

EMBARCADERO TECHNOLOGIES INC  
Form 10-Q  
August 09, 2006  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**  
**Washington, D.C. 20549**

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**Form 10-Q**

**QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**  
For the quarterly period ended June 30, 2006.

**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

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**EMBARCADERO TECHNOLOGIES, INC.**

(Exact Name of Registrant as Specified in Its Charter)

<b>Delaware</b> (State or other jurisdiction of incorporation or organization)	<b>68-0310015</b> (I.R.S. Employer Identification No.)
<b>100 CALIFORNIA STREET, SUITE 1200</b>	

**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 such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.  Yes  No

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Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer

Accelerated filer

Non-accelerated filer

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).  Yes  No

The number of shares outstanding of the Registrant's Common Stock as of August 1, 2006 was 25,860,834.

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**Table of Contents****PART I - FINANCIAL INFORMATION****ITEM 1. FINANCIAL STATEMENTS****EMBARCADERO TECHNOLOGIES, INC.****CONDENSED CONSOLIDATED BALANCE SHEETS**

(in thousands)

	June 30, 2006 (unaudited)	December 31, 2005 (1)
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 15,018	\$ 7,943
Short-term investments	52,857	52,026
Trade accounts receivable, net	7,560	9,407
Prepaid expenses and other current assets	1,813	1,863
Deferred income taxes	397	377
Total current assets	77,645	71,616
Property and equipment, net	1,771	2,059
Goodwill	14,091	13,920
Other intangible assets, net	2,554	3,037
Deferred income taxes	2,500	2,500
Other assets, net	25	24
Total assets	\$ 98,586	\$ 93,156
<b>LIABILITIES AND STOCKHOLDERS EQUITY</b>		
Current liabilities:		
Accounts payable	\$ 240	\$ 817
Accrued liabilities	5,820	5,291
Capital lease obligations	143	161
Deferred revenue	17,617	15,802
Total current liabilities	23,820	22,071
Long-term capital lease obligations	19	87
Long-term deferred revenue	228	180
Long-term restructuring accrual	719	1,061
Total liabilities	24,786	23,399
Commitments and contingencies (Note 10)		
Stockholders' Equity:		
Common stock: \$0.001 par value	26	26
Treasury stock	(20,664)	(20,664)
Additional paid-in capital	86,877	87,295
Accumulated other comprehensive income	532	333
Deferred stock-based compensation		(1,948)

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Retained earnings	7,029	4,715
Stockholders' equity	73,800	69,757
Total liabilities and stockholders' equity	\$ 98,586	\$ 93,156

- (1) The balance sheet as of December 31, 2005 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		Six Months Ended	
	June 30, 2006	June 30, 2005	June 30, 2006	June 30, 2005
<b>Revenues:</b>				
License	\$ 6,670	\$ 6,478	\$ 13,283	\$ 12,601
Maintenance	8,294	7,498	16,203	14,554
Total revenues	14,964	13,976	29,486	27,155
<b>Cost of revenues:</b>				
License	149	216	286	464
Amortization of acquired technology	199	192	398	564
Maintenance	691	504	1,341	1,062
Total cost of revenues	1,039	912	2,025	2,090
Gross profit	13,925	13,064	27,461	25,065
<b>Operating expenses:</b>				
Research and development	4,386	3,840	9,046	7,782
Sales and marketing	5,497	5,513	11,670	11,261
General and administrative	2,177	2,221	4,503	4,874
Litigation settlement charge		573		573
Total operating expenses	12,060	12,147	25,219	24,490
Income from operations	1,865	917	2,242	575
Other income, net	469	294	908	572
Cumulative effect of change in accounting principle			200	
Income before provision for income taxes	2,334	1,211	3,350	1,147
Provision for income taxes	(702)	(408)	(1,042)	(385)
Net income	\$ 1,632	\$ 803	\$ 2,308	\$ 762
<b>Net income per share basic</b>	\$ 0.06	\$ 0.03	\$ 0.09	\$ 0.03
<b>Net income per share diluted</b>	\$ 0.06	\$ 0.03	\$ 0.08	\$ 0.03
<b>Weighted average shares outstanding basic</b>	25,845	26,200	25,789	26,091
<b>Weighted average shares outstanding diluted</b>	27,610	27,482	27,432	27,509
<b>Non-cash stock-based compensation included in the above expense:</b>				
Cost of revenues	\$ 21	\$ 3	\$ 41	\$ 7

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Research and development	161	(16)	398	258
Sales and marketing	90	126	368	346
General and administrative	352	210	719	389
	\$ 624	\$ 323	\$ 1,526	\$ 1,000

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

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**Table of Contents****EMBARCADERO TECHNOLOGIES, INC.****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS****(in thousands)****(unaudited)**

	<b>Six Months Ended June 30,</b>	
	<b>2006</b>	<b>2005</b>
<b>Cash from operating activities:</b>		
Net income	\$ 2,308	\$ 762
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	643	760
Provision for doubtful accounts	61	33
Amortization of acquired technology and capitalized software	441	962
Amortization of other intangible assets	42	
Amortization of deferred stock-based compensation	1,326	990
Issuance of options in exchange for services		10
Changes in operating assets and liabilities:		
Trade accounts receivable	1,877	1,441
Prepaid expenses and other assets	49	(262)
Deferred income taxes	(20)	
Accounts payable and accrued liabilities	(397)	(684)
Deferred revenue	1,735	1,324
Net cash provided by operating activities	8,065	5,336
<b>Cash from investing activities:</b>		
Purchases of investments	(11,951)	(59,165)
Sales and maturities of investments	11,120	58,440
Purchases of property and equipment	(343)	(120)
Capitalized acquisition costs	(5)	
Net cash used in investing activities	(1,179)	(845)
<b>Cash from financing activities:</b>		
Repurchase of common stock		(2,076)
Payments of principal under capital lease obligation	(86)	(81)
Proceeds from exercise of stock options	214	242
Net cash (used in) provided by financing activities	128	(1,915)
Effect of exchange rate changes on cash and cash equivalents	61	(131)
Net increase in cash and cash equivalents	7,075	2,445
Cash and cash equivalents at beginning of period	7,943	7,422
Cash and cash equivalents at end of period	\$ 15,018	\$ 9,867

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)**

**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, Munich, Germany 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, 2005, 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 for the year ended December 31, 2005, filed with Securities and Exchange Commission on March 16, 2006.

Operating results for the three and six months ended June 30, 2006, are not necessarily indicative of the results that may be expected for the full year ending December 31, 2006 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**

***Stock-Based Compensation***

Effective January 1, 2006, the Company adopted Statement of Financial Accounting Standards No. 123(R), Share-Based Payment ( SFAS 123(R) ). SFAS 123(R) supersedes the Company's previous accounting under Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees ( APB 25 ), for periods beginning in fiscal 2006. Under APB 25, the Company accounted for stock options under the intrinsic value method. Accordingly, the Company did not recognize expense related to employee stock options because the exercise price of such options equaled the fair value of the underlying stock on the grant date. The Company previously disclosed the fair value of its stock options under the provisions of Statement of Financial Accounting Standards No. 123, Accounting for Stock Based Compensation ( SFAS 123 ). The non-cash stock-based compensation recognized under APB 25 related to fair value of restricted stock awards determined based on the number of shares granted and the quoted price of our common stock.

On January 1, 2006, we adopted SFAS 123(R) using the modified prospective method, which requires measurement of compensation cost for all stock-based awards at fair value on date of grant and recognition of compensation over the service period for awards expected to vest. The fair value of restricted stock is determined based on the number of shares granted and the quoted price of our common stock, and the fair value of stock options is determined using the Black-Scholes valuation model, which is consistent with our valuation techniques previously utilized for options in footnote disclosures required under



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SFAS 123, Accounting for Stock Based Compensation, as amended by SFAS 148, Accounting for Stock-Based Compensation Transition and Disclosure. Such value is recognized as expense over the service period, net of estimated forfeitures, using the straight-line method under SFAS 123(R) for new grants post adoption and accelerated method for grants made prior to January 1, 2006. The estimation of stock awards that will ultimately vest requires judgment, and to the extent actual results or updated estimates differ from our current estimates, such amounts will be recorded as a cumulative adjustment in the period estimates are revised. We consider many factors when estimating expected forfeitures, including types of awards, employee class, and historical experience. Actual results, and future changes in estimates, may differ substantially from our current estimates.

The Company's condensed consolidated financial statements for prior periods have not been restated to reflect, and do not include, the impact of SFAS 123(R).

The adoption of SFAS 123(R) resulted in a cumulative benefit from accounting change of \$200,000 in the six months ended June 30, 2006, which reflects the net cumulative impact of estimating future forfeitures related to stock grants previously expensed in the income statement under APB 25, in the determination of period expense, rather than recording forfeitures when they occur as previously permitted.

Under SFAS 123(R), the Company recognized \$437,000 and \$904,000, net of taxes, of compensation expense related to stock options and employee stock purchases in the three and six months ended June 30, 2006, respectively. The following table summarizes stock-based compensation expense related to employee stock options and employee stock purchases under SFAS 123(R) for the three and six months ended June 30, 2006, which was allocated as follows (in thousands, except per share amounts):

	<b>Three Months</b>	<b>Six Months</b>
	<b>Ended June 30, 2006</b>	<b>Ended June 30, 2006 (unaudited)</b>
<b>Stock-based compensation expense included in:</b>		
Cost of revenues	\$ 21	\$ 41
Research and development	161	398
Sales and marketing	90	368
General and administrative	352	719
Stock-based compensation expense included in operating earnings	\$ 624	\$ 1,526
Cumulative effect of change in accounting principle		(200)
Stock-based compensation expense included in total income	624	1,326
Tax benefit	(187)	(422)
Stock-based compensation expense, net of tax	\$ 437	\$ 904
Decrease in Basic earnings per share	\$ 0.02	\$ 0.04
Decrease in Diluted earnings per share	\$ 0.02	\$ 0.03

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SFAS 123(R) requires us to present pro forma information for the comparative period prior to its adoption as if we had accounted for all our employee stock options under the fair value method of the original SFAS 123. The following table illustrates the effect on net income and earnings per share if we had applied the fair value recognition provisions of SFAS 123 to stock-based employee compensation in the prior-year periods (in thousands except per share amounts):

	<b>Three Months Ended June 30, 2005</b>	<b>Six Months Ended June 30, 2005 (unaudited)</b>
<b>Income (loss):</b>		
Net loss as reported for the prior period (1)	\$ 803	\$ 762
Stock-based compensation expense included in net loss, net of tax	214	623
Stock-based compensation expense, net of tax	(434)	(1,363)
<b>Net loss, including the effect of stock-based compensation expense</b>	<b>\$ 583</b>	<b>\$ 22</b>
<b>Basic earnings per share:</b>		
As reported for the prior period (1)	\$ 0.03	\$ 0.03
Including the effect of stock-based compensation expense	\$ 0.02	\$ 0.00
<b>Diluted earnings per share:</b>		
As reported for the prior period (1)	\$ 0.03	\$ 0.03
Including the effect of stock-based compensation expense	\$ 0.02	\$ 0.00

Upon adoption of SFAS 123(R), the Company continued to calculate the value of each employee stock option, estimated on the date of grant, using the Black-Scholes model in accordance with SFAS 123(R). The weighted-average estimated value of employee stock options granted during the three and six months ended June 30, 2006 were \$2.83 per share and \$2.99 per share, respectively, using the following weighted-average assumptions:

	<b>Three Months Ended</b>		<b>Six Months Ended</b>	
	<b>June 30,</b>		<b>June 30,</b>	
	<b>2006</b>	<b>2005</b>	<b>2006</b>	<b>2005</b>
Risk-free interest rate	4.93%	3.78%	4.74%	3.89%
Expected life	4 years	3 years	4 years	3 years
Expected dividends	0	0	0	0
Volatility	55%	70%	55%	70%

The risk-free interest rate assumption is based upon the average daily closing rates during the quarter for U.S. treasury notes that have a life which approximates the expected life of the option. The expected life of employee stock options represents the weighted-average period the stock options are expected to remain outstanding. These expected life assumptions are established through the review of annual historical employee exercise behavior of option grants with similar vesting periods. Beginning in the first quarter of 2006, the Company began using an estimated forfeiture rate of 27% for stock options and 20% for stock awards based on historical data. Prior to 2006, the Company used the actual forfeiture method allowed under SFAS 123, which assumed that all options would vest and pro forma expense was adjusted when options were forfeited prior to the vesting dates.

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SFAS 123(R) requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. The Company has no history or expectation of paying dividends on its common stock.

The Company used blended volatility rate using a combination of historical stock price volatility and market-implied volatility as the expected volatility assumption required in the Black-Scholes model, consistent with SFAS 123(R) and Staff Accounting Bulletin No. 107. Prior to the first quarter of fiscal 2006, the Company used historical stock price volatility in accordance with SFAS 123 for purposes of its pro forma information. The selection of the blended volatility using a combination of historical stock price and market-implied volatility was based upon the availability of actively traded options on the Company's stock and the Company's assessment that implied volatility is also representative of future stock price especially when combined with historical trends in volatility.

**Recent Accounting Pronouncements**

Effective January 1, 2006, we adopted Statement of Financial Accounting Standards (SFAS) No. 123R, Share-Based Payment (SFAS No. 123R) using the Modified Prospective Approach. See Note 2 for further detail regarding the adoption of this standard.

In February 2006, the Financial Accounting Standards Board (FASB) issued SFAS No. 155, Accounting for Certain Hybrid Financial Instruments - an Amendment of FASB Statements No. 133 and 140 (SFAS No. 155). SFAS No. 155 allows financial instruments that contain an embedded derivative and that otherwise would require bifurcation to be accounted for as a whole on a fair value basis, at the holders' election. SFAS No. 155 also clarifies and amends certain other provisions of SFAS No. 133 and SFAS No. 140. This statement is effective for all financial instruments acquired or issued in fiscal years beginning after September 15, 2006. We do not expect that the adoption of SFAS No. 155 will have a material impact on our consolidated financial condition or results of operations.

In July 2006, the FASB issued FIN 48, Accounting for Uncertainty in Income Taxes - an interpretation of FASB Statement No. 109 (FIN 48). FIN 48 clarifies the recognition threshold and measurement of a tax position taken on a tax return. FIN 48 is effective for fiscal years beginning after December 15, 2006. FIN 48 also requires expanded disclosure with respect to the uncertainty in income taxes. We are currently evaluating the requirements of FIN 48 and the impact this interpretation may have on our financial statements.

**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 other comprehensive income are as follows (in thousands):

	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
	2006	2005	2006	2005
	(unaudited)		(unaudited)	
Net income	\$ 1,632	\$ 803	\$ 2,308	\$ 762
Unrealized loss on available-for-sale investments		(2)		(5)
Foreign currency translation adjustments	164	(155)	199	(303)
Comprehensive income	\$ 1,796	\$ 646	\$ 2,507	\$ 454

**NOTE 4 EARNINGS PER SHARE**

Basic net income per share excludes the effect of the 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. Diluted net loss per share is the same as basic net loss per share because the calculation of diluted net loss per share excludes potential dilutive shares of common stock since their effect is anti-dilutive. Potentially dilutive shares of common stock consist of unvested restricted common stock and shares of common stock issuable upon the exercise of outstanding stock options.



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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 June 30,		Six Months Ended June 30,	
	2006 (unaudited)	2005	2006 (unaudited)	2005 (unaudited)
<b>Calculation of basic net income per share:</b>				
Net income	\$ 1,632	\$ 803	\$ 2,308	\$ 762
Weighted average common shares outstanding-basic	25,845	26,200	25,789	26,091
Net income per share	\$ 0.06	\$ 0.03	\$ 0.09	\$ 0.03
<b>Calculation of diluted net income:</b>				
Net income	\$ 1,632	\$ 803	\$ 2,308	\$ 762
Weighted average shares of common stock outstanding	25,845	26,200	25,789	26,091
Add: Dilutive securities common stock options and non- vested shares	1,765	1,282	1,643	1,418
Weighted average common shares outstanding and potentially dilutive common shares	27,610	27,482	27,432	27,509
Net income per share	\$ 0.06	\$ 0.03	\$ 0.08	\$ 0.03
Anti-dilutive common stock options and non-vested restricted common stock, not included in net income per share	3,033	2,744	2,961	4,418

**NOTE 5 ACCOUNTING FOR GOODWILL**

The Company's goodwill balance as of June 30, 2006 is \$14.1 million compared to \$13.9 million as of December 31, 2005. The change was due to foreign currency translation. The Company performed its annual goodwill impairment test in September 2005 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.

**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 and the six months ended June 30, 2006 and 2005, the Company did not capitalize any software development costs because no costs met the definition for capitalization. Capitalized software is typically amortized over a period of 36 months. The remaining lives of the capitalized software at June 30, 2006 are between 18 months and 30 months. The capitalized software development costs are as follows (in thousands):

	As of June 30, 2005			As of December 31, 2005		
	(unaudited)		Net Carrying Amount	Gross		Net Carrying Amount
Gross Amortization Carrying Amount	Accumulated Amortization	Gross Amortization Carrying Amount		Accumulated Amortization		
Capitalized software	\$ 8,546	\$ 6,720	\$ 1,826	\$ 8,546	\$ 6,321	\$ 2,225





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The net capitalized software costs are included in long-term Other intangible assets, net 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 \$4.1 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	Other Restructuring Expenses	Total
Balance as of December 31, 2005	\$ 1,692	\$ 4	\$ 1,696
Net cash payments during the six months ended June 30, 2006	\$ (365)		\$ (365)
Balance as of June 30, 2006	\$ 1,327	\$ 4	\$ 1,331

As of June 30, 2006, approximately \$719,000 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 our 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 (in thousands)	Cost of Repurchase (in thousands)	Average Cost
Initial repurchase program authorized in September 2001	1,000		
Increase in repurchase program authorized in July 2002	1,230		
Increase in repurchase program authorized in July 2004	1,000		
Increase 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	554	3,195	5.76
Shares repurchased in 2006			

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Total shares repurchased	3,235	\$	20,664	\$	6.39
Remaining shares available for repurchase at June 30, 2006	995				

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Operating segments are components of a business enterprise, the individual operations where the chief operating decision maker applies his decisions to allocate the resources to the different segments and to make assessments on the segments' 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, Europe, the Middle East, Australia and Africa ( EMEA ) and Asia Pacific ( APAC ). The Company's wholly owned subsidiary, Embarcadero Europe Ltd., transacts all sales in Europe, the Middle East, Australia and Africa. Our San Francisco headquarters transacts all sales in North America and Asian Pacific. 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		Six Months Ended	
	June 30,		June 30,	
	2006	2005	2006	2005
	(unaudited)		(unaudited)	
Revenues:				
North America (1)	\$ 11,912	\$ 11,433	\$ 23,689	\$ 22,705
EMEA	2,314	2,093	4,004	3,526
APAC	737	450	1,793	924
Total	\$ 14,964	\$ 13,976	\$ 29,486	\$ 27,155

(1) Includes gross revenues related to Canada of \$569 and \$525 for the three months ended June 30, 2006 and 2005, respectively, and also \$1,245 and \$1,123 for the six months ended June 30, 2006 and 2005, respectively.

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

	As of June 30,	
	2005	
	(unaudited)	As of December 31, 2005
Long lived assets:		
North America (2)	\$ 1,653	\$ 1,925
EMEA	98	118
APAC	20	16
Total	\$ 1,771	\$ 2,059

(2) Includes long lived assets related to Canada of \$213 and \$229 as of June 30, 2006 and December 31, 2005, 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, 2007.

**Table of Contents****Leases**

The Company leases office space and equipment under non-cancelable operating lease agreements that expire at various dates through 2011. 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 \$560,000 receivable as follows: \$134,000 in year 2006 and \$269,000 in 2007 and \$157,000 in 2008.

The Company entered into a three-year capital lease agreement in September 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 September 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
2006	\$ 90	\$ 815		\$ 905
2007	76	1,418	\$ 120	1,614
2008		903		903
2009		483		483
2010		165		165
2011		21		21
Total minimum payments	166	\$ 3,805	\$ 120	\$ 4,091
Less: amount representing interest	(4)			
Present value of net minimum lease payments	\$ 162			

**Contingencies**

There are no known material legal proceedings. However, the Company may, from time to time, become a party to 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.

**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



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discussion and analysis included in the Company's Annual Report on Form 10-K for the year ended December 31, 2005, filed on March 16, 2006.

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 in Part II. Item 1A. Risk Factors 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 do not intend to update any of the forward-looking statements after the date of this report or to conform these statements to actual results.

***Overview***

Embarcadero Technologies, Inc. is a leading provider of strategic data management solutions that help companies to improve the availability, integrity, accessibility, and security of corporate data. 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, which was 40% of our license revenue in fiscal 2004 and 39% of our license revenue in fiscal 2005. For the three and six months ended June 30, 2006, DBArtisan and DBArtisan add-on products accounted for more than 49% and 42%, respectively, 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, MySQL, and Sybase, running in Unix, Windows NT, and Linux environments.

Our key products and their core functionality are summarized below:

<b>Product Category</b>	<b>Embarcadero Product</b>	<b>Description</b>
Data Architecture	ER/Studio <sup>®</sup>	Software to capture, design and document database schemas for a variety of popular database platforms. It serves as a mechanism for gaining visibility and control over corporate database designs and for managing the metadata that describes the underlying data structures.
	DT/Studio <sup>®</sup>	Software to extract, transform, move and load data from a wide variety of data sources. It helps customers to integrate data from disparate sources in order to deliver more meaningful information to business users.
	Describe <sup>®</sup>	Software to architect applications, particularly those that utilize databases to store application data. It supports the UML industry standard and helps developers to develop a blueprint for an application intended to facilitate a more productive development process.
Data Availability	DBArtisan <sup>®</sup>	Software to administer databases for a variety of popular database platforms. It helps database administrators and other data professionals with key tasks in managing databases, including security administration, disaster recovery, space management and schema management.
	Rapid SQL <sup>®</sup>	Software to develop database code for a variety of popular database platforms. It helps to improve the productivity and quality of work from database developers as they write, test and debug SQL to be deployed against a database.
	Embarcadero Performance Center	Software to monitor databases on a variety of popular database platforms. It helps customers to guard against unplanned downtime of critical databases by providing insight into internal performance and availability metrics of the target databases.
	Embarcadero Change	Software to manage the release of changes to database schema. It serves as a change control mechanism to ensure that code changes are reviewed, tested and approved before they are released into production.



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	Manager	
Data Security	DSAuditor	DSAuditor can be purchased as software or packaged in an appliance. The product audits how users access and manipulate data for a variety of popular database platforms. It helps customers to tighten data privacy and access control by providing a detailed audit trail of how sensitive data is accessed and used across the enterprise.

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Since the second half of 2003, there have generally been improvements in the global economic conditions as well as the fundamentals of our market and broader acceptance of our core and new products. In 2005, with the improvement in enterprise and commercial sales in North America, coupled with higher closure rates internationally, we saw a year over year growth in total revenues. In the first quarter of 2006, despite an unexpected slowdown in closure rates of sales transactions in Europe and the shortfall from our domestic telesales operations, our total revenues were \$14.5 million for the three months ended March 31, 2006 as compared to \$13.2 million for three months ended March 31, 2005. Due to improvements in our international sector, total revenues in the second quarter ended June 30, 2006 increased to \$15.0 million as compared to \$14.0 million in the same quarter in 2005.

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 six months ended June 30, 2006 were \$12.1 million and \$25.2 million, respectively, as compared to \$12.1 million and \$24.5 million for the three and six months ended June 30, 2005, respectively. Included in our operating expenses for the three and six months ended June 30, 2006 were charges of \$624,000 and \$1,526,000, respectively, for non-cash stock-based compensation. For the three and six months ended June 30, 2005, non-cash stock-based compensation expenses were \$323,000 and \$1,000,000, respectively.

Our cash flow from operations was approximately \$8.1 million and \$5.3 million for the six months ended June 30, 2006 and 2005, respectively. Cash and cash equivalents and short-term investments were \$67.9 million at June 30, 2006.

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 or 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 software development costs, lease related impairment loss, goodwill impairment, accounting for income taxes, and accounting for 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, 2006 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 for the fiscal year ended December 31, 2005, filed with Securities and Exchange Commission on March 16, 2006.

**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,	
	2006 (unaudited)	2005	2006 (unaudited)	2005
<b>Revenues:</b>				
License	44.6%	46.4%	45.0%	46.4%
Maintenance	55.4	53.6	55.0	53.6
Total revenues	100.0%	100.0%	100.0%	100.0%
<b>Cost of revenues:</b>				
License	1.0	1.5	1.0	1.7
Amortization of acquired technology	1.3	1.4	1.3	2.1
Maintenance	4.6	3.6	4.5	3.9
Total cost of revenues	6.9	6.5	6.8	7.7
Gross profit	93.1	93.5	93.2	92.3
<b>Operating expenses:</b>				
Research and development	29.3	27.5	30.7	28.7
Sales and marketing	36.7	39.4	39.6	41.5
General and administrative	14.5	15.9	15.3	17.9
Litigation settlement charge	0.0	4.1	0.0	2.1
Total operating expenses	80.5	86.9	85.6	90.2
Income from operations	12.6	6.6	7.6	2.1
Other income, net	3.1	2.1	3.1	2.1
Cumulative effect of change in accounting principle	0.0	0.0	0.7	0.0
Income before provision for income taxes	15.7	8.7	11.4	4.2
Provision for income taxes	(4.7)	(2.9)	(3.5)	(1.4)
Net income	11.0%	5.8%	7.9%	2.8%

**Revenues :**

	Three months ended			Six months ended		
	2006	June 30, 2005 (unaudited)	Percent change	2006	June 30, 2005 (unaudited)	Percent change
<b>Revenues:</b>						
License	\$ 6,670	\$ 6,478	3.0%	\$ 13,283	\$ 12,601	5.4%
Maintenance	8,294	7,498	10.6	16,203	14,554	11.3

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Total revenues	\$ 14,964	\$ 13,976	7.1%	\$ 29,486	\$ 27,155	8.6%
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**Total Revenues.** Total revenues were \$15.0 million for the three months ended June 30, 2006, an increase of 7.1 % over the \$14.0 million reported for the comparable period in 2005. The increase is primarily due to increases in maintenance revenue in the second quarter of 2006 driven by the larger customer base. Total revenues were \$29.5 million for the six months ended June 30, 2006, an increase of 8.6 % over the \$27.2 million in the comparable period in 2005. The increase is due to higher sales both domestically and

internationally in the first half of 2006 compared to 2005. In 2006, the Company had significant increases in maintenance revenue as license revenues in the second half of 2005 increased from prior year and the majority of customers renewed their existing maintenance agreements.

**License.** License revenues were \$6.7 million and \$6.5 million for the three months ended June 30, 2006 and 2005, respectively, representing a 3.0% increase. The increase in license revenues was primarily attributable to improved sales domestically in the second quarter of 2006 compared to the same quarter in 2005 offset by a decrease in channel sales resulting from the expiration of an original equipment manufacturer's (OEM) license agreement in the first quarter of 2006. For the six months ended June 30, 2006 and 2005, license revenues were \$13.3 million and \$12.6 million, respectively, a 5.4% increase. This increase is due to higher sales closure rates domestically in 2006 offset by a decrease in channel sales resulting from the expiration of OEM license agreement in March 2006. 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 \$8.3 million for the three months ended June 30, 2006, representing a 10.6% increase over the \$7.5 million reported for the comparable period in 2005. Similarly, maintenance revenues were \$16.2 million and \$14.6 million, respectively, for the six months ended June 30, 2006 and 2005, representing an 11.3% increase year over year. 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. We expect that maintenance revenue will remain consistent as a percentage of revenues.

**Cost of Revenues**

	Three months ended			Six months ended		
	June 30,		Percent change	June 30,		Percent change
	2006	2005 (unaudited)		2006	2005 (unaudited)	
Cost of revenues						
License	\$ 149	\$ 216	(31.0)%	\$ 286	\$ 464	(38.4)%
Amortization of acquired technology	199	192	3.6	398	564	(29.4)
Maintenance	691	504	37.1	1,341	1,062	26.3
	\$ 1,039	\$ 912	13.9%	\$ 2,025	\$ 2,090	(3.1)%

**License.** Cost of license revenues consists primarily of OEM royalties, credit card processing fees and product media and packaging. Cost of license revenues was \$149,000 for the three months ended June 30, 2006, as compared to \$216,000 for the comparable period in 2005. The decrease is due to no amortization of internally developed products in 2006. Cost of license revenues were \$286,000 for the six months ended June 30, 2006, a 38.4% decrease from the \$464,000 for the comparable period in 2005. The decrease for the six months is also due to no amortization of internally developed products in 2006.

**Amortization of acquired technology and capitalized software.** This amortization expense relates to licensed technologies acquired from third parties that were deemed to have reached technological feasibility at the date of acquisition and therefore capitalized as well as capitalized internal development costs for software that have reached technological feasibility. The amortization of acquired technology and capitalized software was \$199,000 and \$192,000 for the three months ended June 30, 2006 and 2005, respectively. For the six months ended June 30, 2006, the amortization of acquired technology and capitalized software was \$398,000, a 29.4% decrease from \$564,000 for the comparable period in 2005. The decrease is due to certain of our intangible assets which became fully amortized in the second quarter of 2005, thus resulting in a decrease in amortization expense which continued into the first six months of 2006. We expect amortization expense at this decreased level to continue into 2006.

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*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 \$691,000 for the three months ended June 30, 2006 as compared to \$504,000 for the comparable period in 2005. The increase in the three months period is due to

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higher temporary personnel costs and salaries as well as higher travel costs. Maintenance costs for the six months ended June 30, 2006 were \$1.3 million, a 26.3% increase from \$1.1 million in the comparable period in 2005. The increase for the six months period is due higher temporary personnel costs and higher stock-based compensation expense. We expect to hire additional support personnel to support our existing product line and expanding customer base, and that the cost of maintenance revenues may increase in the future.

**Operating Expenses**

	Three months ended June 30,			Six months ended June 30,		
	2006	2005 (unaudited)	Percent change	2006	2005 (unaudited)	Percent change
Operating expenses:						
Research and development	\$ 4,386	\$ 3,840	14.2%	\$ 9,046	\$ 7,782	16.2%
Sales and marketing	5,497	5,513	(0.3)	11,670	11,261	3.6
General and administrative	2,177	2,221	(2.0)	4,503	4,874	(7.6)
Litigation settlement charge		573	(100.0)		573	(100.0)
Total operating expenses	\$ 12,060	\$ 12,147	(0.7)%	\$ 25,219	\$ 24,490	3.0%

*Research and Development.* Research and development expenses primarily consist of personnel and related expenses, including payroll and employee benefits, allocated overhead, and non-cash stock-based compensation, as well as expenses related to third-party development services. Research and development expenses were \$4.4 million for the three months ended June 30, 2006 and \$3.8 million for the comparable period in 2005. The increase was primarily due to an increase in wages and other employee related costs resulting from increases in headcount. Research and development expenses were \$9.0 million and \$7.8 million for the six months period ended June 30, 2006 and 2005, respectively. The increase is due to higher third-party development costs in 2006 and increased salaries and related costs. Additionally, as a result of the adoption of FAS 123(R), stock-based compensation expenses was higher in 2006 compared to the same period in 2005. We anticipate that we will continue to invest resources into research and development activities in order to develop new products and advance the technology relating to our existing products.

*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 \$5,497,000 for the three months ended June 30, 2006 and \$5,513,000 for the comparable period in 2005. The \$16,000 decrease was mainly due to lower salaries and related costs resulting from employee turnover in sales and marketing. Sales and marketing expenses for the six months ended June 30, 2006 were \$11.7 million, a 3.6% increase from \$11.3 million for the same period in 2005. 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, higher stock-based compensation expense and sales related travel and entertainment expenses. The marketing personnel related costs were also higher in 2006 compared to comparable period in 2005. We anticipate that we will continue to selectively increase staff in our sales organization and to create marketing programs to support our product initiatives.

*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 \$2,177,000 for the three months ended June 30, 2006 and were \$2,221,000 for the comparable period in 2005. The \$44,000 decrease was mainly due to decreases in accounting and audit fees offset by higher salaries and related costs. General and administrative expenses were \$4.5 million and \$4.9 million, respectively, for the six months period ended June 30, 2006 and 2005. The decrease is primarily due to lower accounting and consulting fees in 2006 partially offset by increases in stock-based compensation expense. We expect general and administrative costs to increase from the quarter ended June 30, 2006 due to the planned audit and Sarbanes & Oxley Act of 2002 compliance costs.

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*Other Income, net.* Other income, net, consists primarily of interest income and was \$469,000 and \$294,000 for the three months ended June 30, 2006 and 2005, respectively. Other income for the six months ended June 30, 2006 and 2005 were \$908,000 and \$572,000, respectively. The increase was due to an increase in the average balance of the cash balance throughout the periods and a corresponding increase in interest rates.

*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 \$702,000 and \$408,000 for the three month period and \$1,042,000 and \$385,000 for the six month period ended June 30, 2006 and 2005, respectively. The estimated effective tax rate for the three month period ended June 30, 2006 and 2005 was 30% and 34%, respectively. The estimated effective tax rate for the six months ended June 30, 2006 and 2005 was 31% and 34%, respectively. The effective tax rates for the three and the six month periods were lower in 2006 primarily due to the tax benefit from an increase in tax-exempt interest.

We had net deferred tax assets totaling \$2.9 million as of June 30, 2006 and December 31, 2005. We believe that these net assets will be realizable in the future. As of December 31, 2005, we had federal and state net operating loss carry forwards ( NOLs ) of approximately \$4.9 million and \$7.2 million, respectively. These NOLs can be carried forward to offset future taxable income, if any. The federal and state NOLs expire in 2006 through 2020, if not utilized. As of December 31, 2005, we had federal, state and foreign research and development credits of approximately \$1.5 million, \$75,000 and \$769,000, respectively. The federal credits expire in 2020 through 2025. The state credits and foreign credits do not expire. Pursuant to the provisions of Internal Revenue Code Sec. 382, the amount of benefits from NOLs and credits available annually to the Company may be limited.

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 returns for the fiscal years ended 2003 and 2004. As of June 30, 2006, the IRS had issued only one proposed adjustment for \$88,000, for which we have already provided a reserve. 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, our results of operations may be adversely affected for the period in which the matter is ultimately resolved or an unfavorable outcome becomes probable and reasonably estimable.

**RECENT ACCOUNTING PRONOUNCEMENTS**

Effective January 1, 2006, we adopted Statement of Financial Accounting Standards ( SFAS ) No. 123R, *Share-Based Payment* ( SFAS No. 123R ) using the Modified Prospective Approach. See Note 8 for further detail regarding the adoption of this standard.

In February 2006, the Financial Accounting Standards Board ( FASB ) issued SFAS No. 155, *Accounting for Certain Hybrid Financial Instruments* an Amendment of FASB Statements No. 133 and 140 ( SFAS No. 155 ). SFAS No. 155 allows financial instruments that contain an embedded derivative and that otherwise would require bifurcation to be accounted for as a whole on a fair value basis, at the holders election. SFAS No. 155 also clarifies and amends certain other provisions of SFAS No. 133 and SFAS No. 140. This statement is effective for all financial instruments acquired or issued in fiscal years beginning after September 15, 2006. We do not expect that the adoption of SFAS No. 155 will have a material impact on our consolidated financial condition or results of operations.

In July 2006, the FASB issued FIN 48, *Accounting for Uncertainty in Income Taxes* an interpretation of FASB Statement No. 109 ( FIN 48 ). FIN 48 clarifies the recognition threshold and measurement of a tax position taken on a tax return. FIN 48 is effective for fiscal years beginning after December 15, 2006. FIN 48 also requires expanded disclosure with respect to the uncertainty in income taxes. We are currently evaluating the requirements of FIN 48 and the impact this interpretation may have on our financial statements.



**Table of Contents****LIQUIDITY AND CAPITAL RESOURCES**

We have funded our business to date principally from cash generated by our operations and financings. As of June 30, 2006, we had cash, cash equivalents and short-term investments of \$67.9 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,	
	2006	2005
Net income	\$ 2,308	\$ 762
Non-cash adjustments	2,513	2,755
Increase in operating assets	1,906	1,179
Increase in operating liabilities	1,338	640
<b>Net cash provided by operating activities</b>	<b>\$ 8,065</b>	<b>\$ 5,336</b>

Our primary source of operating cash flows is the collection of accounts receivable from our customers. We measure the effectiveness of our collection efforts by various indicators, including an analysis of average accounts receivable daily sales outstanding (DSO). Our DSO for the six months ended June 30, 2006 and 2005 was 46 days and 45 days, respectively. Collection of accounts receivable and related DSO could fluctuate in future periods due to the 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, which to date; they have typically been net thirty days.

The non-cash adjustments include depreciation and amortization of property and equipment and intangible assets, as well as stock-based compensation. 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 was mainly due to a decrease of \$479,000 in amortization of other intangible asset, and an \$117,000 decrease in depreciation and amortization of property and equipment, partially offset by a \$336,000 increase in stock-based compensation and \$28,000 increase in allowance for doubtful accounts to specifically allow for doubtful accounts.

The increase in operating assets during the six months ended June 30, 2006 was primarily due to an increase in accounts receivable change of \$436,000, a \$20,000 decrease in deferred income taxes change and an increase in prepaid expenses and other assets change of \$311,000. The decrease in operating liabilities during the six months ended June 30, 2006 was primarily due to an increase in deferred revenue change of \$411,000 offset by an increase in the changes to accounts payable and accrued liabilities of \$287,000.

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.

**Table of Contents****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	
	2006	2005
	June 30, (unaudited)	
Proceeds from sales or maturities of investments	\$ 11,120	\$ 58,440
Purchase of investments	(11,951)	(59,165)
Purchase of property and equipment	(343)	(120)
Capitalized acquisition cost	(5)	
<b>Net cash used in investing activities</b>	<b>\$ (1,179)</b>	<b>\$ (845)</b>

The main use of cash used in investing activities during the six months ended June 30, 2006 was 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, 2006 and 2005, purchases of property and equipment were \$343,000 and \$120,000, respectively.

**Financing Activities**

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

	Six months ended	
	2006	2005
	June 30, (unaudited)	
Repurchase of common stock	\$	\$ (2,077)
Payments of principal under capital lease obligation	(86)	(80)
Proceeds from exercise of stock options	214	242
<b>Net cash provided by (used in) financing activities</b>	<b>\$ 128</b>	<b>\$ (1,915)</b>

The primary source of cash provided by financing activities during the six months ended June 30, 2006 was the exercise of options to purchase 38,056 shares of common stock for \$214,000. 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. As of June 30, 2006, we had approximately 995,000 shares remaining available for repurchase under our stock repurchase program. The timing of future repurchases and the price paid for the shares could have a material impact on our liquidity.

**Table of Contents****Contractual Obligations**

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 into a new five-year lease commitment and subleased the remainder of our long-term San Francisco office leases.

In September 2004, we entered into a \$499,000 three-year capital lease agreement with a financial institution to finance the 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 September 2007. It is likely we will enter into additional capital lease arrangements as long as interest rates remain attractive.

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

	Capital Lease	Operating Leases	Bank Letter of Credit	Total
2006	\$ 90	\$ 815		\$ 905
2007	76	1,418	\$ 120	1,614
2008		903		903
2009		483		483
2010		165		165
2011		21		21
Total minimum payments	166	\$ 3,805	\$ 120	\$ 4,091
Less: amount representing interest		(4)		
Present value of net minimum lease payments		\$ 162		

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, such financing may not be available to us on reasonable business terms, or at all.

**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, 2006 included auction rate securities with a fair value of approximately \$52.9 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, 2006, if interest rates were to change by 10%, interest income could be impacted positively or negatively by approximately \$185,000 on an annualized basis. There would be no material impact on the fair market value of the portfolio. As of June 30, 2006, all of our investments were in tax-exempt municipal auction rate securities.

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### *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 and also Asia Pacific countries. With respect to our European 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

We maintain disclosure controls and procedures as defined in Rules 13a-15(e) and 15d-15(e) under the Securities and Exchange Act of 1934 (the Exchange Act ) designed to ensure that we are able to collect the information we are required to disclose in the reports we file under the Exchange Act, and to record, process, summarize and report this information within the time periods specified in the rules of the Securities and Exchange Commission. Our Chief Executive Officer and Chief Financial Officer evaluated the effectiveness of our disclosure controls and procedures 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 effective as of June 30, 2006.

### (b) Changes in Internal Controls over Financial Reporting

During the most recent fiscal quarter, there has not occurred any change in our internal control over financial reporting that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

## **PART II**

### **OTHER INFORMATION**

## **ITEM 1. LEGAL PROCEEDINGS**

There are no known material legal proceedings. However, the Company may, from time to time, become a party to 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.

## **ITEM 1A. RISK FACTORS**

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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.

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***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.

***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. Further, the expiration or termination of OEM agreements could adversely affect our channel sales. 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.

***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.

***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. The information technology market has generally improved since the second half of 2003. However, economic conditions remain uncertain and this market may decline in the future. During the first quarter 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. While our closure rates improved through the remainder of 2005 and slightly in the first half of 2006, any renewed 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.***

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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. The loss of these officers or personnel would adversely affect our operations.

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We have recently experienced increased employee turnover, especially in our sales and marketing and research and development departments. We will need to continue to recruit, new personnel into our organizations. 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.

### ***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 including:

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



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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 if 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.

***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, which was 40% of our license revenue in fiscal 2004 and 39% of our license revenue in fiscal 2005. For the three and six months ended June 30, 2006, DBArtisan and DBArtisan add-on products accounted for more than 49% and 42%, respectively, of our license revenues. We expect that sales of DBArtisan will continue to represent a substantial portion of our license revenues

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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.

***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.

***Future changes in financial accounting standards may adversely affect our reported results of operations.***

A change in accounting standards can have a significant effect on our reported results. New accounting pronouncements and varying interpretations of accounting pronouncements have occurred and may occur in the future. These new accounting pronouncements may adversely affect our reported financial results.

For example, effective January 1, 2006, we adopted Statement of Financial Accounting Standards No. 123(R), Share Based Payment (SFAS 123(R)), which requires us to calculate compensation expense related to all share-based awards and to recognize the expense in our financial statements. For the quarter ended March 31, 2006 and for the quarter ended June 30, 2006, we recognized \$702,000 and \$624,000 in stock-based compensation expenses related to the adoption of SFAS 123(R), respectively. In future periods, we expect that compensation expenses associated with the adoption of SFAS 123(R) will be significant and will cause our net income and net income per share to be significantly reduced.

***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.

We are currently under Internal Revenue Service (the IRS) audit of our United States federal income tax return for the fiscal years ended 2003 and 2004. As of June 30, 2006, the IRS has issued only one proposed adjustments to the amounts reflected by us on our return for \$88,000 for which we have already provided a reserve. 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, our results of operations may be adversely affected for the period in which the matter is ultimately resolved or an unfavorable outcome becomes probable and reasonably estimable.

***We may lose market share and be required to reduce prices as a result of competition***

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, Informatica Corporation, 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

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compete effectively with those products or efforts, which could significantly harm our business and operating results.

There has continued to be consolidation in our industry, such as IBM's acquisition of Ascential Software. This 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, since our acquisition of SHC Ambeo Acquisition Corp. in 2005, we have been competing in the data security market. While industry analysts project the market for data security to grow rapidly competition has been strong and in addition to our traditional competitors, we face competition from new competitors with broad security expertise. If the market for strategic data management solutions 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

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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.

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.

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

In October 2005, we completed the acquisition of SHC Ambeo Acquisition Corp. ( Ambeo ), a privately-held company providing database auditing and activity monitoring products. We may make additional strategic acquisitions of companies, products, or

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technologies as necessary in order to implement our business strategy. If we are unable to successfully integrate these acquisitions 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 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 were involved in litigation related to our acquisition of Engineering Performance, Inc, which we settled in 2005. This litigation involved significant legal expenses and settlement costs.

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.

### ***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, which would negatively affect our stock price.

### ***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.

### ***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.

### ***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 impairment test in September 2005 and determined that there had been no impairment to our goodwill. As of June 30, 2006, our goodwill balance was \$14.1 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.

### ***Increased costs associated with corporate governance compliance may significantly impact our results of 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. Our compliance costs in 2005 were lower than in 2004 as

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we were able to better control our costs in our second year of compliance with the requirements of the Sarbanes-Oxley Act of 2002. However, these costs could increase in 2006 or in the future. 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 more stringent 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.

In addition, we will continue to incur higher general and administrative expenses relative to historical periods to comply with the requirements relating to internal control over financial reporting in accordance with Section 404 of the Sarbanes-Oxley Act.

***We are required to undertake an annual evaluation of our internal control over financial reporting that may identify internal control weaknesses requiring remediation, which could harm our reputation and confidence in our financial reporting.***

The Sarbanes-Oxley Act imposes duties on us, our executives, and directors. As of December 31, 2004, we reported that our internal control over financial reporting was not effective and identified certain material weaknesses. During 2005, we took actions to remediate those weaknesses and concluded that, as of December 31, 2005, our internal controls over financial reporting were effective. However, we are required to assess, test and evaluate the design and operating effectiveness of our internal control over financial reporting each year end and we cannot predict the outcome of our testing in future periods. If we conclude in future periods that our internal controls over financial reporting is not effective, we may be required to change our internal controls over financial reporting to remediate deficiencies, investors may lose confidence in the reliability of our financial statements, and we may be subject to investigation and sanctions by regulatory authorities. Also, if we identify areas of our internal controls over financial reporting that require improvement, we could incur additional expenses to implement enhanced processes and controls to address such issues. Any such events could adversely affect our financial results and may result in a negative reaction in the stock market.

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***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.

***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.

***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 more than 24% of our outstanding common stock as of June 30, 2006. 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;

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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.

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

(c) 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. During the six months ended June 30, 2006, we did not repurchase any stock under the stock repurchase program.

**ITEM 3. DEFAULTS UPON SENIOR SECURITIES**

None.

**ITEM 5. OTHER INFORMATION**

None.



**ITEM 6. EXHIBITS**

(a) Exhibits:

The following documents are furnished as Exhibits to this Report:

- 10.1 Lease agreement between Embarcadero Technologies Australia Pty Ltd and Vulcann Pty Ltd.
- 10.2 Letter Agreement between Embarcadero Technologies, Inc. and Michael Shahbazian dated July 27, 2006.
- 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 Michael Shahbazian 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 Michael Shahbazian 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.

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**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/ MICHAEL SHAHBAZIAN*  
**Michael Shahbazian**  
*Senior Vice President and Chief Financial Officer*

Date: August 8, 2006

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