000 in 2008.

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The Company entered into a three-year capital lease agreement in June 2004, for approximately $500,000 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):

Year Ending December 31,	Operating Leases	Capital Lease	Bank Letter of Credit	Total
Remainder of 2004	$ 287	$ 45	$	$ 332
Fiscal year 2005	1,524	182	120	1,826
Fiscal year 2006	1,333	182		1,515
Fiscal year 2007	1,146	76		1,222
Thereafter	1,350			1,350
Total	$ 5,640	$ 485	$ 120	$ 6,245

Contingencies

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

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

NOTE 11 RESTATEMENT OF FINANCIAL STATEMENTS

The Audit Committee of our Board of Directors recently completed an 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 certain financial data to properly reflect sales to certain international 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.

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The Audit Committee s independent investigation concluded on January 5, 2005, and identified certain revenue recognition practices that were determined not to be in compliance with our stated revenue recognition policy. Pursuant to our stated policy, we recognize revenue from sales by distributors and resellers on a sell-through basis, meaning that revenue is recognized only when persuasive evidence of an arrangement with an end user exists and all other revenue recognition criteria are met. The investigation resulted in the conclusion that revenue from certain transactions entered into during 2004 between Embarcadero Europe and certain of its distributors and resellers had not been recorded on a sell-through basis, thereby resulting in fees that were not fixed and determinable as required by Statement of Position (SOP) 97-2, *Software Revenue Recognition.*

As a result of the investigation, the Audit Committee determined that certain distributors and resellers had an implied right to (i) pay us only when they were paid by end users, (ii) return product in the event that a sale to an end user was ultimately not consummated or (iii) pay us on extended terms beyond their initial contractual obligations. Had we accounted for the subject transactions giving consideration to these implied rights, we would not have recorded revenues in the period in which they were originally recorded, as the fees associated with the contracts would not have been fixed and determinable.

As a result of the foregoing factors, and to correct an error in calculating the amortization of our deferred revenue related to maintenance contracts generated by Embarcadero Europe in the quarter ended June 30, 2004, we have restated our financial results for the three and six months ended March 31 and June 30, 2004, to conform to our internal revenue recognition policies to recognize revenue from sales by distributors and resellers on a sell-through basis. The restatement excludes revenue previously recognized from certain distributors and resellers, and defers it until all criteria for the recognition of revenue have been satisfied. Further, the restatement corrects an error in calculating the amortization of our deferred revenue related to maintenance contracts generated by Embarcadero Europe in the quarter ended June 30, 2004. As a result of the restatement, total revenues have decreased by $181,000 for the quarter ended March 31, 2004, $366,000 for the quarter ended June 30, 2004, and $547,000 for the six months ended June 30, 2004; net income has decreased by $130,000 for the quarter ended March 31, 2004, net loss increased by $326,000 for the quarter ended June 30, 2004, and net income has decreased by $456,000 for the six months ended June 30, 2004; and diluted earnings per share has decreased $0.01 for the quarter ended March 31, 2004, basic and diluted loss per share increased by $0.01 for the quarter ended June 30, 2004, and basic and diluted earnings per share decreased by $0.02 for the six months ended June 30, 2004.

None of the adjustments described above had any impact on cash balances for any affected period. However, our condensed consolidated statements of cash flows and certain items in the cash provided by operating activities were restated to reflect the restated net income (loss) and revisions to certain balance sheet accounts. There were no other changes to the consolidated statements of cash flows.

NOTE 12 SUBSEQUENT EVENTS

From November 5, 2004 to November 10, 2004, multiple class action lawsuits were filed against the Company and certain of its officers in the United States District Court for the Northern District of California. Each lawsuit purports to be filed on behalf of all purchasers of the Company s securities from April 20, 2004 through October 27, 2004, inclusive (the class period), and each lawsuit alleges various violations of securities laws during the class period. The lawsuits seek unspecified damages.

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

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. Such statements are only predictions. Risks and uncertainties and the occurrence of other events could cause actual results to differ materially from these predictions. The 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.

This Management s Discussion and Analysis of Financial Condition and Results of Operations gives effect to the restatement of our consolidated financial statements for the quarters ended March 31 and June 30, 2004. 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 our Annual Report on Form 10-K for the year ended December 31, 2003, filed on March 12, 2004, and with the Forms 10-Q/A for the quarters ended March 31, 2004 and June 30, 2004, each filed on January 18, 2005.

The Audit Committee of our Board of Directors recently completed an investigation focused on our revenue recognition practices related to transactions with certain distributors and resellers, principally those of our United Kingdom subsidiary, Embarcadero Europe. As a result of the investigation, the Audit Committee determined that certain distributors and resellers had an implied right to (i) pay us only when they were paid by end users, (ii) return product in the event that a sale to an end user was ultimately not consummated or (iii) pay us on extended terms beyond their initial contractual obligations. Had we accounted for the subject transactions giving consideration to these implied rights, we would not have recorded revenues in the period in which they were originally recorded, as the fees associated with the contracts would not have been fixed and determinable.

As a result of the foregoing, and an error in calculating the amortization of our deferred revenue related to maintenance contracts generated by Embarcadero Europe in the quarter ended June 30, 2004, total revenues have decreased by $181,000 for the quarter ended March 31, 2004, $366,000 for the quarter ended June 30, 2004, and $547,000 for the six months ended June 30, 2004; net income has decreased by $130,000 for the quarter ended March 31, 2004, net loss has increased by $326,000 for the quarter ended June 30, 2004, and net income has decreased by $456,000 for the six months ended June 30, 2004; and diluted earnings per share has decreased $0.01 for the quarter ended March 31, 2004, basic and diluted loss per share have increased by $0.01 for the quarter ended June 30, 2004, and basic and diluted earnings per share have decreased by $0.02 for the six months ended June 30, 2004.

The restatement adjustments did not materially affect our reported deferred revenue balances. None of the adjustments described above had any impact on cash balances or net cash provided by operating activities for any period. However, our condensed consolidated statements of cash flows and certain items in the cash provided by operating activities were restated to reflect the restated net income (loss), and revisions to certain balance sheet accounts. There were no other changes to the consolidated statements of cash flows.

Overview

We provide data management solutions that help organizations cost-effectively build, optimize, test, and manage their critical data, database, and application infrastructures. We earn revenues from the world-wide sale of these software solutions and related maintenance and support services to corporations, government agencies, educational institutions, and other entities. 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. 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.

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Our key products and their functionality are summarized below:

Embarcadero

Solution	Related Products	Description
Model-Driven Data Solutions	ER/Studio	Captures business requirements and helps translate them into database applications from a graphical user interface.
	DT/Studio	Provides data integration capabilities across disparate data sources. Interfaces with almost any relational or non-relational data store and provides extensive data integration functionality.
Cross-Platform Data Management	DBArtisan	Ensures the availability, performance, security, and recoverability of applications through cross-platform management of databases from a single graphical console. New Analyst Series add-on products proactively manage and optimize performance, storage, and capacity.
	Rapid SQL	Streamlines the process of developing complex database code in a graphical environment and mitigates the differences between different database platforms.
	Embarcadero Job Scheduler	Automates the scheduling and management of database jobs and routine tasks across the enterprise.
Data Performance and Availability	Performance Center	Monitors production databases to avert problems that could affect the availability and performance of mission-critical applications.
	Extreme Test	Employs goals-based performance to allow enterprises to emulate realistic utilization scenarios to help optimize and ensure application performance and availability.

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 the first quarter of 2004, we noticed some improvements to the fundamentals of our market. Towards the end of the second quarter, however, we encountered an abrupt, and perhaps temporary, slow down in IT spending, and we were not able to close some key transactions. Any renewed slowdown in the global economy could adversely impact our revenue growth and profitability.

Slightly stronger IT spending, better sales execution in the U.S. market and new product offerings increased our total revenues to $14.0 million and $41.8 million for the three and nine months ended September 30, 2004, as compared to $13.2 million and $37.8 million for the corresponding periods in 2003.

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. The operating expenditures for the three and nine months ended September 30, 2004, were at $11.4 million and $36.1 million, respectively, as compared to $9.9 million and $30.0 million for the three and nine months ended September 30, 2003, respectively.

As discussed above, our Audit Committee recently completed an accounting investigation. The Committee engaged independent legal and accounting experts to conduct the investigation. We estimate that the cost of the investigation will be between $2.1 million and $2.3 million, which will be recorded in operating expenses in the three month period ending December 31, 2004.

Our revenues for the three and nine months ended September 30, 2004 increased by 6.6% and 10.5%, respectively, while the operating expenditures, including the restructuring and impairment charges of $4.1 million, increased by 15.5% and 20.3%, respectively, for the same periods.

Our cash flow from operations was approximately $10.1 million for the nine months ended September 30, 2004. Cash, cash equivalents, and short-term investments were $58 million at September 30, 2004, which remained unchanged compared to December 31, 2003, including cash payments of approximately $11.2 million related to acquisition of common stock under the Company s stock repurchase program during the nine months ended September 30, 2004.

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

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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 September 30,		Nine months ended September 30,	
	2004	**2003**	**2004**	**2003**
	(unaudited)		(unaudited)	
Revenues:				
License	50.6%	52.2%	49.2%	51.9%
Maintenance	49.4	47.8	50.8	48.1
Total revenues	100.0	100.0	100.0	100.0
Cost of revenues:				
License	2.0	1.3	1.7	1.0
Amortization of acquired technology	4.0	4.2	4.0	4.4
Maintenance	4.1	4.3	4.3	4.5
Total cost of revenues	10.1	9.8	10.0	9.9
Gross profit	89.9	90.2	90.0	90.1
Operating expenses:				
Research and development	27.9	30.3	27.8	31.2
Sales and marketing	37.1	35.0	36.9	37.9
General and administrative	16.1	9.6	12.0	10.3
Restructuring and impairment charges			9.7	
Total operating expenses	81.1	74.9	86.4	79.4
Income from operations	8.8	15.3	3.5	10.7
Other income, net	1.5	0.6	1.3	1.0
Income before provision for income taxes	10.3	15.9	4.8	11.7
Provision for income taxes	(4.9)	(4.6)	(0.8)	(3.4)
Net income	5.4%	11.3%	4.0%	8.3%

Revenues

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

	Three months ended September 30,				Nine months ended September 30,			
			Change				Change	
	2004	2003	Amount	Percent	2004	2003	Amount	Percent
&								