



# **FORM 10-K**

## **PHASE FORWARD INC – PFWD**

**Filed: March 09, 2005 (period: December 31, 2004)**

Annual report which provides a comprehensive overview of the company for the past year

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**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**  
Washington, D.C. 20549

**FORM 10-K**

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

For the fiscal year ended December 31, 2004

or

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

Commission File Number: **000-50839**

**Phase Forward Incorporated**

(Exact name of registrant as specified in its charter)

**Delaware**  
(State or other jurisdiction of  
incorporation or organization)

**04-3386549**  
(I.R.S. Employer  
Identification No.)

**880 Winter Street**  
**Waltham, Massachusetts 02451**  
(Address of principal executive offices)

**(888) 703-1122**  
(Registrant's telephone number, including area code)

Securities registered pursuant to Section 12(b) of the Act:  
**None**

Securities registered pursuant to Section 12(g) of the Act:  
**Common Stock, \$0.01 par value per share**

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

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

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

State the aggregate market value of the voting stock held by non-affiliates of the registrant.

Date	Non-Affiliate Voting Shares Outstanding	Aggregate Market Value
July 15, 2004	7,162,206	\$53,716,545

Our common stock began trading on the Nasdaq National Market on July 15, 2004. Shares of voting stock held by each officer and director and by each person who owns 5% or more of the outstanding common stock have been excluded in that such persons may be deemed to be affiliates. This determination of affiliate status is not necessarily a conclusive determination for other purposes. The registrant has no shares of non-voting stock authorized or outstanding.

Indicate the number of shares outstanding of each of the registrant's classes of common stock, as of the latest practicable date.

Date	Class	Outstanding Shares
March 4, 2005	Common Stock, \$0.01 par value per share	32,545,805

**DOCUMENTS INCORPORATED BY REFERENCE.**

Portions of the registrant's definitive Proxy Statement for the registrant's 2005 Annual Meeting of Stockholders, which is expected to be filed pursuant to Regulation 14A within 120 days of the registrant's fiscal year ended December 31, 2004, are incorporated by reference into Part III of the Form 10-K. With the exceptions of the portions of the Proxy Statement expressly incorporated by reference, such document shall not be deemed filed with this Form 10-K.

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**PHASE FORWARD INCORPORATED**  
**ANNUAL REPORT ON**  
**FORM 10-K**  
**FOR THE YEAR ENDED DECEMBER 31, 2004**

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## PART I

### Item 1. Business

*This Business section and other parts of this Annual Report on Form 10-K ("Annual Report") contain forward-looking statements that involve risk and uncertainties. Our actual results may differ significantly from the results discussed in the forward-looking statements. Factors that might cause such a difference include, but are not limited to, those set forth in "Management's Discussion and Analysis of Financial Condition and Results of Operations—Certain Factors That May Affect Future Results" and elsewhere in this Annual Report.*

#### Overview

Phase Forward is a provider of integrated enterprise-level software products, services and hosted solutions for use in the clinical trial component of our customers' global research and development initiatives. Our customers include pharmaceutical, biotechnology and medical device companies, as well as academic institutions, clinical research organizations, or CROs, and other entities engaged in clinical trials. By automating essential elements of the clinical trial process, we believe our products allow our customers to accelerate the market introduction of new medical therapies and corresponding revenue, reduce overall research and development expenditures, enhance existing data quality control efforts and reduce clinical and economic risk.

Our products are designed to offer our customers enterprise-level automation of time-consuming, paper-based clinical trial processes and to scale securely, reliably and cost-effectively for clinical trials involving substantial numbers of clinical sites and patients worldwide. Our products are supported by comprehensive consulting and training services and robust application hosting and support capabilities on a global scale. Our product line is comprised of three software solutions including: *InForm*<sup>TM</sup>, our Internet-based electronic data capture solution for collection and transmission of patient information in clinical trials; *Clintrial*<sup>TM</sup>, our clinical data management solution; and *Clintrace*<sup>TM</sup>, our solution for monitoring drug safety and reporting adverse events that occur during the clinical trial process. We principally offer our software products under multi-year enterprise licenses and additionally, in the case of our *InForm* product, as a hosted application solution delivered through a standard web-browser.

We believe our enterprise software and hosted solutions are the most widely adopted commercial electronic data capture, data management and adverse event reporting solutions in the clinical trial marketplace, having been utilized in over 10,000 clinical trials involving more than 1,000,000 clinical trial study participants and 300 therapeutic compounds and medical devices. Our customer base of over 220 customers is comprised of the leading pharmaceutical, biotechnology, medical device and clinical research organizations.

#### Our Strategy

Our objective is to become the standard in technology solutions for electronic data capture, data management and adverse event reporting for use in the clinical trial component of our customers' global research and development initiatives. Key strategic directives include:

- *Expand the customer base for our software products, services and hosted solutions.* We believe that adoption is accelerating for electronic data capture, integrated clinical data management and adverse event reporting solutions in the clinical trial marketplace. Our current base of over 220 customers represents a small number of the prospective customers for our software products, services and hosted solutions. We intend to secure additional customers by leveraging our industry position and domain expertise in technology development, sales and customer support.
- *Increase penetration within our existing customer base.* We believe that there is a significant opportunity to migrate existing customers that are utilizing a component of our product offerings

to a comprehensive solution that integrates our *InForm*, *Clintrial* and *Clintrace* products on an enterprise-wide basis. We believe that a large percentage of our current customers would benefit from the integration of our software solutions and we intend to aggressively pursue these cross-selling opportunities. Furthermore, our customers' decentralized nature offers us the opportunity to increase adoption of our currently deployed software products, services and hosted solutions within their enterprises by targeting additional functional areas and business units.

• *Continue to capitalize on our technology position and expand our product offerings.* Our recognized domain expertise and advanced technologies have enabled us to become well-positioned as a single-source vendor of electronic data capture, data management and adverse event reporting software solutions to pharmaceutical, biotechnology and medical device companies, and other entities engaged in clinical trials, for use in their clinical trial initiatives. We intend to strengthen our position by leveraging our technology development resources to introduce additional integrated software solutions to our product suite. We intend to develop new software products, services and hosted solutions through internal development, possible acquisitions and relationships with third-party technology providers with the intent of strengthening our market position.

• *Continue to provide a superior level of global customer service and support.* In light of the critical importance of the clinical trial process for our global customers, the delivery of a high level of multinational customer service and support with deep regulatory expertise is essential, and we believe a significant differentiating characteristic of our business strategy. Our enterprise deployments are supported by comprehensive consulting and training services ranging from project planning and management to training, installation, validation and hosting for our multinational customer base. In the case of our fully-hosted deployment of the *InForm* product, we offer robust hosting and support services worldwide. We intend to leverage the knowledge and extensive expertise of our employees in the areas of clinical trial management and drug development and regulatory approval (which we term our domain expertise) to provide customers with exceptional support capabilities and consulting services that accelerate the adoption of our technologies.

### **Our Business Model**

Our software solutions are principally provided to our customers for enterprise adoption through multi-year term licenses with periodic fees. This pricing model, in conjunction with the contractual nature of our services and support solutions, requires us to recognize revenue ratably over the life of a contract, typically three to five years. This allows us to maintain a backlog that provides multi-year visibility in revenues. We believe this visibility significantly differentiates us from our competitors, as our current and potential customers frequently look to long-term financial stability as a key criterion in evaluating a vendor to utilize in the clinical development process. We also offer fully-hosted solutions of our *InForm* product for customers who prefer a hosted solution as well as for new customers to evaluate our *InForm* software product prior to transition to enterprise-level term licenses.

### **Our Software Products, Services and Hosted Solutions**

Our software solutions offer integration capabilities with certain complementary commercial applications used by our customers. Our primary product and service offerings consist of the following:

*InForm.* *InForm* is our Internet-based electronic data capture software solution that helps reduce the inefficiencies, inaccuracies and costs associated with paper-based clinical data collection methodologies that are traditionally employed at the remote sites where clinical trial participants are monitored. Through the *InForm* platform, our customers can deploy customized electronic case report forms, or eCRFs, for on-site clinical data input, which incorporate automated edit checking and deliver

real-time enterprise data visibility previously unavailable through paper-based clinical trial data collection approaches. Additional features of *InForm* include eCRF modules for designing interactive eCRFs and for submitting clinical trial data to regulatory agencies electronically. The *InForm* software product also enables clinical trial sponsors to publish relevant clinical trial-related materials for use by clinical investigators utilizing the software through a standard web-browser. *InForm's* Internet-based platform and automated site assessment capabilities facilitate rapid multi-site deployment by the entity engaged in clinical trials on a cost-effective basis. *InForm* is highly scalable and has been utilized by our customers to run clinical trials involving tens of thousands of patients across multiple continents. In addition to its availability through term licenses, customers may elect to use *InForm* through our fully-hosted deployment program, which includes application hosting as well as clinical trial site assessment, provisioning, training and support. An offline version of our *InForm* product is also offered where network connections are not reliable or available.

*Clintrial.* *Clintrial* is our clinical data management software solution which allows customers to input, monitor, correct, code and analyze clinical data collected through integration with our *InForm* platform or through traditional paper-based methods. Our *Clintrial* platform employs comprehensive tools for automated data entry control and tracking, error checking, industry-standard clinical coding, quality assurance and data import/export. *Clintrial* features an architecture that can manage thousands of clinical trials per customer and accommodate highly intricate study designs with little degradation of performance over a large amount of data. We believe that our *Clintrial* product can be rapidly deployed across the customer enterprise at a lower cost than competing third-party clinical data management solutions.

*Clintrace.* *Clintrace* is our adverse event reporting software solution that helps customers comply with the complex global safety regulations and reporting deadlines associated with clinical research, post-approval marketing and drug surveillance by expediting the clinical evaluation and tracking of adverse events. Through *Clintrace*, our customers can enter adverse event data from multiple sources, code, reconcile and analyze the data reports, and then submit required adverse event reports to regulatory authorities via electronic or paper-based methods. Our *Clintrace* product provides customers with near real-time visibility of adverse event data, thereby facilitating compliance with regulatory reporting deadlines and more timely identification of therapeutics that may pose risks to patients or not warrant further investment in research and development. The *Clintrace* platform is highly scalable and able to manage hundreds of thousands of adverse event reports annually.

*Product Integration.* Although each of our *InForm*, *Clintrial* and *Clintrace* software solutions are available as stand-alone enterprise applications, we offer integrated enterprise solutions incorporating certain of our electronic data capture, clinical data management and adverse event reporting products. The operation of *Clintrial* and *InForm* can be integrated by our *Clintrial Integration Solution* which allows customers to eliminate the need for paper-based data input or otherwise support hybrid clinical trials that involve both paper-based and our electronic data capture technologies. Integrated use of *Clintrial* and *InForm* enables sharing of data across the enterprise, expedites trial setup and accelerates data consolidation, reporting, analysis and submission activities. Integration between *Clintrial* and *Clintrace* is also available to facilitate electronic transfer to *Clintrace* of adverse event data identified during clinical trials. This integration is designed to reduce adverse event reporting errors, facilitate the reconciliation of *Clintrace* data with data reported to the customers' safety operations and accelerate availability of adverse event data to the clinical trial sponsor.

*Services.* Our services include delivery of the hosted solution of our *InForm* software product, consulting services, customer support and training. There are numerous sites throughout the United States where we could host our *InForm* software product. Consulting services include business process mapping and workflow design, project planning and management services, guidance on best practices in using our software products, as well as implementation services consisting of application architecture

design, systems integration, installation and validation. Our software product deployments are supported by comprehensive technology transfer services ranging from project planning and management to training, installation and validation. We have a multinational professional services organization to support our software products and hosted solutions worldwide, including our Japanese versions of *InForm* and *Clintrial*. Our technical support staff speaks 18 languages and is available 24 hours per day, seven days per week. In addition to our U.S. headquarters, we have offices in the United Kingdom, France, Japan and Australia.

We believe that all of our software products, services and hosted solutions currently allow our customers to comply with all applicable global regulatory requirements, including applicable rules established by the FDA and other governmental regulatory authorities regarding the use of software in the clinical development process. We have a dedicated team that monitors regulatory developments applicable to our customers and their clinical trials.

## Our Customers

As of December 31, 2004, we had over 220 customers, including 32 of the top 50 pharmaceutical companies. Our representative customers include leading pharmaceutical, biotechnology, medical device companies, academic institutions, CROs and other entities engaged in clinical trials. Some of our representative customers include:

Pharmaceutical	Biotechnology	Contract Research Organizations
AstraZeneca Pharmaceuticals LP	Alexion Pharmaceuticals Inc.	CMIC
Eli Lilly and Company	Biogen Idec Inc.	PAREXEL International Corporation
GlaxoSmithKline	Corixa Corporation	PharmaLink FHI, Inc.
Institut de Recherches Internationales Servier	Chiron Corporation	Veristat Inc.
Novartis AG	Eyeteq Pharmaceuticals, Inc.	
		Academic
Pfizer Canada	Genzyme Corporation	Cedars-Sinai Medical Center
The Procter & Gamble Company	Serono S.A.	The Children's Hospital of Philadelphia
sanofi-aventis		Dana Farber Cancer Institute
	Medical Devices	
Schering-Plough Research Institute	Conceptus, Inc.	Harvard Clinical Research Institute
Yamanouchi Pharmaceutical Co., Ltd.	Depuy, a Johnson & Johnson Company	Mayo Clinic College of Medicine
	Guidant Corporation Medtronic Inc.	National Health & Medical Research Council

Eli Lilly and Company and GlaxoSmithKline accounted for approximately 12% and 10% of our revenues in 2004, respectively.

## Sales and Marketing

We sell our products through a direct sales force and through relationships with CROs and other channel arrangements. Our marketing efforts focus on raising awareness for our products and services and generating qualified sales leads. As of December 31, 2004, we had 55 employees in sales and marketing.

*Direct Sales.* Our direct sales force, which is the source of the majority of our revenues, is operated out of eight global field offices. In addition, follow-on sales are accomplished by the efforts of sales professionals, sales engineers, project managers and other consulting services professionals.

*Channel Arrangements.* In Japan, we have established channel relationships to market and sell our hosted solution for our Japanese version of the *InForm* product. We also have channel relationships with a number of major CROs that enable them to market and sell our hosted solution for the *InForm* product. Our CRO channel revenue is based on the volume of data collected and managed.

*Marketing.* Our marketing strategy is to generate qualified sales leads, build our brand and establish Phase Forward as the leading provider of integrated electronic data capture, management and adverse event reporting solutions in the clinical trial marketplace. Our principal marketing initiatives target key executives and decision makers within our existing and prospective customers, and include:

- participation in, and sponsorship of, user conferences, trade shows, workshops, seminars and industry events;
- publication of articles and opinion pieces in trade magazines and journals;
- cooperative marketing efforts with providers of complementary services or technology, including joint press announcements, joint trade show activities, channel marketing campaigns and joint seminars;
- participation in industry standards and bodies;
- press and industry analyst relations; and
- direct mail and email campaigns.

The marketing organization also works closely with our customers, our direct sales organization and CROs to collect and prioritize customer feedback to help guide our product development efforts.

#### **Research and Development**

We believe that our future success will depend on our ability to continue to enhance and broaden our software products, services and hosted solutions to meet the evolving needs of clinical trial sponsors and other entities engaged in clinical trials. As of December 31, 2004, we had 93 employees in research and development. Our research and development efforts are focused on developing new, complementary software solutions, as well as enhancing our existing software solutions through the addition of increased functionality and the integration of third-party software. From time to time, we supplement our internal research and development resources with outside developers. Our research and development expenses were \$10.7 million in fiscal 2002, \$10.6 million in fiscal 2003, and \$12.4 million in fiscal 2004.

#### **Technology**

The technology incorporated into our products is designed to provide customers with ease of use, flexibility, data visibility and system scalability to handle high volume, global trials.

Our *InForm* electronic data capture software product, which we have designed to support large numbers of users connecting to the system via the Internet, utilizes three logical tiers: a user interface; a proprietary application server; and a database. Our *InForm Architect*<sup>™</sup> tool allows users to design electronic case report forms without extensive coding knowledge. End-users of our *InForm* software product can utilize a widely-available web-browser without the need to download or install any software on their computer. The *InForm* product line was developed utilizing Microsoft technologies for the user interface and application server and was designed to operate with an Oracle database.

We obtained our *Clintrial* clinical data management software through our acquisition in 2001 of Clinsoft Corporation, a developer, marketer and provider of clinical data management and adverse event reporting and tracking products and services. The *Clintrial* software is installed on the system of the entity conducting the clinical trial, where data is entered either from a paper case report form that

has been sent to such entity by the clinical investigator or by using our *InForm* electronic data capture solution. *Clintrial* is a client/server based system that runs on most versions of Microsoft client operating systems and the Oracle database utilized with the product can run on a wide variety of server operating systems, including Microsoft, Solaris, HP-UX and Linux. We are currently designing future releases of our *Clintrial* product to leverage Microsoft web technologies, which may provide an easier and more flexible deployment for our customers.

Our *Clintrace* adverse event reporting software was also acquired through our Clinsoft acquisition. It is used for critical drug safety reporting and surveillance operations throughout the marketing of a drug product, as well as recording serious adverse events arising during clinical trials. *Clintrace* utilizes rules and procedures that can be redefined to provide for coding of safety data automatically or manually. The *Clintrial* software product has the ability to synchronize adverse event data with *Clintrace*. It is also able to integrate with other industry-leading clinical management systems. Like our *Clintrial* product, *Clintrace* is installed locally at the site of the entity conducting the clinical trial. In September 2004, we released a new web-based version of the *Clintrace* software which was developed using Microsoft's development platform. All versions of *Clintrace* use an Oracle database that can be used on a wide variety of operating systems including versions from Microsoft, Solaris, HP-UX and Linux.

Our *Clintrial Integration Solution* can integrate the operations of our *InForm* and *Clintrial* products. The *Clintrial Integration Solution* software is designed to allow entities engaged in clinical trials to run hybrid trials, with some sites capturing data using our electronic data capture technology and others collecting patient clinical data using paper case report forms. It also allows entities engaged in clinical trials to re-use system elements, such as case report forms and automated rules developed in *Clintrial* for paper-based clinical trials, in a clinical trial using our *InForm* electronic data capture software. The *Clintrial Integration Solution* has a built-in message queue that can communicate through firewalls and is based on a multi-server, load-balanced architecture that is scalable and allows for the efficient network routing of data packets to the server with the most available capacity.

Our products have been designed to allow our customers to deploy them as part of a validated system compliant with Good Clinical Practices, laws and regulations applicable to the conduct of clinical trials and 21 CFR Part 11 pertaining to the use of electronic records, password security and signatures. Additionally, the *Clintrace* adverse event reporting software incorporates support for EMEA EudraVigilance V6.0.

We have worked with, and continue to work with, a number of vendors of complementary products, services and technology to develop integration tools that allow third-party systems to interact with our software products. Our products, except for the *Clintrial Integration Solution*, utilize a database supplied by Oracle Corporation. Although we believe that there are other commercially available databases which our products could utilize, the loss of the right to use the Oracle database, and any delay in procuring a replacement, could adversely affect our business. Our products run on most major versions of the Microsoft operating system.

#### **Competition**

The market for electronic data collection, data management and adverse event reporting systems is highly competitive, rapidly evolving, fragmented and is subject to changing technology, shifting customer needs and frequent introductions of new products and services. We compete with systems and paper-based processes utilized by existing or prospective customers, as well as other commercial vendors of electronic data capture applications, clinical data management systems and adverse event reporting software, including:

- systems developed internally by existing or prospective customers;

- vendors of electronic data capture, clinical data management and adverse event reporting product suites, particularly Oracle Clinical, a business unit of Oracle Corporation;
- vendors of stand-alone electronic data capture, data management and adverse event reporting products;
- CROs with internally developed electronic data capture, clinical data management systems or adverse event reporting systems; and
- systems integrators, as well as smaller independent consulting firms specializing in clinical trial or safety implementations.

Our ability to remain competitive will depend to a great extent upon our ongoing performance in the areas of product development, customer support and service delivery. We believe that the principal competitive factors in our market include the following:

- product functionality and breadth of integration among the electronic data capture, management and adverse event reporting solutions;
- reputation and financial stability of the vendor;
- low total cost of ownership and demonstrable benefits for customers;
- depth of expertise and quality of consulting and training services;
- performance, security, scalability, flexibility and reliability of the solutions;
- speed and ease of implementation and integration; and
- sales and marketing capabilities, and the quality of customer support.

We believe that we compete favorably with our competitors on the basis of these factors. However, some of our competitors and potential competitors have greater name recognition, longer operating histories and significantly greater resources. There can be no assurance that our current or prospective competitors will not offer or develop products or services that are superior to, or that achieve greater market acceptance than, our products and services.

### **Government Regulation**

The conduct of clinical trials is subject to regulation and regulatory guidance associated with the approval of new drugs, biological products and medical devices imposed upon the clinical trial process by the U.S. federal government and related regulatory authorities such as the U.S. Food and Drug Administration, or FDA, and by foreign governments. Use of our software products, services and hosted solutions by entities engaged in clinical trials must be done in a manner that is compliant with these regulations and regulatory guidance. Failure to do so could have an adverse impact on a clinical trial sponsor's ability to obtain regulatory approval of new drugs, biological products or medical devices. If our product and service offerings fail to allow our customers and potential customers to operate in a manner that is compliant with applicable regulations and regulatory guidance, clinical trial sponsors and other entities conducting clinical research may be unwilling to use our software products, services and hosted solutions. Accordingly, we design our product and service offerings to allow our customers and potential customers to operate in a manner that is compliant with applicable regulations and regulatory guidance. We also expend considerable time and effort monitoring regulatory developments that could impact the use of our products and services by our customers and use this information in designing or modifying our product and service offerings.

The following is an overview of some of the regulations that our customers and potential customers are required to comply with in the conduct of clinical trials.

The clinical testing of drugs, biologics and medical devices is subject to regulation by the U.S. Food and Drug Administration, or FDA, and other governmental authorities worldwide. The use of software during the clinical trial process must adhere to the regulations and regulatory guidance known as Good Clinical Practices, other various codified FDA regulations, the Consolidated Guidance for Industry from the International Conference on Harmonization regarding Good Clinical Practice for Europe, Japan and the United States and other guidance documents. Our products, services and hosted solutions are developed using our domain expertise and are designed to allow compliance with applicable rules or regulations. The foregoing regulations and regulatory guidance are subject to change at any time. Changes in regulations and regulatory guidance to either more or less stringent conditions could adversely affect our business and the software products, services and hosted solutions we make available to our customers. Further, a material violation by us or our customers of Good Clinical Practices could result in a warning letter from the FDA, the suspension of clinical trials, investigator disqualification, debarment, the rejection or withdrawal of a product marketing application, criminal prosecution or civil penalties, any of which could have a material adverse effect on our business, results of operations or financial condition.

In addition to the aforementioned regulations and regulatory guidance, the FDA has developed regulations and regulatory guidance concerning electronic records and electronic signatures. The regulations, codified as 21 CFR Part 11, are interpreted for clinical trials in a guidance document titled Computerized Systems Used in Clinical Trials. This regulatory guidance stipulates that computerized systems used to capture or manage clinical trial data must meet certain standards for attributability, accuracy, retrievability, traceability, inspectability, validity, security and dependability. Other guidance documents have been issued that also help in the interpretation of 21 CFR Part 11. We cannot assure you that the design of our software solutions will continue to allow customers to maintain compliance with these guidelines as they develop. Any changes in applicable regulations that are inconsistent with the design of any of our software solutions or which reduce the overall level of record-keeping or other controls or performances of clinical trials may have a material adverse effect on our business and operations. If we fail to offer solutions that allow our customers to comply with applicable regulations, it could result in the termination of on-going clinical trials or the disqualification of data for submission to regulatory authorities, or the withdrawal of approved marketing applications.

Demand for our software products, services and hosted solutions is largely a function of the regulatory requirements associated with the approval of drugs, biologics and medical devices. In recent years, efforts have been made to streamline the drug approval process and coordinate U.S. standards with those of other developed countries. Changes in the level of regulation, including a relaxation in regulatory requirements or the introduction of simplified drug approval procedures, could have a material adverse effect on the demand for our software products, services and hosted solutions. Several competing proposals to reform the system of health care delivery in the United States have been considered by Congress in recent years. To date, none of the proposals has been adopted. While it is difficult to predict the impact of any proposal which may be adopted in the future, proposals that cause or contribute to a reduction in clinical research and development expenditures could have a material adverse impact on the demand for our software products, services and hosted solutions. For example, proposals to place caps on drug prices could limit the profitability of existing or planned drug development programs, making investment in new drugs and therapies less attractive to pharmaceutical companies. Likewise, a proposal for government-funded universal health care could subject expenditures for health care to governmental budget constraints and limits on spending. Finally, the uncertainty surrounding the possible adoption and impact of any health care reforms could cause our customers to delay planned research and development until some of these uncertainties are resolved.

The U.S. government and the governments of some states and foreign countries have also attempted to regulate activities on the Internet. Any new legislation or regulation regarding the Internet could decrease our potential revenues or otherwise harm our business, financial condition and

operating results. For instance, proposed federal, state and foreign privacy regulations and other laws restricting the collection, use and disclosure of personal information could limit our customers' ability to use the information in our databases to generate revenues or subject us to additional administrative or compliance burdens or potential liabilities.

Regulation of the use and disclosure of personal medical information is complex and growing. Federal legislation in the United States, known as the Health Insurance Portability and Accountability Act of 1996, or HIPAA, imposes a number of requirements on the use and disclosure of "protected health information" which is individually identifiable, including standards for the use and disclosure by the health care facilities and providers who are involved in clinical trials. HIPAA also imposes on these healthcare facilities and providers standards to assure the confidentiality of health information stored or processed electronically, including a series of administrative, technical and physical security procedures. This may affect us in several ways. Many users of our products and services are directly regulated under HIPAA and, to the extent our products cannot be utilized in a manner that is consistent with the users' HIPAA compliance requirements, our products will likely not be selected. In addition, we may be directly affected by HIPAA and similar state privacy laws. Under HIPAA, to the extent we perform functions or activities on behalf of customers that are directly regulated by such medical privacy laws, such customers may be required to obtain satisfactory assurance, in the form of a written agreement, that we will comply with a number of the same HIPAA requirements. We may be burdened with compliance with such agreements, and breach of such an agreement may result in contractual liability to our customer or other adverse consequences. Regulation of medical information generally is increasing at the state and federal levels in the United States and elsewhere, and such regulations may negatively affect our business.

### **Intellectual Property**

Our success and ability to compete are dependent on our ability to develop and maintain the proprietary aspects of our technology and operate without infringing the proprietary rights of others. We rely upon a combination of trademark, trade secret, copyright, patent and unfair competition laws, as well as license agreements and other contractual provisions, to protect our intellectual property and other proprietary rights. In addition, we attempt to protect our intellectual property and proprietary information by requiring our employees and consultants to enter into confidentiality, noncompetition and assignment of inventions agreements. These legal protections afford only limited protection for our technology. We have registered trademarks and service marks in the United States and abroad, and applications for the registration of additional trademarks and service marks. Our principal trademarks are our company name "Phase Forward" and our product names, "InForm", "Clintrial" and "Clintrace." We cannot predict whether registrations will be approved or, if approved, will provide meaningful protection. In addition, we have been granted a patent by the U.S. Patent and Trademark Office. We cannot predict whether this patent will provide meaningful protection. Our agreements with employees, consultants and others who participate in development activities could be breached. We may not have adequate remedies for any breach, and our trade secrets may otherwise become known or independently developed by our competitors or other third parties. In addition, the laws of some foreign countries do not protect proprietary rights to the same extent as the laws of the United States, and effective copyright, patent, trademark and trade secret protection may not be available in those jurisdictions.

We have licensed in the past, and expect that we may license in the future, certain of our proprietary rights, such as trademarks, technology or copyrighted material, to third parties. Due to rapid technological change, we believe that factors such as the technological and creative skills of our personnel, new product and service developments and enhancements to existing products and services are more important than the various legal protections of our technology to establishing and maintaining a technology leadership position.

In addition, we license, and expect to continue to license, third-party technologies that are incorporated into some elements of our services and solutions.

Despite our efforts to protect our proprietary rights, unauthorized parties may attempt to copy aspects of our software solutions or to obtain and use information that we regard as proprietary. The laws of many countries do not protect our proprietary rights to as great an extent as do the laws of the United States. Litigation may be necessary in the future to enforce our intellectual property rights or to determine the validity and scope of the proprietary rights of others. Any such litigation could result in substantial costs and diversion of resources and could have a material adverse effect on our business, operating results or financial condition. There can be no assurance that our means of protecting our proprietary rights will be adequate or that our competitors will not independently develop similar technology. Any failure to meaningfully protect our intellectual property and other proprietary rights could have a material adverse effect on our business, operating results or financial condition.

In addition, if any of our software solutions is covered by third-party patents or other intellectual property rights, we could be subject to infringement actions. We cannot assure you that our software solutions do not infringe patents held by others or that they will not in the future. Any infringement claims made against us, including the claims made by Datasci, LLC and Dr. Mark L. Kozam disclosed in this Annual Report under "Item 3. *Legal Proceedings*," could cause us to incur substantial costs defending against the claim, even if the claim is without merit, and could distract our management from our business. Moreover, any settlement of or adverse judgment resulting from such claims could require us to pay substantial amounts or obtain a license to continue to use the technology that is the subject of the claim, or otherwise restrict or prohibit our use of the technology. Any required licenses may not be available to us on acceptable terms, if at all. If we do not obtain any required licenses, we could encounter delays in product introductions if we attempt to design around the technology at issue or to find another provider of suitable alternative technology to permit us to continue offering the applicable software solution. In addition, we generally provide in our customer agreements, including our agreement with the customer that is the subject of the Datasci and Kozam claims referenced above, that we will indemnify our customers against third-party infringement claims relating to our technology provided to the customer, which could obligate us to fund significant amounts.

### **Business Segments and Geographic Information**

The company views its operations and manages its business as one operating segment. For information regarding net revenues by geographic regions for each of the last three fiscal years, see Note 13 of the notes to our 2004 consolidated financial statements contained in this Annual Report.

For information regarding risks and dependencies associated with foreign operations, see risk factors listed in the "*Management's Discussion and Analysis of Financial Condition and Results of Operations*" contained in this Annual Report.

### **Employees**

As of December 31, 2004, we had a total of 361 employees, with 249 employees at our headquarters in Waltham, Massachusetts, 12 at other locations in the United States, and 100 employees in the United Kingdom, France, Germany, Australia and Japan. We had 164 employees in services and information technology, 93 employees in research and development, 55 employees in sales and marketing and 49 employees in administration and executive management. We also retained 58 outside contractors as of December 31, 2004. None of our employees are covered by a collective bargaining agreement. We consider our relations with our employees to be good.

## Available Information

We were incorporated in Delaware in 1997. We maintain a number of subsidiaries in the United States and abroad, including Phase Forward Europe Limited in the United Kingdom, Phase Forward SAS in France, Phase Forward Pty. Limited in Australia and Phase Forward Japan KK in Japan. We also maintain Phase Forward Securities Corporation, a Massachusetts securities corporation, to invest our cash balances on a short-term basis. On August 14, 2001, we acquired Clinsoft Corporation, a developer, marketer and provider of clinical data management and adverse event reporting and tracking products and services. Our Internet website address is <http://www.phaseforward.com>. Our Annual Report on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K and amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934 are available through the investor relations page of our internet website as soon as reasonably practicable after we electronically file such material with, or furnish it to, the Securities and Exchange Commission.

## Item 2. Properties

Our corporate headquarters are located at 880 Winter Street, Waltham, Massachusetts, where we lease approximately 98,968 square feet. This lease expires on February 28, 2009. We also lease 14,960 square feet of office space in Maidenhead, England for our European headquarters under a lease that expires in May 2012, and we lease smaller offices in Paris, France; Sydney, Australia; and Tokyo, Japan. We also lease individual offices in various locations to accommodate field sales personnel. We believe these facilities and additional or alternative space available to us will be adequate to meet our needs for the foreseeable future.

## Item 3. Legal Proceedings

From time to time and in the ordinary course of business, we are subject to various claims, charges and litigation. Intellectual property disputes often have a risk of injunctive relief which, if imposed against us, could materially and adversely affect our financial condition, or results of operations. From time to time, third parties have asserted and may in the future assert intellectual property rights to technologies that are important to our business and have demanded and may in the future demand that we license their technology. The outcome of litigation cannot be predicted with certainty and some lawsuits, claims or proceedings may be disposed of unfavorably to us, which could materially and adversely affect our financial condition or results of operations.

On April 26, 2004, Datasci, LLC ("Datasci") filed suit (Civil Action No. 04-1328(MJG)) in the United States District Court for the District of Maryland (Greenbelt Division) against Phase Forward Incorporated and Quintiles Inc., one of our customers. Datasci asserted that our *InForm*, *Clintrial* and *Clintrial Integration Solution* products and our services, and the products and services of Quintiles, infringe a United States patent claimed to be owned by Datasci (Patent No. 6,496,827). Datasci sought separate injunctions and unspecified damages from each of us and Quintiles. We filed an Answer and Counterclaim, on May 4, 2004, to Datasci's complaint denying that we infringe the patent which Datasci claimed to own. The Answer also challenged the validity of the patent and asserted numerous affirmative defenses. Our Counterclaim sought a declaratory judgment that we do not infringe the patent claimed to be owned by Datasci. Datasci responded by denying all the allegations in our Counterclaim. On or about June 7, 2004, Datasci filed a motion to dismiss its complaint against us and Quintiles. In its filing, Datasci disclosed that it did not exist when it filed its complaint against us and Quintiles.

Also on or about June 7, 2004, Dr. Mark L. Kozam, doing business under the name MLK Software and claiming to be the owner of the patent, filed suit (Civil Action No. 04-CV-1787 (MJG)) against us and Quintiles in the same court where Datasci filed its initial complaint. Dr. Kozam's

complaint contains the same allegations and seeks the same remedies that were contained in the Datasci complaint. On June 22, 2004, we filed an Answer and Counterclaim to Dr. Kozam's complaint denying that we infringe the patent which Dr. Kozam claims to own. Our Answer also challenges the validity of the patent and asserts numerous affirmative defenses. Our Counterclaim seeks a declaratory judgment that we do not infringe the patent claimed to be owned by Dr. Kozam. Dr. Kozam responded by denying all the allegations in our Counterclaim. This matter is ongoing and we are prepared to vigorously defend the claim and pursue our Counterclaims and any other remedies available to us.

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

No matters were submitted to a vote of our stockholders during the quarter ended December 31, 2004.

**PART II**

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

**Stock Market Information**

On July 20, 2004, we completed an initial public offering, or IPO, of 5,250,000 shares of common stock at \$7.50 per share. Our common stock is traded on the Nasdaq National Market under the symbol PFWDD. The following table sets forth the high and low sales prices for fiscal 2004 since our IPO. These over-the-counter market quotations reflect interdealer prices, without retail mark-up, mark-down or commission and may not necessarily represent actual transactions.

Fiscal	2004	
	High	Low
Third quarter*	\$ 9.35	\$ 7.15
Fourth quarter	\$ 8.60	\$ 6.70

\* Our common stock began trading on July 15, 2004.

**Holder**

As of March 4, 2005 there were approximately 280 stockholders of record of our common stock based on the records of our transfer agent.

**Dividends**

On June 1, 2004, our board of directors declared a special cash dividend of \$4.7 million, payable on September 15, 2004, to the holders of record of Series B, C and D Preferred Stock as of June 15, 2004. This distribution is included in accrued special distribution and net loss to common stockholders as of June 30, 2004. Except for this payment, we have not paid any cash dividends on our common stock, and our present policy is to retain earnings for use in our business.

**Recent Sales of Unregistered Securities; Use of Proceeds From Registered Securities.**

During the period covered by this report, we granted options to purchase an aggregate of 684,805 shares of our common stock to employees under our Amended and Restated 1997 Stock Option Plan and our 2004 Stock Option and Incentive Plan, at a weighted average exercise price of \$6.01 per share. In addition, we issued 361,050 shares of common stock during the period covered by this report in connection with the exercise of outstanding options under our 1997 Stock Option Plan by 56 of our employees, at a weighted exercise price of \$2.07 per share. These option exercises resulted in aggregate

proceeds to us of approximately \$747,000. No underwriters were involved in the foregoing stock or option issuances. The foregoing stock and option issuances were exempt from registration under the Securities Act of 1933, as amended, either pursuant to Rule 701 under the Act, as transactions pursuant to a compensatory benefit plan, or pursuant to Section 4(2) under the Act, as a transaction by an issuer not involving a public offering.

The aggregate net proceeds from the sale of 5,580,000 shares of our common stock, \$0.01 par value, in our initial public offering was approximately \$36.6 million, including approximately \$34.3 million as a result of the initial sale of 5,250,000 shares in the initial public offering and approximately \$2.3 million as a result of the exercise of an over-allotment option granted to the underwriters in the offering. To date, other than the repayment of our \$2.5 million equipment line of credit as disclosed in the prospectus, none of the net proceeds from the initial public offering has been applied. Pending such application, we have invested the remaining net proceeds of the offering in cash, cash equivalents and short-term investments in accordance with our investment policy in one or more of the following fixed income instruments: money-market mutual funds, U.S. Government agencies and direct and guaranteed obligations of the United States, as well as corporate bonds. None of the net proceeds were paid, directly or indirectly, to directors, officers, persons owning ten percent or more of our equity securities, or our affiliates.

#### **Issuer Purchases of Equity Securities**

During the quarter ended December 31, 2004, there were no repurchases made by us or on our behalf, or by any "affiliated purchaser," of shares of our common stock registered pursuant to Section 12 of the Securities Exchange Act of 1934, as amended.

Item 6. Selected Financial Data

**SELECTED CONSOLIDATED FINANCIAL DATA**  
(in thousands, except per share data)

The selected historical financial data set forth below as of December 31, 2003 and 2004 and for the years ended December 31, 2002, 2003 and 2004 are derived from our financial statements, which have been audited by Ernst & Young LLP, our independent registered public accounting firm, and which are included elsewhere in this Annual Report. The selected historical financial data as of December 31, 2000, 2001 and 2002, and for the years ended December 31, 2000 and 2001 are derived from our audited financial statements, which have been audited by Arthur Andersen LLP, our former independent public accountants, and which are not included elsewhere in this Annual Report.

The following selected consolidated financial data should be read in conjunction with our consolidated financial statements, the related notes and "Management's Discussion and Analysis of Financial Condition and Results of Operations" included elsewhere in this Annual Report. The historical results are not necessarily indicative of the results to be expected for any future period.

	Year Ended December 31,				
	2000	2001(1)	2002	2003	2004
<b>Consolidated Statement of Operations:</b>					
Revenues:					
License	\$ 1,229	\$ 9,134	\$ 15,746	\$ 21,377	\$ 28,180
Service	9,131	26,690	44,826	40,648	45,550
<b>Total revenues</b>	<b>10,360</b>	<b>35,824</b>	<b>60,572</b>	<b>62,025</b>	<b>73,730</b>
Cost of revenues:					
License	—	912	2,157	2,300	1,875
Service(2)	18,581	26,851	30,870	28,466	27,782
<b>Total cost of revenues</b>	<b>18,581</b>	<b>27,763</b>	<b>33,027</b>	<b>30,766</b>	<b>29,657</b>
Gross margin:					
License	1,229	8,222	13,589	19,077	26,305
Service	(9,450)	(161)	13,956	12,182	17,768
<b>Total gross margin</b>	<b>(8,221)</b>	<b>8,061</b>	<b>27,545</b>	<b>31,259</b>	<b>44,073</b>
Operating expenses:					
Sales and marketing(2)	8,208	11,235	13,581	12,709	14,403
Research and development(2)	6,754	8,338	10,654	10,569	12,423
General and administrative(2)	5,571	7,461	10,447	10,138	13,246
Restructuring charge	—	—	—	4,503	(168)
<b>Total operating expenses</b>	<b>20,533</b>	<b>27,034</b>	<b>34,682</b>	<b>37,919</b>	<b>39,904</b>
<b>Income (loss) from operations</b>	<b>(28,754)</b>	<b>(18,973)</b>	<b>(7,137)</b>	<b>(6,660)</b>	<b>4,169</b>
Other income (expense):					
Interest income	1,180	568	307	111	518
Interest expense	(419)	(558)	(418)	(364)	(394)
Other income (expense)	(510)	(185)	729	721	(32)
<b>Total other income (expense)</b>	<b>251</b>	<b>(175)</b>	<b>618</b>	<b>468</b>	<b>92</b>
<b>Income (loss) before provision for income taxes</b>	<b>(28,503)</b>	<b>(19,148)</b>	<b>(6,519)</b>	<b>(6,192)</b>	<b>4,261</b>
<b>Provision for income taxes</b>	<b>—</b>	<b>—</b>	<b>435</b>	<b>434</b>	<b>2,392</b>
<b>Net income (loss)</b>	<b>(28,503)</b>	<b>(19,148)</b>	<b>(6,954)</b>	<b>(6,626)</b>	<b>1,869</b>
<b>Accretion of preferred stock and dividend declared</b>	<b>3,739</b>	<b>5,573</b>	<b>8,068</b>	<b>7,672</b>	<b>8,953</b>
<b>Net loss applicable to common stockholders</b>	<b>\$ (32,242)</b>	<b>\$ (24,721)</b>	<b>\$ (15,022)</b>	<b>\$ (14,298)</b>	<b>\$ (7,084)</b>
<b>Net loss per share applicable to common stockholders:</b>					
Basic and diluted(3)	\$ (16.78)	\$ (10.36)	\$ (5.05)	\$ (4.23)	\$ (0.43)
<b>Weighted-average number of common shares used in computing per share amounts:</b>					
Basic and diluted(3)	1,921	2,386	2,975	3,383	16,447

As of December 31,

	2000	2001	2002	2003	2004
<b>Consolidated Balance Sheet Data:</b>					
Cash, cash equivalents, short-term investments and restricted cash	\$ 24,198	\$ 29,035	\$ 19,082	\$ 20,657	\$ 58,220
Working capital, net of deferred revenue(4)	20,321	26,874	24,182	28,107	67,734
Total assets	39,866	83,771	73,576	80,844	115,250
Total deferred revenue	7,183	31,209	28,608	37,788	36,352
Redeemable convertible preferred stock and warrant	69,541	106,410	116,448	124,120	—
Debt, net of current portion	3,545	1,821	2,238	1,970	1,849
Accumulated deficit	(49,513)	(74,234)	(87,855)	(98,911)	(104,386)
Total stockholders' (deficit) equity	(49,201)	(73,978)	(88,347)	(102,446)	59,247

(1) On August 14, 2001, the Company acquired all of the outstanding capital stock of Clinsoft Corporation, which was accounted for as a purchase under Statement of Financial Accounting Standards No. 141, *Business Combinations*. Accordingly, the results of Clinsoft have been included in the accompanying consolidated financial statements since the date of acquisition. The Clinsoft acquisition is further described in Note 3 of the notes to our 2003 consolidated financial statements contained in our Registration Statement No. 333-113594 on Form S-1, as amended, filed with the Securities and Exchange Commission.

(2) Cost of revenues and operating expenses include stock-based expenses, consisting of:

	Year Ended December 31,				
	2000	2001	2002	2003	2004
Cost of service revenues	\$ —	\$ —	\$ —	\$ 264	\$ 105
Sales and marketing	188	69	103	124	141
Research and development	—	—	—	184	312
General and administrative	—	—	—	155	1,553
Total stock-based expenses	\$ 188	\$ 69	\$ 103	\$ 727	\$ 2,111

(3) For information regarding the computation of per share amounts, refer to Note 2 of the notes to our consolidated financial statements.

(4) Working capital consists of current assets less current liabilities, net of deferred revenue.

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

*The information contained in this section has been derived from our consolidated financial statements and should be read together with our consolidated financial statements and related notes included elsewhere in this Annual Report. This Annual Report contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities and Exchange Act of 1934, as amended, and are subject to the "safe harbor" created by those sections. Some of the forward-looking statements can be identified by the use of forward-looking terms such as "believes," "expects," "may," "will," "should," "could," "seek," "intends," "plans," "estimates," "anticipates" or other comparable terms. Forward-looking statements involve inherent risks and uncertainties. A number of important factors could cause actual results to differ materially from those in the forward-looking statements. We urge you to consider the risks and uncertainties discussed at the end of this section under "Certain Factors That May Impact Future Results" in evaluating our forward-looking statements. We have no plans to update our forward-looking statements to reflect events or circumstances after the date of this report. We caution readers not to place undue reliance upon any such forward-looking statements, which speak only as of the date made.*

### **Overview**

We are a provider of integrated, enterprise-level electronic data capture, management and adverse event reporting software solutions for use in the clinical trial component of our customers' global research and development initiatives. We offer software products, services and hosted solutions to pharmaceutical, biotechnology and medical device companies, as well as academic institutions, clinical research organizations and other entities engaged in clinical trials. By automating essential elements of the clinical trial process, we believe our products allow our customers to accelerate the market introduction of new medical therapies and corresponding revenue, reduce overall research and development expenditures, enhance existing data quality control efforts and reduce clinical and economic risk.

### **Fiscal Year**

Our fiscal year ends on December 31. Reference to 2004, for example, refers to the fiscal year ended December 31, 2004.

### **Initial Public Offering**

On July 20, 2004, we completed an initial public offering of 5,250,000 shares of common stock at \$7.50 per share. In connection with the offering, all of the outstanding shares of our preferred stock (and a warrant to purchase preferred stock) were converted into an equal number of shares of common stock (and a warrant to purchase common stock). On August 19, 2004, we sold an additional 330,000 shares of common stock at \$7.50 per share as a result of the exercise of the over-allotment option by the underwriters of the offering. A summary of the terms of the offering can be found in our Registration Statement No. 333-113594 on Form S-1, as amended, as filed with the Securities and Exchange Commission.

The sale of the 5,580,000 shares of common stock in connection with the initial public offering resulted in net proceeds to us of \$36.6 million after deducting underwriters' discounts and offering-related expenses.

### **Sources of Revenues**

We derive our revenues from software licenses and services. License revenue is derived principally from the sale of multi-year software term licenses for our *InForm*, *Clintrial* and *Clintrace* software products. Service revenue is derived from our delivery of the hosted solution of our *InForm* software

product, consulting services and customer support, including training. We generally recognize revenues ratably over the life of a license or service contract. This allows us to maintain a backlog that provides multi-year visibility in revenue. As our backlog grows, we believe that the predictability of our future revenues will increase. One customer, Eli Lilly and Company, the holder of record of approximately one percent of our common stock, accounted for approximately 10% and 12% of our total revenues in 2003 and 2004, respectively. Our top 20 customers accounted for approximately 67% and 70% of our total revenues in 2003 and 2004, respectively, net of reimbursable out-of-pocket expenses. No customers accounted for more than 10% of our total revenues in 2002.

#### *License Revenue*

We derive our license revenues from our three major software products: *InForm*, our Internet based electronic data capture solution; *Clintrial*, our clinical data management solution; and *Clintrace*, our adverse event reporting solution. Although each of our *InForm*, *Clintrial* and *Clintrace* software solutions are available as stand-alone enterprise applications, we offer integrated enterprise solutions incorporating certain of our electronic data capture, data management and adverse event reporting products.

License revenues for our *InForm* electronic data capture software solution, either on a stand-alone or integrated basis, are determined primarily by the number, complexity and duration of the clinical trials and the number of participants in each clinical trial. License revenues for our *Clintrial* and *Clintrace* software solutions are determined primarily by the number of users accessing the software solution. Except as discussed below, we enter into software license agreements with terms generally of three to five years with payment terms generally annually in advance. License revenues are recognized ratably over the duration of the software term license agreement, to the extent that amounts are fixed or determinable and collectable.

In August 2001, we acquired Clinsoft Corporation, which developed, marketed and sold the *Clintrial* clinical data management and *Clintrace* adverse event reporting and tracking products. Historically, Clinsoft sold the *Clintrial* and *Clintrace* software products as a perpetual software license with the option to purchase customer support. Following the acquisition and subsequent integration of our software products, we began converting holders of Clinsoft perpetual software licenses to our software term license arrangements. We continue to sell perpetual licenses of these products in certain situations to our existing customers. We recognize revenue on the perpetual licenses upon delivery of the software. Perpetual license revenue represented less than one percent of total revenue for the twelve months ended December 31, 2003 and December 31, 2004. We continue to provide and charge for maintenance and support on our products to those customers who do not convert to our software term license arrangements. We generally charge 18% of the perpetual license fee for customer support. We will continue our efforts to convert the remaining former Clinsoft customer base to software term license arrangements.

#### *Service Revenue*

*Application Hosting Services.* In addition to making our software products available to customers through licenses, we offer our *InForm* electronic data capture software as a hosted application solution delivered through a standard web-browser, with customer support and training services. Revenue resulting from this hosting service consists of three stages for each clinical trial:

- *First stage*—trial and application setup, including design of electronic case report forms and edit checks, installation and server configuration of the system;
- *Second stage*—application hosting and related support services; and
- *Third stage*—services required to close out, or lock, the database for the clinical trial.

Services provided for the first and third stages are provided on a fixed fee basis depending upon the complexity of the trial and system requirements. Services for the second stage are charged separately as a fixed monthly fee. We recognize revenue from all stages of the hosting service over the second and third stages. Fees charged and costs incurred for the trial system design, setup and implementation are deferred until the start of the second stage and then amortized ratably over the estimated hosting period. The deferred costs include direct costs related to the trial and application setup. Fees for the first and third stages of the services are billed based upon milestones. Fees for application hosting and related services in the second stage are billed quarterly in advance. Bundled into this revenue element is the revenue attributable to the software license used by the customer. In addition, application hosting services revenue includes reimbursable out-of-pocket expenses.

In the event that an application hosting customer cancels a clinical trial and its related statement of work, all deferred revenue is recognized and all deferred setup costs are expensed and certain termination-related fees may be charged. In addition, application hosting services revenue includes hosting services associated with term license arrangements and reimbursable out-of-pocket expenses.

*Consulting Services.* Consulting services include the design and documentation of the processes related to our customers' use of our products and services in their clinical trials. Consulting services also include project planning and management services, guidance on best practices in using our software products, as well as implementation services consisting of application architecture design, systems integration, installation and validation. Revenues from consulting services included in a multiple element software license agreement or in a hosted solution are recognized ratably over the term of the arrangement. The associated costs are expensed as incurred. Revenues from consulting services that are not included in a multiple element software license arrangement are recognized as services are performed. Fixed priced arrangements are billed based upon contractual milestones, and time-and-materials arrangements are billed monthly.

*Customer Support.* We have a multinational services organization to support our software products and hosted solutions worldwide. Customer support includes telephone support, software maintenance and training. We bundle customer support in our software term licenses and allocate 10% of the value of the license to customer support revenue. Our customer support revenue also consists of customer support fees paid by the *Clintrial* and *Clintrace* perpetual license customers. Customer support revenue is recognized ratably over the period of the customer support or term license agreement, with payment terms generally annually in advance.

### **Cost of Revenues and Operating Expenses**

We allocate overhead expenses such as rent and occupancy charges and employee benefit costs to all departments based on headcount. As such, general overhead expenses are reflected in cost of service revenues and in the sales and marketing, research and development, and general and administrative expense categories.

*Cost of Revenues.* Cost of license revenues consists primarily of the amortization of royalties paid for certain modules within our *Clintrial* software product and the Japanese version of our *InForm* software product. In addition to these costs we also incurred expense for the amortization of acquired technologies in years prior to 2004. The cost of license revenue varies based upon the mix of revenue from software licenses for our products. We operate our service organization on a global basis as one distinct unit, and do not segment costs for our various service revenue elements. These services include performing application hosting, consulting and customer support services, and costs consist primarily of employee-related costs associated with these services, amortization of the deferred clinical trial set-up costs, allocated overhead, outside contractors, royalties associated with providing customer support for third-party modules licensed to our customers for use with the *Clintrial* software product and reimbursable out-of-pocket expenses. Cost of services also includes hosting costs that primarily consist

of hosting facility fees and server depreciation. The cost of service revenue varies based upon employee utilization levels in the service organization and royalties associated with revenue derived from providing customer support, as well as costs associated with the flexible use of outside contractors to support internal resources. We supplement the trial design and set up activity for application hosting services through the use of outside contractors. This allows us to utilize outside contractors in those periods where trial design and set up activity is highest while reducing the use of outside contractors in those periods where trial activity lessens, allowing for a more flexible delivery model. The percentage of the services workforce represented by outside contractors varies from period to period depending on the volume of specific support required. During 2004, utilization of outside contractors varied from approximately 25% to 30% of our services workforce. The cost of services is significantly higher as a percentage of revenue as compared to our cost of license revenue primarily due to the employee-related and outside contractor expenses associated with providing services.

*Gross Margin.* Our gross margin on license revenue varies based on the mix of royalty- and nonroyalty-bearing license revenue and the amount of amortization of acquired technologies. Our gross margin on service revenue varies primarily due to variations in the utilization levels of the professional service team and the timing of expense and revenue recognition under our service arrangements. In situations where the service revenue is recognized ratably over the software license term, typically three to five years, our costs associated with delivery of the services are recognized as the services are performed, which is typically during the first 9 to 12 months of the contract period. Accordingly, our gross margin on service revenue will vary significantly over the life of a contract. In addition, consolidated gross margin will vary depending upon the mix of license and service revenue.

*Sales and Marketing.* Sales and marketing expenses consist primarily of employee-related expenses, including travel, marketing programs (which include product marketing expenses such as trade shows, workshops and seminars, corporate communications, other brand building and advertising), allocated overhead and the amortization of commissions. We expect that sales and marketing expenses will increase as we expand and further penetrate our customer base, expand our domestic and international selling and marketing activities associated with existing and new product and service offerings, build brand awareness and sponsor additional marketing events.

*Research and Development.* Research and development expenses consist primarily of employee-related expenses, allocated overhead and outside contractors. We have historically focused our research and development efforts on increasing the functionality, performance and integration of our software products. We expect that in the future, research and development expenses will increase as we introduce additional integrated software solutions to our product suite.

*General and Administrative.* General and administrative expenses consist primarily of employee-related expenses, professional fees, other corporate expenses and allocated overhead. We expect that in the future, general and administrative expenses will increase as we add personnel and incur additional professional fees and insurance costs related to the growth of our business and operations, as well as professional fees associated with ongoing legal proceedings.

*Restructuring Charge.* We recorded a \$4.5 million restructuring charge in 2003 which related to the relocation of our corporate headquarters. This charge includes approximately \$2.5 million relating to the estimated future obligation under the non-cancelable lease and an approximate \$2.0 million write-off of the related abandoned leasehold improvements and fixed assets. We review this estimate quarterly and during the fourth quarter of 2004 we recorded an expense reduction of \$168,000.

*Stock-Based Expenses.* Our cost of service revenues and operating expenses, excluding our restructuring charges, include stock-based expenses related to the fair value of options issued to non-employees and option grants to employees in situations where the exercise price is determined to be less than the deemed fair value of our common stock at the date of grant.

## Foreign Currency Translation

With regard to our international operations, we frequently enter into transactions in currencies other than the U.S. dollar. As a result, our revenues, expenses and cash flows are subject to fluctuations due to changes in foreign currency exchange rates, particularly changes in the Euro, British pound sterling, Australian dollar and Japanese yen. In 2003 and 2004, approximately 39% and 43%, respectively, of our revenues were generated in locations outside the United States. The majority of these revenues are in currencies other than the U.S. dollar, as are many of the associated expenses. In periods when the U.S. dollar declines in value as compared to the foreign currencies in which we conduct business, our foreign currency-based revenues and expenses increase in value when translated into U.S. dollars.

## Critical Accounting Policies and Estimates

Our financial statements are prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires us to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues, costs and expenses and related disclosures. On an ongoing basis, we evaluate our estimates and assumptions with our audit committee. There have been no material changes to these estimates for the periods presented in this Annual Report. Our actual results may differ from these estimates.

We believe that of our significant accounting policies, which are described in Note 2 of the notes to our 2004 consolidated financial statements included in this Annual Report, the following accounting policies involve a greater degree of judgment and complexity. Accordingly, these are the policies we believe are the most critical to aid in fully understanding and evaluating our consolidated financial condition and results of operations.

*Revenue Recognition and Deferred Setup Costs.* We recognize software license revenue in accordance with Statement of Position (SOP) No. 97-2, *Software Revenue Recognition*, as amended, issued by the American Institute of Certified Public Accountants, while revenues resulting from application services are recognized in accordance with Emerging Issues Task Force (EITF) Issue No. 00-03, *Application of AICPA Statement of Position 97-2 to Arrangements that Include the Right to Use Software Stored on Another Entity's Hardware* and Securities and Exchange Commission's (SEC) Staff Accounting Bulletin (SAB) Nos. 101 and 104, *Revenue Recognition*. On August 1, 2003, we adopted EITF Issue No. 00-21, *Revenue Arrangements with Multiple Deliverables*. The adoption of EITF Issue No. 00-21 did not have a material impact on our financial position or results of operations.

Our customers generally have the ability to terminate service agreements upon 30 days notice to us. License and services agreements can be terminated by either party for material breach of obligations generally not corrected within 30 days after notice of the breach.

We recognize revenue when all of the following conditions are satisfied: (1) there is persuasive evidence of an arrangement; (2) the service has been provided to the customer; (3) the collection of our fees is probable; and (4) the amount of fees to be paid by the customer is fixed or determinable.

We generally enter into software term licenses with our customers for 3- to 5-year periods. These arrangements typically include multiple elements: software license, consulting services and customer support. We bill our customers in accordance with the terms of the underlying contract. Generally, we bill the annual license fee for the first year of the multi-year contract in advance and bill license fees for subsequent years on the anniversary date. Our payment terms are generally net 30 days.

Our software license revenue is earned from the sale of off-the-shelf software requiring no significant modification or customization subsequent to delivery to the customer. Consulting services, which can also be performed by third-party consultants, are deemed to be non-essential to the

functionality of the software and typically are for trial configuration, implementation planning, loading of software, building simple interfaces and running test data and documentation of procedures.

We generally bundle customer support with the software license for the entire term of the arrangement. As a result, we generally recognize revenue for all elements ratably over the term of the multiple element arrangement. We allocate the revenue for these arrangements to the different elements based on management's estimate of the relative fair value of each element. For our contracts accounted for ratably under SOP No. 97-2, we allocate to consulting services the anticipated service level throughout the term of the arrangement at an amount equal to what it would have been had those services been sold separately to the customer. The remaining value is allocated to license and support services, with a 10% value allocated to support services. The costs associated with the consulting and customer support services are expensed as incurred. There are instances in which we sell software licenses based on usage levels. These software licenses can be based on estimated usage, in which case the license fee charged to the customer is fixed based on this estimate. When the fee is fixed, the revenue is recognized over the contractual term of the arrangement. If the fee is based on actual usage, and therefore variable, the revenue is recognized in the period of use. Revenue from certain follow-on consulting services, which are sold separately to customers with existing software licenses and are not considered part of a multiple element arrangement, is generally recognized as the services are performed.

Revenue from perpetual software licenses represented less than one percent of total revenues in 2003 and 2004. We continue to sell perpetual licenses for the *Clintrial* and *Clintrace* software products in certain situations to our existing customers with the option to purchase customer support. We have established vendor specific objective evidence of fair value for the customer support. Accordingly the perpetual license revenue is recognized upon delivery of the software and when all other revenue recognition criteria are met. Customer support revenues are recognized ratably over the term of the underlying support arrangement.

In addition to making our software products available to customers through licenses, we offer our *InForm* electronic data capture software solution through a hosted application solution delivered through a standard web-browser. Revenue resulting from application hosting services consist of three stages for each clinical trial: the first stage involves application setup, including design of electronic case report forms and edit checks, implementation of the system and server configuration; the second stage involves application hosting and related support services; and the third stage involves services required to close out, or lock, the database for the clinical trial. Services provided for the first and third stages are provided on a fixed fee basis based upon the complexity of the trial and system requirements. Services for the second stage are charged separately as a fixed monthly fee. We recognize revenue from all stages of the hosting service over the second and third stages. Fees charged and costs incurred for the trial system design, setup and implementation are deferred and capitalized as applicable, until the start of the second stage and then amortized and recognized, as applicable, ratably over the estimated hosting period. The capitalized costs include incremental direct costs with third parties and certain internal direct costs related to the trial and application setup, as defined under Statement of Financial Accounting Standards (SFAS) No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Indirect Costs of Leases*. These costs include salary and benefits associated with direct labor costs incurred during trial setup, as well as third-party subcontract fees and other contract labor costs. Work performed outside the original scope of work is contracted for separately as an additional fee and is generally recognized over the remaining term of the hosting period. Fees for the first and third stages of the services are billed based upon milestones. Fees for application hosting and related services in the second stage are billed quarterly in advance. Bundled into this revenue element is the revenue attributable to the software license used by the customer.

We capitalized \$1.7 million, \$1.7 million and \$1.6 million of deferred setup costs and amortized \$2.9 million, \$1.7 million and \$2.0 million during the years ended December 31, 2002, 2003 and 2004, respectively. The amortization of deferred setup costs is a component of cost of services.

Deferred revenue represents amounts billed or cash received in advance of revenue recognition.

*Accounting for Commission Payments and Royalties.* For arrangements where we recognize revenue over the relevant contract period, we defer related commission payments to our direct sales force and software license royalties paid to third parties and amortize these amounts over the same period that the related revenues are recognized. This is done to better match commission and royalty expenses with the related revenues. During 2002, 2003 and 2004, we deferred \$2.3 million, \$4.0 million and \$3.8 million, respectively, of commissions and amortized \$1.7 million, \$1.7 million and \$3.0 million, respectively, to sales and marketing expense. Royalties are paid on a percentage of billings basis for certain of our products. During 2002, 2003 and 2004, we deferred \$1.7 million, \$1.7 million and \$2.7 million, respectively, of royalty expenditures and amortized \$1.7 million, \$2.0 million and \$2.4 million, respectively, to cost of license and service revenue.

*Accounts Receivable Reserves.* We maintain allowances for doubtful accounts for estimated losses resulting from the inability of our customers to make required payments. We regularly evaluate the collectibility of our trade receivables based on a combination of factors, which may include dialogue with the customer to determine the cause of non-payment, the use of collection agencies, and/or the use of litigation. In the event it is determined that the customer may not be able to meet its full obligation to us, we record a specific allowance to reduce the related receivable to the amount that we expect to recover given all information available to us. We continuously monitor collections from our customers and maintain a provision for estimated credit losses based upon our historical experience and any specific customer collection issues that we have identified. While such credit losses have historically been within our expectations and the provisions established, we cannot guarantee that we will continue to experience the same credit loss rates in the future. If the financial condition of our customers were to deteriorate, resulting in an impairment of their ability to make payments, additional allowances may be required. Our accounts receivable reserves were \$212,000, \$425,000 and \$391,000 as of December 31, 2002, 2003 and 2004, respectively.

*Accounting for Stock-Based Awards.* We record deferred stock-based compensation charges in the amount by which the exercise price of an option is less than the deemed fair value of our common stock at the date of grant. Because there had been no public market for our stock prior to the July 2004 initial public offering of our common stock, our board of directors had determined the fair value of our common stock based upon several factors, including, but not limited to, our operating and financial performance, sales of convertible preferred stock to third parties, the rights and preferences of securities senior to common stock and the anticipated offering price of our common stock in connection with our July 2004 initial public offering.

We have not historically engaged unrelated third parties to prepare valuations of our common stock. In connection with our July 2004 initial public offering, management and the board of directors retroactively assessed the fair value of our common stock during 2003 and through the date of our initial public offering, July 14, 2004.

During 2003, all stock options were granted with an exercise price of \$3.00 per share, while the estimated per share fair value of our common stock ranged from \$3.00 to \$4.00 in the first quarter of 2003, \$4.00 to \$5.00 in the second quarter of 2003, \$5.00 to \$7.50 in the third quarter of 2003 and \$7.50 to \$9.00 in the fourth quarter of 2003.

At the beginning of 2003, we determined the value of our common stock based principally on the per share amounts that would have been distributed to the common stockholders, after all required distributions to the preferred stockholders, in the event of a sale of the Company at the value

established in our January 2002 preferred stock financing. We chose this valuation methodology based on our operating performance during 2002 and the limited, if any, access we had to the public equity markets at the time.

The increase in our estimated per share fair value of common stock since the beginning of 2003 reflects a number of significant factors, including an improvement in our operating results, especially in the second half of the year, changes to our management team throughout 2003, additions to our board of directors in the second half of 2003 and an overall improvement in stock market indices and increasing volume of initial public offerings of common stock throughout 2003.

We improved our operating results during each of the four quarters of 2003. In the first, second and third quarters, we incurred operating losses of \$1.4 million, \$1.1 million and \$31,000, respectively. In the fourth quarter, we had an operating profit of \$432,000, excluding a restructuring charge in the fourth quarter. Our increasing per share fair value of common stock throughout 2003 reflects this positive trend in operating results. In addition, in the second half of 2003, because of our improved operating performance and the improving equity markets, we began to contemplate an initial public offering of our common stock.

During the six months ended June 30, 2004, options were granted at exercise prices ranging from \$4.50 to \$6.00 per share while the estimated fair value of our common stock was \$10.00 per share. The fair value of our common stock in the six months ended June 30, 2004 was based on the high end of the range of estimated offering prices of common stock as contemplated in the preliminary prospectus for our initial public offering that was filed with the Securities and Exchange Commission. No options were granted during the three months ending September 30, 2004 and options that were granted in the three months ending December 31, 2004 were priced at fair market value.

In the three month period ended March 31, 2004, we granted options to purchase 205,000 shares of common stock that vest upon the earlier of 7 years from date of grant or the attainment of specified milestones. Upon completion of our July 2004 initial public offering, 61,250 options automatically vested, which accelerated \$264,300 in stock-based expense compensation in the three and nine month periods ended September 30, 2004.

As of December 31, 2004, there was an aggregate of \$1.8 million of deferred stock-based compensation remaining to be amortized approximately as follows: \$929,000 in the year ending December 31, 2005; \$511,000 in the year ending December 31, 2006; \$220,000 in the year ending December 31, 2007 and \$94,000 through December 31, 2011. We have elected not to record the fair value of employee stock-based awards. The impact of recording employee stock-based awards at fair value, using the Black-Scholes option-pricing model, is further described in Note 2 of the notes to our 2004 consolidated financial statements contained in this Annual Report.

In the past, we have awarded a limited number of stock options to non-employees. For these options, we recognize the stock-based compensation over the vesting periods of the underlying awards, based on an estimate of their fair value on the vesting dates using the Black-Scholes option-pricing model.

#### *Other Significant Estimates*

*Goodwill Impairment.* We review the carrying value of goodwill periodically based upon the expected future discounted operating cash flows of our business. Our cash flow estimates are based on historical results adjusted to reflect our best estimate of future markets and operating conditions. Actual results may differ materially from these estimates. The timing and size of impairment charges, if any, involves the application of management's judgment regarding the estimates and could significantly affect our operating results.

*Accounting for Income Taxes.* In connection with preparing our financial statements, we are required to estimate our income taxes in each of the jurisdictions in which we operate. This process involves the assessment of our net operating loss carryforwards and credits, as well as estimating the actual current tax liability together with assessing temporary differences resulting from differing treatment of items, such as reserves and accrued liabilities, for tax and accounting purposes. We then assess the likelihood that deferred tax assets will be recovered from future taxable income, and to the extent we believe that recovery is not likely, we must establish a valuation allowance. Based on historical results, we believe that it is more likely than not that we will not realize the value of our deferred tax assets and therefore have provided a full valuation allowance against our net deferred tax assets, which amounted to \$40.0 million at December 31, 2004.

The American Jobs Creation Act of 2004 (the "Act") introduced a special one-time dividends received deduction on the repatriation of certain foreign earnings to a U.S. taxpayer (repatriation provision), provided certain criteria are met. On October 22, 2004, the Act was signed into law by the President. Even in light of the Act, our current intention is to reinvest the total amount of our unremitted earnings in the local jurisdiction or to repatriate the earnings only when tax-effective. As such, we have not provided U.S. tax expense on the unremitted earnings of our foreign subsidiaries.

*Restructuring Charge.* We recorded a \$4.5 million restructuring charge in 2003 which related to the relocation of our corporate headquarters. This charge includes approximately \$2.5 million relating to the estimated future obligation under the non-cancelable lease and an approximate \$2.0 million write-off of the related abandoned leasehold improvements and fixed assets. We review this estimate quarterly and during the fourth quarter of 2004 we recorded an expense reduction of \$168,000.

#### **Overview of Results of Operations for the Years Ended December 31, 2003 and 2004**

Backlog grew significantly in 2004 to \$181.6 million at December 31, 2004, an increase of 29% from \$140.8 million of backlog at December 31, 2003. The license portion of our backlog grew from \$70.0 million at December 31, 2003 to \$102.0 million at December 31, 2004, representing a 46% increase. The increase in license backlog was due primarily to an increase in license sales of our *InForm* product to our existing *Clintrial* customers, which reflects an increase in the adoption of our products. The service portion of our backlog increased by 12% during this same period from \$70.8 million to \$79.6 million. Approximately \$70.5 million of the December 31, 2004 total backlog is expected to be recognized as revenue in fiscal 2005. Approximately 17% of the value of our backlog as of December 31, 2004 represented contract commitments that may be cancelled by our customers at any time with limited notice. Based on historical cancellations since inception, less than 2% of the value of our total backlog is estimated to be at risk for cancellation prior to completion.

License revenue increased by 32% for 2004 as compared to 2003. Service revenue increased by 12% for 2004 as compared to 2003.

Our gross margin increased by 41% or \$12.8 million in the year ended December 31, 2004 compared to the same period in 2003, primarily due to the increase in license revenue as a percentage of total revenue, an increase in services revenue, and the decrease in cost of products and services, resulting from decreases in amortization expense and reimbursable out-of-pocket expenses.

Operating income increased by \$10.8 million from an operating loss of \$6.7 million in 2003 to an operating income of \$4.2 million 2004. The operating income (loss) in 2003 and 2004 included a restructuring charge of \$4.5 million and a benefit of \$168,000, respectively. The operating income (loss) for the twelve months ended December 31, 2003 and 2004 also included \$727,000 and \$2.1 million of stock-based compensation, respectively.

As of December 31, 2004, we had \$58.2 million of cash, cash equivalents and short term investments, an increase of \$37.5 million from \$20.7 million at December 31, 2003. The sale of the 5,580,000 shares of common stock in connection with the initial public offering resulted in net proceeds to us of \$36.6 million after deducting underwriters' discounts and offering-related expenses.

#### Revenues

Revenues	Year Ended December 31,				Change	
	2003		2004		Amount	%
	Amount	Percentage of Revenue	Amount	Percentage of Revenue		
(in thousands)						
License	\$ 21,377	34%	\$ 28,180	38%	\$ 6,803	32%
Application hosting services	20,217	33	27,444	37	7,227	36%
Consulting services	6,107	10	4,976	7	(1,131)	(19)%
Customer support	14,324	23	13,130	18	(1,194)	(8)%
<b>Total</b>	<b>\$ 62,025</b>	<b>100%</b>	<b>\$ 73,730</b>	<b>100%</b>	<b>\$ 11,705</b>	<b>19%</b>

Total revenues increased in 2004 as compared to 2003, primarily due to an increase in license revenue across all products as well as *InForm* application hosting services revenue. The increase in license revenue for 2004 was primarily due an increase in sales of *Clintrial* and *Clintrace* to existing customers and to an increase in sales of *InForm* into our existing *Clintrial* customer base. This increase was a result of our continued strategy to expand the usage of our software products by cross selling the *InForm*, *Clintrial* and *Clintrace* products to our existing customer base, additional utilization of our products within our customer base and sales to new customers. The increase in revenue associated with the hosted application of our *InForm* product in 2004 was due to an increase in trials under management. Consulting services revenue in 2004 decreased compared to the same period in 2003. The decrease in consulting services revenue was due primarily to the completion of certain *Clintrace* related projects, and, to a lesser extent completion of certain projects associated with integrated enterprise solutions. The decrease in customer support revenue in 2004 was due primarily to a reduction in the *Clintrial* and *Clintrace* maintenance renewal base as a result of the conversion of the former Clinsoft customers to term-based licenses that have a lower customer support fee, partially offset by an increase in *InForm* support due to an increase in *InForm* license revenue. Our revenue was not significantly impacted by price increases or decreases. Inflation had only a nominal impact on our revenues. In the future, we anticipate that license revenue will increase as a percentage of total revenues as a result of increases in the amounts of software license revenue reflected in our backlog.

Revenues by Geography	Year Ended December 31,				Change	
	2003		2004		Amount	%
	Amount	Percentage of Revenue	Amount	Percentage of Revenue		
(in thousands)						
United States	\$ 37,859	61%	\$ 42,172	57%	\$ 4,313	11%
United Kingdom	12,670	20	18,143	25	5,473	43%
France	7,737	13	8,604	12	867	11%
Asia Pacific	3,759	6	4,811	6	1,052	28%
<b>International subtotal</b>	<b>24,166</b>	<b>39</b>	<b>31,558</b>	<b>43</b>	<b>7,392</b>	<b>31%</b>
<b>Total</b>	<b>\$ 62,025</b>	<b>100%</b>	<b>\$ 73,730</b>	<b>100%</b>	<b>\$ 11,705</b>	<b>19%</b>

The increase in revenues worldwide was due to the increase in license sales across all of our products and *InForm* application hosting services, which reflects an increase in the adoption of our products. The increase in international revenues is primarily the result of additional enterprise-wide license arrangements as well as application hosting services.

#### Cost of Revenues

Costs of Revenues	Year Ended December 31,					
	2003		2004		Change	
	Amount	Percentage of Related Revenue	Amount	Percentage of Related Revenue	Amount	%
(in thousands)						
License	\$ 2,300	11%	\$ 1,875	7%	\$ (425)	(18)%
Services	28,466	70	27,782	61	(684)	(2)%
<b>Total</b>	<b>\$ 30,766</b>	<b>50%</b>	<b>\$ 29,657</b>	<b>40%</b>	<b>\$ (1,109)</b>	<b>(4)%</b>

The cost of license revenue decreased in 2004 primarily due to a \$1.0 million decrease in amortization expense from acquired technologies partially offset by an increase in royalty expense of \$601,000 as revenue increased on certain modules of the *Clintrial* software product, and to a lesser extent, the Japanese version of our *InForm* software product. The decrease in the cost of services in 2004 was due primarily to a \$632,000 reduction in reimbursable out-of-pocket expenses, as well as a decrease in facilities and depreciation expense of \$314,000 and \$247,000, respectively, primarily resulting from cost savings associated with the relocation of our corporate headquarters in the fourth quarter of 2003. Additionally, stock-based compensation decreased by \$189,000 as did royalty expense by \$170,000 primarily due to the decrease in customer support revenue from licenses of the *Clintrial* software product. These expense decreases were offset by increases in outside contractor expense of \$392,000, employee-related expenses of \$304,000 while headcount remained relatively constant during these periods and an increase in amortization of capitalized labor of \$201,000.

#### Gross Margin

Gross Margin	Year Ended December 31,					
	2003		2004		Change	
	Amount	Percentage of Related Revenue	Amount	Percentage of Related Revenue	Amount	%
(in thousands)						
License	\$ 19,077	89%	\$ 26,305	93%	\$ 7,228	38%
Services	12,182	30	17,768	39	5,586	46%
<b>Total</b>	<b>\$ 31,259</b>	<b>50%</b>	<b>\$ 44,073</b>	<b>60%</b>	<b>\$ 12,813</b>	<b>41%</b>

The license gross margin percentage increased in 2004 primarily due to an increase in license revenue for all of our products and a reduction in amortization expense associated with acquired technology, partially offset by an increase in royalty expense as revenue grew for certain modules of the *Clintrial* software product, and to a lesser extent, the Japanese version of our *InForm* software product. The services gross margin percentage increased in 2004 due to the increase in *InForm* application hosting revenues and lower overall cost of services revenue.

Operating Expenses

Year Ended December 31,

Operating Expenses	2003		2004		Change	
	Amount	Percentage of Revenue	Amount	Percentage of Revenue	Amount	%
(in thousands)						
Sales and marketing	\$ 12,709	21%	\$ 14,403	20%	\$ 1,694	13%
Research and development	10,569	17	12,423	17	1,854	18%
General and administrative	10,138	16	13,246	18	3,108	31%
Restructuring charge	4,503	7	(168)	0	(4,671)	(104)%
<b>Total</b>	<b>\$ 37,919</b>	<b>61%</b>	<b>\$ 39,904</b>	<b>54%</b>	<b>\$ 1,985</b>	<b>5%</b>

*Sales and Marketing.* Sales and marketing expenses increased in 2004 primarily due to a \$671,000 increase in employee-related expenses, a \$1.4 million increase in commission expense due to both an increase in revenues and an increase in the effective commission rate, which was partially offset by a \$192,000 decrease in marketing programs. We expect that our sales and marketing expense will continue to increase in absolute dollars as commission expense increases with our revenues and we continue to build brand awareness through what we believe are the most cost effective channels available, but will fluctuate due to the timing of marketing programs.

*Research and Development.* Research and development expenses increased in 2004 primarily due to an increase in employee-related expenses of \$2.6 million as we hired 22 additional people to expand and improve our quality assurance and product development team, and a \$128,000 increase in stock-based compensation. This was partially offset by a \$571,000 decrease in outside contractors as we brought certain research and development activities in house and a \$261,000 decrease in depreciation expense from cost savings associated with the relocation of our corporate headquarters in the fourth quarter of 2003. We expect that our research and development costs will continue to increase in absolute dollars as we continue to add features and functionality to our products and expand our product and service offerings.

*General and Administrative.* General and administrative expenses increased for the twelve months ended December 31, 2004 primarily due to a \$1.4 million increase in stock-based compensation, an increase in professional fees of \$1.0 million primarily relating to legal fees associated with actions defending our intellectual properties, and an increase in employee-related expenses of \$853,000, while headcount remained stable during these periods, and an increase in insurance of \$241,000 due to additional requirements relating to being a public company. This was partially offset by decreases in depreciation and occupancy of \$213,000 and \$138,000, respectively. These decreases resulted from cost savings associated with the relocation of our corporate headquarters in the fourth quarter of 2003. We expect our general and administrative expenses to increase in absolute dollars as we incur additional costs associated with being a public company.

Operating Loss, Other Income (Expense)

	Year Ended December 31,					
	2003		2004		Change	
	Amount	Percentage of Revenue	Amount	Percentage of Revenue	Amount	%
	(in thousands)					
Operating income (loss)	\$ (6,660)	(11)%	\$ 4,169	6%	\$ 10,829	163%
Other income (expense)						
Interest income	\$ 111	0%	\$ 518	1%	\$ 407	367%
Interest expense	(364)	(1)	(394)	(1)	(30)	(8)%
Other income (expense)	721	1	(32)	(0)	(753)	(104)%
Total	\$ 468	0%	\$ 92	0%	\$ (376)	(80)%

*Operating Income (Loss).* The increase in operating income in the twelve months ended December 31, 2004 was primarily due to an increase in gross margin from both license and services, partially offset by increased operating expenses, resulting from increases in employee-related expenses, commission expense, stock-based compensation, and professional fees. It is likely that operating income (loss), as a percentage of revenue will fluctuate, due to the timing, amount and type of service required in delivery of certain projects as well as the timing of operating expense activities.

*Other Income (Expense).* The increase in interest income in the twelve months ended December 31, 2004 was primarily due to an increase in cash and cash equivalents available for investment and \$84,000 of interest received in connection with the repayment of a subscription receivable. Other income (expense) decreased due to a decrease in the foreign exchange gains related to exchange rate movements on both non-U.S. dollar denominated accounts receivable and intercompany balances partially offset by forward foreign exchange contracts and lower non-U.S. dollar denominated accounts receivable and intercompany balances.

Provision for Income Taxes

	Year Ended December 31,					
	2003		2004		Change	
	Amount	Percentage of Revenue	Amount	Percentage of Revenue	Amount	%
	(in thousands)					
Provision for income taxes	\$ 434	1%	\$ 2,392	3%	\$ 1,958	17%

*Provision for Income Taxes.* The provision for income taxes in 2003 represents foreign withholding taxes and income taxes payable in certain foreign locations that cannot be offset through loss carryforwards. The provision for income taxes in 2004 represents foreign withholding taxes and income taxes payable in both our U.S. operations and in certain foreign locations that cannot be offset through loss carryforwards. The effective tax rate for 2004 increased to 56% compared to an effective tax rate of 7% for 2003. The increase in our effective tax rate is primarily due to our domestic profitability. In utilizing our net operating loss carryforwards, we are required to use our oldest net operating losses first. As a result, we have first used the net operating losses acquired in the Clinsoft acquisition. The utilization of the acquired net operating losses reduces the amount of income taxes payable to local tax authorities. This benefit has been reflected as a reduction of goodwill. Additionally, our effective tax rate exceeds our statutory tax rate due to the current non-deductibility of our stock-based compensation expense.

## Overview of Results of Operations for the Years Ended December 31, 2002 and 2003

Backlog grew significantly in 2003 to \$140.8 million at December 31, 2003, an approximate 29% change from \$108.9 million of backlog at 2002 year-end, primarily reflecting the growing market acceptance and adoption of our software products, services and hosted solutions. The license portion of our backlog grew from \$45.5 million at December 31, 2002 to \$70.0 million at December 31, 2003, representing an approximate 54% increase. The increase in license backlog was due primarily to an increase in license sales of our Clinsoft products to new customers and our existing customers, which reflects an increase in the adoption of our products. The service portion of our backlog increased by approximately 12% during this same period from \$63.3 million to \$70.8 million, due primarily to an increase in consulting services associated with integrated enterprise solutions of our products.

License revenue increased by approximately 36% in 2003 while service revenue declined, offsetting this license revenue growth substantially. The decline in service revenue resulted from a decrease in our hosted solutions activity and a reduction in our customer support revenue.

Our gross margin increased by \$3.7 million or approximately 13% in 2003, primarily due to the increase in license revenue as a percentage of total revenues.

Total expenses increased in 2003, primarily due to stock-based compensation and restructuring charges.

As of December 31, 2003, we had \$20.7 million of cash, cash equivalents and restricted cash, as compared to \$19.1 million as of December 31, 2002.

### Revenues

Revenues	Year Ended December 31,					
	2002		2003		Change	
	Amount	Percentage of Revenue	Amount	Percentage of Revenue	Amount	%
(in thousands)						
License	\$ 15,746	26%	\$ 21,377	34%	\$ 5,631	36%
Application hosting services	22,003	36	20,217	33	(1,786)	(8)%
Consulting services	4,932	8	6,107	10	1,175	24%
Customer support	17,891	30	14,324	23	(3,567)	(20)%
<b>Total</b>	<b>\$ 60,572</b>	<b>100%</b>	<b>\$ 62,025</b>	<b>100%</b>	<b>\$ 1,453</b>	<b>2%</b>

Total revenues increased slightly in 2003 as compared to 2002. The underlying revenue mix continued to change with the increase in software license and consulting service revenue from our *Clintrial* and *Clintrace* software products. The increase in license revenue in 2003 was due to the increase in software license revenue from the conversion of the former Clinsoft customers to software term license arrangements, new customers and sales into our existing *InForm* customer base. This increase was a result of our continued strategy to expand the usage of our software products by cross-selling the *InForm*, *Clintrial* and *Clintrace* products to our existing customer base, additional utilization of our products within our customer base and sales to new customers. This increase was partially offset by a slight decline in *InForm* license revenue. The decrease in revenue associated with the fully-hosted deployment of our *InForm* product in 2003 was due primarily to a decrease in the number of hosted clinical trials as more of our customers moved to software term licenses as well as the completion of certain projects. The increase in consulting services revenue in 2003 was due primarily to the increase in consulting services associated with integrated enterprise solutions of our products to our existing customer base. The decrease in customer support revenue in 2003 was due primarily to a reduction in the *Clintrial* and *Clintrace* maintenance renewal base from the conversion of the former Clinsoft

customers to term-based licenses which have a lower customer support fee. Our revenue was not significantly impacted by price increases or decreases. Inflation had only a nominal impact on our revenues.

Revenues by Geography	Year Ended December 31,					
	2002		2003		Change	
	Amount	Percentage of Revenue	Amount	Percentage of Revenue	Amount	%
(in thousands)						
United States	\$ 39,552	65%	\$ 37,859	61%	\$ (1,693)	(4)%
United Kingdom	12,341	20	12,670	20	329	3%
France	6,016	10	7,737	13	1,721	29%
Asia Pacific	2,663	5	3,759	6	1,096	41%
International Subtotal	21,020	35	24,166	39	3,146	15%
Total	\$ 60,572	100%	\$ 62,025	100%	\$ 1,453	2%

The increase in revenues outside of North America was due primarily to the increase in sales of our *Clintrial* and *Clintrace* products both to new customers and into our existing *InForm* customer base as a result of our continued strategy to expand the usage of our software products by cross-selling the *InForm*, *Clintrial* and *Clintrace* products to our existing customer base, additional utilization of our products within our customer base and sales to new customers. The decrease in revenues in North America was due primarily to a decrease in our hosted clinical trial activity, reflecting a decrease in the number of hosted clinical trials as some of our customers continued to migrate to a non-hosted software term license solution, as well as the completion of certain projects.

#### Costs of Revenues

Costs of Revenue	Year Ended December 31,					
	2002		2003		Change	
	Amount	Percentage of Related Revenue	Amount	Percentage of Related Revenue	Amount	%
(in thousands)						
License	\$ 2,157	14%	\$ 2,300	11%	\$ 143	7%
Services	30,870	69	28,466	70	(2,404)	(8)%
Total	\$ 33,027	55%	\$ 30,766	50%	\$ (2,261)	(7)%

The cost of license revenue increased in 2003 primarily due to a \$708,000 increase in royalty expense as revenue increased on certain modules of the *Clintrial* software product, partially offset by a \$600,000 decrease in amortization expense of acquired technologies. The decrease in the cost of services in 2003 was due primarily to the consolidation of our professional services and hosted applications services into one global organization and a decrease in royalty expense. The consolidation of our services organization consisted of a reduction in workforce of 42 employees, resulting in an expense savings of approximately \$1.2 million in employee-related costs and \$360,000 in facilities and related expenses. Additionally, royalty expense decreased approximately \$464,000 primarily due to the decrease in the customer support revenue from licensees of the *Clintrial* software product. The decrease was partially offset by an increase of \$264,000 in stock-based compensation expense.

Gross Margin

Gross Margin	Year Ended December 31,					
	2002		2003		Change	
	Amount	Percentage of Related Revenue	Amount	Percentage of Related Revenue	Amount	%
	(in thousands)					
License	\$ 13,589	86%	\$ 19,077	89%	\$ 5,488	40%
Services	13,956	31	12,182	30	(1,774)	(13)%
<b>Total</b>	<b>\$ 27,545</b>	<b>45%</b>	<b>\$ 31,259</b>	<b>50%</b>	<b>\$ 3,714</b>	<b>13%</b>

The license gross margin percentage increased in 2003 primarily due to a change in our software product mix and a reduction in amortization expense associated with acquired technology, partially offset by an increase in royalty expense associated with certain modules of the *Clintrial* software product. The services gross margin percentage decreased in 2003 primarily due to the reduction in the customer support revenue associated with our *Clintrial* software product and an increase in stock-based compensation expense. This reduction in services gross margin is also the result of a smaller revenue allocation to customer support under our software term licenses following the Clinsoft acquisition, partially offset by a reduction in employee-related expenses and facility expenses associated with the consolidation of our services organization and a reduction in royalties associated with our customer support revenue from certain of our software products.

Operating Expenses

Operating Expenses	Year Ended December 31,					
	2002		2003		Change	
	Amount	Percentage of Revenue	Amount	Percentage of Revenue	Amount	%
	(in thousands)					
Sales and marketing	\$ 13,581	22%	\$ 12,709	21%	\$ (872)	(6)%
Research and development	10,654	18	10,569	17	(85)	(1)%
General and administrative	10,447	17	10,138	16	(309)	(3)%
Restructuring charge	—	—	4,503	7	4,503	—
<b>Total</b>	<b>\$ 34,682</b>	<b>57%</b>	<b>\$ 37,919</b>	<b>61%</b>	<b>\$ 3,237</b>	<b>9%</b>

*Sales and Marketing.* Sales and marketing expenses decreased in 2003 primarily due to a \$388,000 decrease in marketing programs and a \$350,000 decrease from the amortization of acquired customer contracts from the Clinsoft acquisition, partially offset by a \$21,000 increase in stock-based compensation expense. The decline in marketing programs reflects the transition from the participation in trade shows to more cost effective workshops and seminars, as well as a reduction in advertising expense.

*Research and Development.* Research and development expenses decreased slightly in 2003 as our new research and development management team focused its expenditures on critical development efforts. The decrease was primarily due to a \$238,000 decrease in travel and occupancy related costs due to cost savings initiatives, partially offset by a \$184,000 increase in stock-based compensation expense.

*General and Administrative.* General and administrative expenses decreased in 2003 primarily due to a reduction in depreciation expense and ongoing cost-containment activities, partially offset by a \$155,000 increase in stock-based compensation expense.

*Restructuring Charge.* We recorded a \$4.5 million restructuring charge in 2003 which related to the relocation of our corporate headquarters. This charge includes approximately \$2.5 million relating to the estimated future obligation under the non-cancelable lease and an approximate \$2.0 million write-off of the related abandoned leasehold improvements and fixed assets.

*Operating Loss, Other Income (Expense)*

	Year Ended December 31,					
	2002		2003		Change	
	Amount	Percentage of Revenue	Amount	Percentage of Revenue	Amount	%
(in thousands)						
Operating loss	\$ (7,137)	(12)%	\$ (6,660)	(11)%	\$ 477	7%
Other income (expense)						
Interest income	\$ 307	1%	\$ 111	0%	\$ (196)	(64)%
Interest expense	(418)	(1)	(364)	(1)	54	13%
Other income	729	1	721	1	(8)	(1)%
Total	\$ 618	1%	\$ 468	0%	\$ (150)	(24)%

*Operating Loss.* The decrease in the operating loss in 2003 was primarily due to an increase in gross margin resulting from an increase in license revenue as a percentage of total revenue, partially offset by an increase in operating expenses which includes \$624,000 of stock-based compensation expense.

*Other Income (Expense).* The decrease in interest income was primarily due to declining interest rates, partially offset by an increase in the cash, cash equivalents and restricted cash balances. Other income (expense) primarily consisted of foreign exchange gains, and loss on the sale of fixed assets. Other income (expense) remained relatively consistent from year to year.

*Provision for Income Taxes*

Provision for Income Taxes	Year Ended December 31,					
	2002		2003		Change	
	Amount	Percentage of Revenue	Amount	Percentage of Revenue	Amount	%
(in thousands)						
Provision for income taxes	\$ 435	1%	\$ 434	1%	\$ (1)	(0)%

*Provision for Income Taxes.* The provision for income taxes for 2002 and 2003 represents foreign withholding taxes and income taxes payable in certain foreign locations that cannot be offset through loss carryforwards.

**Liquidity and Capital Resources**

Our principal sources of liquidity were cash, cash equivalents, short-term investments and restricted cash totaling \$20.7 million and \$58.2 million at December 31, 2003 and 2004, respectively, and accounts receivable of \$22.9 million and \$19.7 million, respectively.

From our inception, we funded our operations primarily through issuances of convertible preferred stock for aggregate net cash proceeds of \$79.7 million, including net cash acquired in the Clinsoft acquisition, the proceeds from the initial public offering and exercise of the over-allotment option resulting in net proceeds of \$36.6 million, and the issuance of notes payable for an aggregate of \$17.3 million.

Cash provided by and used in operating activities has historically been affected by changes in working capital accounts, primarily deferred revenue, accounts receivable and accrued expenses, and add-backs of non-cash expense items such as depreciation and amortization and stock-based compensation. Fluctuations within accounts receivable and deferred revenue are primarily related to the timing of billings of our term license customers and the associated revenue recognition. Movements in deferred costs are related to the volume and stages of hosted clinical trials and movements in accrued expenses and accounts payable are due to the timing of certain transactions.

Net cash generated from operating activities was \$9.8 million in 2004, which was greater than net income of \$1.9 million. This difference is primarily due to \$8.7 million of non-cash depreciation, deferred rent, stock-based compensation and non-cash income tax expense and changes in working capital, which consisted primarily of a \$3.5 million decrease in accounts receivable, offset partially by decreases in accrued expenses of \$1.8 million and deferred revenue of \$1.6 million.

Net cash used by investing activities was \$6.6 million during 2004, consisting primarily of the purchase of short-term investments of \$4.8 million and capital expenditures associated with computer equipment and furniture and fixtures in support of our expanding work force of \$3.4 million, partially offset by a \$1.6 million reduction in restricted cash.

Net cash provided by financing activities was \$31.0 million in 2004, consisting primarily of the \$36.6 million of net proceeds from the initial public offering and proceeds from the issuance of notes payable for \$2.9 million, partially offset by a special dividend to our Series B, C and D preferred stockholders of \$4.7 million and payments on notes payable and line of credit borrowings of \$5.2 million.

At December 31, 2003, we had approximately \$1.6 million of restricted cash held in certificates of deposits as collateral for letters of credit related to our facilities. The certificates of deposit matured and the collateral for the letters of credit is now reflected as a reduction in the amount available under the line of credit.

Substantially all of our long-lived assets for the years ended December 31, 2003 and 2004 are located in the United States.

We do not have any special purpose entities or any off balance sheet financing arrangements.

We generally do not enter into binding purchase commitments. Our principal commitments consist of obligations under our lines of credit and leases for office space. At December 31, 2004, the future minimum payments under these commitments were as follows:

Year Ending December 31,	Equipment and Working Capital Line of Credit	Operating Leases	Total
(in thousands)			
2005	\$ 2,558	\$ 2,699	\$ 5,257
2006	1,364	2,622	3,986
2007	485	2,252	2,737
2008	—	2,047	2,047
2009	—	346	346
Total minimum payments	\$ 4,407	\$ 9,966	\$ 14,373

Between April 2000 and September 2004 we entered into several equipment lines of credit with a bank. All advances under these equipment lines of credit are payable in 30 to 36 equal monthly installments of principal, plus accrued interest. The interest that accrues under these credit lines ranges from prime to prime plus 1%. At December 31, 2003 and December 31, 2004, respectively, we had \$4.2 million and \$4.4 million outstanding under all of our equipment lines of credit. As of December 31, 2004, there was \$3.2 million available under the equipment line of credit.

Effective March 31, 2004, we amended our working capital line of credit with a bank and increased the amount under which we can borrow up to \$5.0 million. Interest accrues at the prime rate. The line expires March 31, 2006 at which time all advances will be immediately due and payable. As of December 31, 2003 and 2004, we had \$2.5 million and \$0 outstanding under the working capital line of credit, respectively. At December 31, 2004, there was \$3.4 million available under the working capital line of credit, which reflects amounts used to replace the restricted cash associated with our leased facilities.

Borrowings are secured by substantially all of our assets other than our intellectual property. We have also entered into a negative pledge agreement that, subject to certain exceptions, generally prohibits us from pledging our intellectual property to others. Under the terms of these credit lines, we are required to comply with certain financial covenants. At December 31, 2003, we were in violation of the financial covenant requiring \$16.0 million for fourth quarter 2003 revenue, net of reimbursable out-of-pocket expenses, for which we received a waiver from the bank. That waiver, however, did not remove or limit the financial covenants we must satisfy under the credit agreement in the future. At December 31, 2004, we were in compliance with all financial covenants. Although the financial covenants were amended in connection with the March 2004 renewal, to the extent we are unable to satisfy those covenants in the future, we will need to obtain additional waivers to avoid being in default of the terms of these credit lines. If an unwaived default occurs, the bank may require that we repay all amounts then outstanding. We currently expect that we will have sufficient resources to fund any amounts which may become due under these credit lines as a result of a default by us or otherwise. However, any amounts which we may be required to repay prior to a scheduled repayment date would reduce funds that we could otherwise allocate to other opportunities that we consider desirable.

At December 31, 2004, we had net operating loss carryforwards of approximately \$88.4 million, which may be used to offset future U.S. federal taxable income, if any, and \$4.8 million of federal research and development tax credit carryforwards. In addition, we have \$5.6 million of net operating losses relating to our non-U.S. jurisdictions. Of these amounts, approximately \$26.9 million and \$3.0 million of net operating loss carryforwards and tax credit carryforwards, respectively, relate to amounts acquired as part of the Clinsoft acquisition. These tax carryforwards may reduce our future cash payments to the taxing authorities. The cash benefits of the acquired carryforwards will be reflected as an adjustment through goodwill and not a reduction in the effective tax rate. The carryforwards expire beginning in 2008 through 2023 and are subject to review and possible adjustment by the taxing authorities. The Internal Revenue Code contains provisions that may limit the net operating loss and tax credit carryforwards available to be used in any given year in the event of certain changes in the ownership interests of significant stockholders.

We believe our existing cash, cash equivalents, short-term investments and cash provided by operating activities and our various debt facilities will be sufficient to meet our working capital and capital expenditure needs over the next 12 months. Our future capital requirements will depend on many factors, including our rate of revenue growth, the expansion of our marketing and sales activities, the timing and extent of spending to support product development efforts, the timing of introductions of new services and enhancements to existing services, and the continuing market acceptance of our services. In 2005, we intend to spend approximately \$4.6 million for the purchase of computer equipment for our hosting services and for general corporate purposes. To the extent that existing cash and securities and cash from operations are insufficient to fund our future activities, we may need to

raise additional funds through public or private equity or debt financing. Although we are currently not a party to any agreement or letter of intent with respect to potential investments in, or acquisitions of, businesses, services or technologies, we may enter into these types of arrangements in the future, which could also require us to seek additional equity or debt financing. Additional funds for those purposes may not be available on terms favorable to us or at all.

### Recent Accounting Pronouncements

On December 16, 2004, the Financial Accounting Standards Board (FASB) issued SFAS No. 123 (revised 2004), *Share-Based Payment*, which is a revision of SFAS No. 123, *Accounting for Stock-Based Compensation*. SFAS No. 123(R) supersedes APB Opinion No. 25, *Accounting for Stock Issued to Employees*, and amends SFAS No. 95, *Statement of Cash Flows*. Generally, the approach in SFAS No. 123(R) is similar to the approach described in Statement 123. However, SFAS No. 123(R) *requires* all share-based payments to employees, including grants of employee stock options, to be recognized in the income statement based on their fair values. Pro forma disclosure is no longer an alternative.

SFAS No. 123(R) must be adopted no later than July 1, 2005 for calendar year-end companies. Early adoption will be permitted in periods in which financial statements have not yet been issued.

SFAS No. 123(R) permits public companies to adopt its requirements using one of two methods:

- A "modified prospective" method in which compensation cost is recognized beginning with the effective date (a) based on the requirements of SFAS No. 123(R) for all share-based payments granted after the effective date and (b) based on the requirements of SFAS No. 123 for all awards granted to employees prior to the effective date of SFAS No. 123(R) that remain unvested on the effective date.
- A "modified retrospective" method which includes the requirements of the modified prospective method described above, but also permits entities to restate based on the amounts previously recognized under SFAS No. 123 for purposes of pro forma disclosures either (a) all prior periods presented or (b) prior interim periods of the year of adoption.

We will be reviewing the two alternative adoption methods in the first quarter of 2005 and the resulting impact of fair valuing awards in our financial statements. We will also be reviewing various option valuation techniques and may use a valuation method other than the Black-Scholes model upon adoption of SFAS No. 123(R).

The adoption of SFAS No. 123(R)'s fair value method will likely have a significant impact on our results of operations, although it will have no impact on our overall financial position. The impact of adoption of SFAS No. 123(R) cannot be predicted at this time because it will depend in part on levels of share-based payments granted in the future. However, had we adopted SFAS No. 123(R) in prior periods, the impact of that standard would have approximated the impact of SFAS No. 123 as described in the disclosure of pro forma net income and earnings per share in Note 2 to our consolidated financial statements contained in this Annual Report.

### Certain Factors Which May Affect Future Results

We operate in a rapidly changing environment that involves a number of risks, some of which are beyond our control. This discussion highlights some of the risks which may affect future operating results. These are the risks and uncertainties we believe are most important for you to consider. Additional risks and uncertainties not presently known to us, which we currently deem immaterial or which are similar to those faced by other companies in our industry or business in general, may also impair our business operations. If any of the following risks or uncertainties actually occurs, our business, financial condition and operating results would likely suffer.

## Risks Related to Our Industry

*We depend primarily on the pharmaceutical, biotechnology and medical device industries and are therefore subject to risks relating to changes in these industries.*

Our business depends on the clinical trials conducted or sponsored by pharmaceutical, biotechnology and medical device companies and other entities conducting clinical research. General economic downturns, increased consolidation or decreased competition in the industries in which these companies operate could result in fewer products under development or decreased pressure to accelerate product approval which, in turn, could materially adversely impact our revenues. Our operating results may also be adversely impacted by other developments that affect these industries generally, including:

- the introduction or adoption of new technologies or products;
- changes in third-party reimbursement practices;
- changes in government regulation or governmental price controls;
- changes in medical practices;
- changes in the purchasing patterns of entities conducting clinical research;
- the discovery of safety issues with approved products or products in clinical development;
- the assertion of product liability claims; and
- changes in general business conditions.

Any decrease in research and development expenditures or in the size, scope or frequency of clinical trials conducted or sponsored by pharmaceutical, biotechnology or medical device companies or other entities as a result of the foregoing or other factors could materially adversely affect our operations or financial condition.

*If entities engaged in clinical trials do not shift from traditional paper-based methods of collecting clinical trial data to electronic systems, we may not achieve the market penetration necessary to obtain or maintain profitability.*

If entities engaged in clinical trials are unwilling to use our electronic data capture solutions or to change the way of collecting clinical trial data, our future growth and market share may be limited. Most clinical trials today rely on pre-printed, three-part paper case report forms for data collection. Our efforts to establish an electronic process to capture clinical trial data are a significant departure from the traditional paper-based methods of collecting clinical trial data. As is typical for new and rapidly evolving industries, customer demand for recently introduced technology is highly uncertain. We may not be successful in persuading entities engaged in clinical trials to change the manner in which they have traditionally collected clinical trial data and to accept our software products, services and hosted solutions. If we fail to convince entities engaged in clinical trials to use our methods of capturing clinical trial data, our revenues may be limited and we may fail to be profitable.

*Changes in regulations and regulatory guidance applicable to our customers or potential customers and the approval process for their products may result in our inability to continue to do business.*

Demand for our software products, services and hosted solutions is largely a function of regulation and regulatory guidance associated with the approval of new drugs, biological products and medical devices imposed upon the clinical trial process by the U.S. federal government and related regulatory authorities such as the U.S. Food and Drug Administration, or FDA, and by foreign governments. In recent years, efforts have been made to streamline the FDA approval process and coordinate U.S.

standards with those of other developed countries. Any change in the scope of applicable regulations and regulatory guidance could alter the type or amount of clinical trial spending or negatively impact interest in our software products, services and hosted solutions. Any regulatory reform that limits or reduces the research and development spending of entities conducting clinical research upon which our business depends could have a material adverse effect on our revenues or gross margins.

In addition, any failure to conform our software products, services and hosted solutions to domestic or international changes in regulations and regulatory guidance applicable to our customers or potential customers and the approval process for their products may result in our inability to continue to do business. Changing our software products, services and hosted solutions to allow our customers to comply with future changes in regulation or regulatory guidance, either domestically or internationally, could cause us to incur substantial costs. We cannot assure you that our product and service offerings will allow our customers and potential customers to stay in compliance with regulations and regulatory guidance as they develop. If our product and service offerings fail to allow our customers and potential customers to operate in a manner that is compliant with applicable regulations and regulatory guidance, clinical trial sponsors and other entities conducting clinical research may be unwilling to use our software products, services and hosted solutions.

***We operate in a highly competitive industry and if we are not able to compete effectively, our business and operating results will be harmed.***

The market for our software products, services and hosted solutions is characterized by rapidly changing technologies, evolving industry standards and frequent new product and service introductions and enhancements that may render existing products and services obsolete. Accordingly, we are susceptible to rapid and significant declines in market share due to unforeseen changes in the features, functions or pricing of competing products. Barriers to entry are relatively low and, with the introduction of new technologies and new market entrants, we expect that competition will increase. Increased competition is likely to result in pricing pressures, which could negatively impact our sales, gross margins or market share. Our failure to compete effectively could materially adversely affect our business, financial condition or results of operations.

Some of our current competitors, as well as many of our potential competitors, have greater name recognition, longer operating histories and significantly greater resources. As a result, our competitors may be able to respond more quickly and effectively than we can to new or changing opportunities, technologies, standards or customer requirements. In addition, current and potential competitors have established, and may in the future establish, cooperative relationships with vendors of complementary products, technologies or services to increase the availability of their products to the marketplace. Accordingly, new competitors or alliances may emerge that have greater market share, larger customer bases, more widely adopted proprietary technologies, greater marketing expertise and larger sales forces than we have, which could put us at a competitive disadvantage. Further, in light of these advantages, even if our products and services are more effective than the product or service offerings of our competitors, current or potential customers might accept competitive products and services in lieu of purchasing our software products, services and hosted solutions. We cannot assure you that we can maintain or enhance our competitive position against current and future competitors.

***Changing customer or prospective customer requirements could decrease the demand for our products and services, which would adversely affect our revenues and operating results.***

Our future success will depend in large part on our ability to enhance and broaden our software products, services and hosted solutions to meet the evolving needs of our customers and prospective customers. To achieve our goals, we need to effectively respond to our customers' and prospective customers' needs, technological changes and new industry standards and developments in a timely manner. If we are unable to enhance our existing product and service offerings or develop new

products and services to meet changing requirements, demand for our software products, services and hosted solutions could suffer and our revenues and operating results could be materially adversely affected. We could also incur substantial costs if we need to modify our products or services, or information technology infrastructure, to adapt to technological changes or new industry standards or developments.

### **Risks Related to Our Company**

#### ***We have incurred substantial losses in the past and may not be profitable in the future.***

We have incurred significant losses in each fiscal year since our inception in June 1997, and we may incur significant operating losses in the future. As a result of our operating losses and accretion of preferred dividends, we had an accumulated deficit of \$104 million at December 31, 2004. You should not consider recent quarterly revenue growth as indicative of our future performance as our operating results may fluctuate significantly from quarter to quarter. In addition, we expect our development, sales and other operating expenses to increase in the future. If our revenue does not grow to offset these expected increased expenses, we may not be profitable. In fact, in future quarters we may not have any revenue growth and our revenue could decline. Furthermore, if our operating expenses exceed our expectations, our financial performance will be adversely affected.

#### ***We operate in an emerging market, which makes it difficult to evaluate our business and future prospects.***

We were incorporated in June 1997 and operate in an emerging market. Accordingly, our business and future prospects are difficult to evaluate. You should consider the challenges, risks and uncertainties frequently encountered by companies using new and unproven business models in rapidly evolving markets. These challenges include our ability to:

- generate sufficient revenues to maintain profitability;
- manage growth in our operations;
- attract and retain customers;
- attract and retain key personnel;
- develop and renew strategic relationships; and
- access additional capital when required and on reasonable terms.

We cannot be certain that we will successfully address these and other challenges, risks and uncertainties or that our business model will be successful. Failure to do so could adversely affect our business, results of operations or financial condition.

#### ***Our software products and hosted solutions are at varying stages of market acceptance and the failure of any of our products to achieve wide acceptance would harm our operating results.***

We began offering our *InForm* electronic data capture software solution for clinical trials in December 1998. Although the *Clintrial* and *Clintrace* products were introduced over 10 years ago, we did not begin offering these products until after our acquisition of Clinsoft Corporation in 2001. Continued use of our *Clintrial* and *Clintrace* software products, and broad and timely acceptance of our *InForm* product, as well as integrated solutions combining one or more of our software products, is critical to our future success and is subject to a number of significant risks, some of which are outside our control. These risks include:

- our customers' and prospective customers' desire for and acceptance of our electronic data capture, management and adverse event reporting software solutions;

- our software products and hosted solutions' ability to support large numbers of users and manage vast amounts of data;
- our customers' ability to use our software products and hosted solutions, train their employees and successfully deploy our technology in their clinical trials; and
- our ability to significantly expand our internal resources and increase our capital and operating expenses to support the anticipated growth and continued integration of our software products, services and hosted solutions.

Our failure to address, mitigate or manage these risks would seriously harm our business, particularly if the failure of any or all of our software products or hosted solutions to achieve market acceptance negatively affects our sales of our other products and services.

***Our operating results may fluctuate significantly and could cause the market price of our common stock to fall rapidly and without notice.***

Our revenues and operating results are difficult to predict and may fluctuate significantly from quarter to quarter, particularly because of the rapidly evolving market in which we operate and our term license model. For instance, our quarterly results ranged from an operating loss of \$4.1 million for the quarter ended December 31, 2003 to operating income of \$1.4 million for the quarter ended December 31, 2004. Our results of operations in any given quarter will be based on a number of factors, including:

- the extent to which our software products, services and hosted solutions achieve or maintain market acceptance;
- our ability to introduce new products and services and enhancements to our existing products and services on a timely basis;
- the competitive environment in which we operate;
- the timing of our product sales and the length of our sales and implementation cycles;
- changes in our operating expenses;
- our ability to hire and retain qualified personnel;
- changes in the regulatory environment related to the clinical trial market;
- changes in our customers' purchasing patterns;
- the financial condition of our current and potential customers; and
- the timing, size and integration success of potential future acquisitions.

A significant portion of our operating expense is relatively fixed in nature and planned expenditures are based in part on expectations regarding future revenues. Accordingly, unexpected revenue shortfalls may decrease our gross margins and could cause significant changes in our operating results from quarter to quarter. Results of operations in any quarterly period should not be considered indicative of the results to be expected for any future period. In addition, our future quarterly operating results may fluctuate and may not meet the expectations of securities analysts or investors. If this occurs, the trading price of our common stock could fall substantially either suddenly or over time.

***We may be required to spend substantial time and expense before we recognize a significant portion of the revenues, if any, attributable to our customer contracts.***

The sales cycle for some of our software solutions frequently takes in excess of nine months from initial customer contact to contract execution. During this time, we may expend substantial time, effort

and financial resources without realizing any revenue with respect to the potential sale. In addition, while we begin recognizing revenue upon the execution of our agreements for software term licenses and related services, it may be difficult for us to rapidly increase our revenue through additional sales in any period, as license revenue and, when applicable, related services revenue, from new customers is recognized over the applicable license term, typically three to five years. As a result, we may not recognize significant revenues, if any, from some customers despite incurring considerable expense related to our sales, implementation, and service delivery processes. Even if we do realize revenues from a contract, our term license pricing model may keep us from recognizing a significant portion of these revenues (including revenues for related services) during the same period in which sales, implementation, and service delivery expenses were incurred. For example, pursuant to our recently announced contract with GlaxoSmithKline, we have incurred, and expect to continue to incur through at least a portion of 2005 significant up-front implementation and other service expenses associated with delivery of services under the contract, whereas the revenue under the contract will be recognized ratably over an approximately 5-year period. Timing differences of this nature could cause our service gross margins and profitability to fluctuate significantly from quarter to quarter. Similarly, a decline in new or renewed software term licenses in any one quarter will not necessarily be fully reflected in the revenue in that quarter and may negatively affect our revenue in future quarters. This could cause our operating results to fluctuate from quarter to quarter.

***The loss of one or more major customers could materially and adversely affect our results of operations and financial condition.***

Our top five customers accounted for approximately 37% of our revenues during 2002, approximately 32% of our revenues during 2003 and approximately 36% of our revenues during 2004. Moreover, sales to two customers, Eli Lilly and Company, a holder of approximately one percent of our outstanding common stock, and GlaxoSmithKline, accounted for approximately 12% and 10% of our revenues, respectively, for the year ended December 31, 2004. The loss of any of our major customers could have a material adverse effect on our results of operations or financial condition. We may not be able to maintain our customer relationships, and our customers may not renew their agreements with us, which could adversely affect our results of operations or financial condition. A significant change in the liquidity or financial position of any of these customers could also have a material adverse effect on the collectibility of our accounts receivables, our liquidity and our future operating results.

***Claims that we or our technologies infringe upon the intellectual property or other proprietary rights of a third party may require us to incur significant costs, to enter into royalty or licensing agreements or to develop or license substitute technology.***

We are, and may in the future be, subject to claims that our technologies infringe upon the intellectual property or other proprietary rights of a third party. For instance, Dr. Mark L. Kozam, doing business under the name MLK Software, has filed a complaint against us and one of our customers alleging that we infringe a patent claimed to be owned by Dr. Kozam. In addition, the vendors who provide us with technology that we use in our technology could become subject to similar infringement claims. Although we believe that our software solutions do not infringe the patents of any third party, we cannot assure you that our technology does not infringe patents held by others or that they will not in the future. Any claims of infringement could cause us to incur substantial costs defending against the claim, even if the claim is without merit, and could distract our management from our business. Moreover, any settlement or adverse judgment resulting from the claim could require us to pay substantial amounts or obtain a license to continue to use the technology that is the subject of the claim, or otherwise restrict or prohibit our use of the technology. There can be no assurance that we would be able to obtain a license from the third party asserting the claim on commercially reasonable terms, if at all, that we would be able to successfully develop alternative

technology on a timely basis, if at all, or that we would be able to obtain a license from another provider of suitable alternative technology to permit us to continue offering, and our customers to continue using, the applicable technology. In addition, we generally provide in our customer agreements, including our agreement with the customer that is the subject of the Kozam claim referenced above, that we will indemnify our customers, against third-party infringement claims relating to our technology provided to the customer, which could obligate us to fund significant amounts. Infringement claims asserted against us or our vendors may have a material adverse effect on our business, results of operations or financial condition.

***Interruptions or delays in service from our third-party providers could impair the delivery of our hosted InForm electronic data capture solution and harm our business.***

We host our *InForm* electronic data capture software solution at third-party facilities. Consequently, the occurrence of a natural disaster or other unanticipated problems at the facilities of our third-party provider could result in unanticipated interruptions in our customers' access to our *InForm* electronic data capture software solution. Our hosted services may also be subject to sabotage, intentional acts of malfeasance and similar misconduct due to the nature of the Internet. In the past, Internet users have occasionally experienced difficulties with Internet and online services due to system or security failures. We cannot assure you that our business interruption insurance will adequately compensate our customers or us for losses that may occur. Even if covered by insurance, any failure or breach of security of our systems could damage our reputation and cause us to lose customers. Further, certain of our hosted *InForm* electronic data capture solutions, representing approximately 37% of our total revenues for the year ended December 31, 2004, are subject to service level agreements that guarantee certain levels of uptime reliability. These agreements provide for 95% to 99% server availability. In the event that we fail to meet those levels, whether resulting from an interruption in service caused by our technology or that of a third-party provider, we could be subject to customer credits or termination of these customer contracts.

***Failure of our technology and products could harm our business and operating results.***

The technology underlying our software products and hosted solutions processes vast amounts of clinical trial data. Customers relying on our products to collect, manage and report clinical trial information may have a greater sensitivity to product errors and security vulnerabilities than customers of software products in general. In the past, failures of our technology and human error have negatively impacted the data capture, management or reporting capabilities of our products, and new errors may be detected in the future. Any delay or failure of our technology may result in the disruption of the clinical trial process and could harm our business and operating results. Product or service errors could materially and adversely affect our reputation, result in significant costs to us and impair our ability to sell our products and services in the future. The costs incurred in correcting any defects or errors may be substantial and could adversely affect our operating margins. In addition, security breaches, whether intentional or accidental, could expose us to a risk of loss of data, litigation and possible liability.

***The global nature of our business exposes us to multiple risks.***

For the year ended December 31, 2004, approximately 43% of our revenues were derived from international operations. We expect that our international operations will continue to account for a significant portion of our revenues. As a result of our international operations, we are exposed to many risks and uncertainties, including:

- difficulties in staffing, managing and supporting operations in multiple countries;
- tariff and international trade barriers;
- fewer legal protections for intellectual property and contract rights abroad;

- different and changing legal and regulatory requirements in the jurisdictions in which we currently operate or may operate in the future;
- government currency control and restrictions on repatriation of earnings;
- fluctuations in foreign currency exchange and interest rates; and
- political and economic changes, hostilities and other disruptions in regions where we currently operate or may operate in the future.

Negative developments in any of these areas in one or more countries could result in a reduction in demand for our software products, services and hosted solutions, the cancellation or delay of orders already placed, threats to our intellectual property, difficulty in collecting receivables, and a higher cost of doing business, any of which could adversely affect our business, results of operations or financial condition. Moreover, with regard to our international operations, we frequently enter into transactions in currencies other than the U.S. dollar and we incur operating expenses in currencies other than the U.S. dollar. This creates a foreign currency exchange risk for us that could have a material adverse effect on our results of operations and financial condition.

***We may lose or delay revenues related to our hosted solutions if our customers terminate or delay their contracts with us.***

Certain of our hosted electronic data capture and other service and consulting contracts are subject to cancellation by our customers at any time with limited notice. Entities engaged in clinical trials may terminate or delay a clinical trial for various reasons including the failure of the tested product to satisfy safety or efficacy requirements, unexpected or undesired clinical results, decisions to de-emphasize a particular product or forego a particular clinical trial, decisions to downsize clinical development programs, insufficient patient enrollment or investigator recruitment and production problems resulting in shortages of required clinical supplies. In the case of our hosted solutions, any termination or delay in the clinical trials would likely result in a consequential delay or termination in those customers' service contracts. We have experienced terminations and delays of our customer service contracts in the past and expect to experience additional terminations and delays in the future. Because we do not recognize any portion of a hosted service contract's revenue until the implementation cycle is complete, the termination or delay of our customers' clinical trials could result in decreased or delayed revenues under these contracts which could materially harm our business.

***We may be unable to adequately protect, and we may incur significant costs in defending, our intellectual property and other proprietary rights.***

Our success depends on our ability to protect our intellectual property and other proprietary rights. We rely upon a combination of trademark, trade secret, copyright, patent and unfair competition laws, as well as license agreements and other contractual provisions, to protect our intellectual property and other proprietary rights. In addition, we attempt to protect our intellectual property and proprietary information by requiring our employees and consultants to enter into confidentiality, noncompetition and assignment of inventions agreements. To the extent that our intellectual property and other proprietary rights are not adequately protected, third parties might gain access to our proprietary information, develop and market products or services similar to ours, or use trademarks similar to ours, each of which could materially harm our business. Existing U.S. federal and state intellectual property laws offer only limited protection. Moreover, the laws of other countries in which we market our software products, services and hosted solutions may afford little or no effective protection of our intellectual property. If we resort to legal proceedings to enforce our intellectual property rights or to determine the validity and scope of the intellectual property or other proprietary rights of others, the proceedings could be burdensome and expensive, even if we were to prevail. The

failure to adequately protect our intellectual property and other proprietary rights may have a material adverse effect on our business, results of operations or financial condition.

***Our business could be seriously harmed by our dependence on a limited number of suppliers.***

We depend upon a limited number of suppliers for specific components of our software products and hosted solutions. We may increase our dependence on certain suppliers as we continue to develop and enhance our software and service solutions. Our dependence on a limited number of suppliers leaves us vulnerable to having an inadequate supply of required components, price increases, delayed supplier performance and poor component quality. For instance, we rely on Oracle Corporation to supply the database component of our software solutions and on IBM Corporation and Equinix, Inc. to provide the server facilities for our hosting services. Oracle Corporation also offers a software package that is competitive with our products and services. If we are unable to obtain components for our software solutions from third-party suppliers in the quantities and of the quality that we need, on a timely basis or at acceptable prices, we may not be able to deliver our software products, services and hosted solutions on a timely or cost-effective basis to our customers, and our business, results of operations and financial condition could be seriously harmed. Moreover, delays or interruptions in our service may reduce our revenue, cause customers to terminate their contracts and adversely affect our customer renewals.

***We could incur substantial costs resulting from product liability claims relating to our products or services or our customers' use of our products or services.***

Any failure or errors in a customer's clinical trial or adverse event reporting obligations caused or allegedly caused by our products or services could result in a claim for substantial damages against us by our customers or the clinical trial participants, regardless of our responsibility for the failure. Although we are entitled to indemnification under our customer contracts against claims brought against us by third parties arising out of our customers' use of our products, we might find ourselves entangled in lawsuits against us that, even if unsuccessful, divert our resources and energy and adversely affect our business. Further, in the event we seek indemnification from a customer, we cannot assure you that a court will enforce our indemnification right if challenged by the customer obligated to indemnify us or that the customer will be able to fund any amounts for indemnification owed to us. We also cannot assure you that our existing general liability insurance coverage will continue to be available on reasonable terms or will be available in amounts sufficient to cover one or more large claims, or that the insurer will not disclaim coverage as to any future claim.

***We and our products and services could be subjected to governmental regulation, requiring us to incur significant compliance costs or to cease offering our products and services.***

The clinical trial process is subject to extensive and strict regulation by the FDA, as well as other regulatory authorities worldwide. Our electronic data capture, management and adverse event reporting products and services could be subjected to state, federal and foreign regulations. We cannot assure you that our products and service offerings will comply with applicable regulations and regulatory guidelines as they develop. If our products or services fail to comply with any applicable government regulations or guidelines, we could incur significant liability or be forced to cease offering our applicable products or services. Also, conforming our products and services to any applicable regulations and guidelines could substantially increase our operating expenses.

***We may acquire or make investments in companies or technologies that could cause disruption of our business and loss of value or dilution to our stockholders.***

We have made in the past, and may make in the future, acquisitions or significant investments in other businesses. Entering into an acquisition entails many risks, any of which could harm our business, including:

- difficulties in integrating the operations, technologies, products, existing contracts and personnel of the target company and realizing the anticipated synergies of the combined businesses;
- the price we pay or other resources that we devote may exceed the value we eventually realize or the value we could have realized if we had allocated the purchase price or other resources to another opportunity;
- potential loss of key employees, customers and strategic alliances from either our current business or the target company's business;
- managing the risks of entering markets or types of businesses in which we have limited or no direct experience;
- the diversion of management's attention from other business concerns; and
- assumption of unanticipated problems or latent liabilities, such as problems with the quality of the target company's products.

In addition, if we finance any future acquisitions by issuing equity securities or convertible debt, our existing stockholders may be diluted or the market price of our stock may be adversely affected. The failure to successfully evaluate and execute acquisitions or investments or otherwise adequately address these risks could materially harm our business and financial results.

***If we are unable to retain our personnel and hire additional skilled personnel, we may be unable to achieve our goals.***

Our future success depends upon our ability to attract, train and retain highly skilled employees and contract workers, particularly our management team, sales and marketing personnel, professional services personnel and software engineers. Each of our executive officers and other employees could terminate his or her relationship with us at any time. The loss of any member of our management team might significantly delay or prevent the achievement of our business or development objectives and could materially harm our business. In addition, because of the technical nature of our software products, services and hosted solutions and the dynamic market in which we compete, any failure to attract and retain qualified direct sales, professional services and product development personnel, as well as our contract workers, could have a material adverse affect on our ability to generate sales or successfully develop new software products, services and hosted solutions or software enhancements.

***Failure to manage our rapid growth effectively could harm our business.***

We have been experiencing a period of rapid growth that has placed a significant strain on our operational and financial resources and our personnel. From January 1, 1999 to December 31, 2004, the number of our employees increased from 35 to approximately 361. To manage our anticipated future growth effectively, we must continue to maintain and may need to enhance our information technology infrastructure, financial and accounting systems and controls and manage expanded operations in geographically distributed locations. We also must attract, integrate, train and retain a significant number of qualified sales and marketing personnel, professional services personnel, software engineers and other management personnel. Our failure to manage our rapid growth effectively could have a material adverse effect on our business, operating results or financial condition.

*We may not be able to obtain capital when desired on favorable terms, if at all, or without dilution to our stockholders.*

We anticipate that our current cash and cash equivalents will be sufficient to meet our current needs for general corporate purposes. However, we may need additional financing to execute on our current or future business strategies, including to:

- hire additional personnel;
- develop new or enhance existing software products, services and hosted solutions;
- enhance our operating infrastructure;
- acquire businesses or technologies; or
- otherwise respond to competitive pressures.

If we raise additional funds through the issuance of equity or convertible debt securities, the percentage ownership of our stockholders could be significantly diluted, and these newly issued securities may have rights, preferences or privileges senior to those of existing stockholders. We cannot assure you that additional financing will be available on terms favorable to us, or at all. If adequate funds are not available or are not available on acceptable terms, when we desire them, our ability to fund our operations, take advantage of unanticipated opportunities, develop or enhance our software products, services and hosted solutions, or otherwise respond to competitive pressures would be significantly limited.

*Our loan agreements contain operating and financial covenants that may restrict our business and financing activities.*

We have loan agreements with a bank that provide for a \$5.0 million working capital credit line and equipment lines of credit. Our loan agreements restrict our ability to:

- redeem subordinated indebtedness;
- incur additional indebtedness;
- create liens;
- enter into transactions with affiliates;
- make investments;
- sell assets;
- pay dividends or make distributions on, or repurchase, our stock; or
- consolidate or merge with other entities.

In addition, our credit facilities require us to meet specified revenue thresholds and maintain specified financial ratios and tests. The operating and financial restrictions and covenants in these credit facilities, as well as any future financing agreements that we may enter into, may restrict our ability to finance our operations, engage in business activities or expand or fully pursue our business strategies. Our ability to comply with these covenants may be affected by events beyond our control, and we may not be able to meet those covenants. A breach of any of these covenants could result in a default under the loan agreement, which could cause all of the outstanding indebtedness under both credit facilities to become immediately due and payable and terminate all commitments to extend further credit.

At December 31, 2003, we were in violation of a financial covenant requiring us to achieve quarterly revenues of \$16.0 million, net of reimbursable out-of-pocket expenses, for which we received

a waiver from the bank. That waiver, however, did not remove or limit the financial covenants we must satisfy under the loan agreement in the future. Although we believe we are currently in compliance under this agreement, we cannot assure you that if a future violation occurs we will receive a waiver or that our indebtedness will not be accelerated. While we believe that we will have sufficient resources to fund any amounts which may become due under these credit facilities, we cannot assure you that we will have sufficient assets to repay our credit facilities upon any default or that the bank will not seek to enforce its remedies against us. If we were unable to repay those amounts, the bank could proceed against the collateral granted to them to secure that indebtedness. We have pledged substantially all of our assets, other than our intellectual property, as collateral under the loan agreement. We have also entered into a negative pledge agreement that, subject to certain exceptions, generally prohibits us from pledging our intellectual property to others.

***In the course of conducting our business, we possess or could be deemed to possess personal medical information in connection with the conduct of clinical trials, which if we fail to keep properly protected, could subject us to significant liability.***

Our software solutions are used to collect, manage and report information in connection with the conduct of clinical trials. This information is or could be considered to be personal medical information of the clinical trial participants. Regulation of the use and disclosure of personal medical information is complex and growing. Increased focus on individuals' rights to confidentiality of their personal information, including personal medical information, could lead to an increase of existing and future legislative or regulatory initiatives giving direct legal remedies to individuals, including rights to damages, against entities deemed responsible for not adequately securing such personal information. In addition, courts may look to regulatory standards in identifying or applying a common law theory of liability, whether or not that law affords a private right of action. Since we receive and process personal information of clinical trial participants from our customers, there is a risk that we could be liable if there were a breach of any obligation to a protected person under contract, standard of practice or regulatory requirement. If we fail to properly protect this personal information that is in our possession or deemed to be in our possession, we could be subjected to significant liability.

### **Risks Related to our Common Stock**

***The market price of our common stock may be volatile, which could result in substantial losses for investors purchasing shares in the public markets and subject us to securities class action litigation. The current market price of our common stock may not be indicative of future market prices and we may be unable to sustain or increase the value of an investment in our common stock.***

We only recently completed our initial public offering. An active public market for our common stock may not continue to develop or be sustained. Market prices for securities of software, technology and health care companies have been particularly volatile. The trading price of our common stock may fluctuate significantly and, accordingly, may not be indicative of future trading prices and we may be unable to sustain or increase the value of an investment in our common stock. Some of the factors that may cause the market price of our common stock to fluctuate include:

- period-to-period fluctuations in our financial results or those of companies that are perceived to be similar to us;
- changes in market valuations of similar companies;
- changes in estimates of our financial results or recommendations by securities analysts;
- the failure of any of our software products, services and hosted solutions to achieve or maintain commercial success;
- success of competitive products and technologies;

- litigation involving our company or our general industry or both;
- future issuances of securities or the incurrence of debt by us, or other changes in our capital structure;
- announcements by us or our competitors of significant products, contracts, acquisitions or strategic alliances;
- regulatory developments in the United States and foreign countries;
- additions or departures of key personnel;
- investors' general perception of us;
- sales or transfers of large blocks of stock by existing investors; and
- changes in general economic, industry and market conditions.

In addition, if the market for software, technology or health care stocks or the stock market in general experiences a loss of investor confidence, the trading price of our common stock could decline for reasons unrelated to our business, operating results or financial condition. If any of the foregoing occurs, it could cause our stock price to fall and may expose us to class action lawsuits that, even if unsuccessful, could be costly to defend and a distraction to management.

***A significant number of our total outstanding shares may be sold into the market in the near future. This could cause the market price of our common stock to drop significantly, even if our business is doing well.***

Approximately 30% of our outstanding shares of common stock are "restricted securities" within the meaning of Rule 144 promulgated under the Securities Act of 1933. This means that they may not be sold without first being registered under the Securities Act unless an exemption from registration is available, including the exemptions contained in Rule 144. These shares are eligible for sale pursuant to Rule 144, subject in certain instances to the volume and manner of sale limitations under Rule 144. In addition, as of March 4, 2005, we had approximately 4.7 million shares subject to outstanding options and approximately 1.4 million shares reserved for future issuance under our stock option and stock purchase plans. Moreover, a relatively small number of our shareholders own large blocks of shares. We cannot predict the effect, if any, that public sales of these shares or the availability of these shares for sale will have on the market price of our common stock. If our stockholders, and particularly our directors and officers, sell substantial amounts of our common stock in the public market, or if the public perceives that such sales could occur, this could have an adverse impact on the market price of our common stock, even if there is no relationship between such sales and the performance of our business.

***Our directors and management exercise significant control over our company.***

At December 31, 2004, our directors and executive officers and their affiliates beneficially control approximately 36% of our outstanding common stock. As a result, these stockholders, if they act together, are able to influence our management and affairs and all matters requiring stockholder approval, including the election of directors and approval of significant corporate transactions. This concentration of ownership may have the effect of delaying or preventing a change in control of our company and might affect the market price of our common stock.

***Delaware law and our corporate documents may prevent or frustrate a change in control or a change in management that stockholders believe is desirable.***

Provisions of our certificate of incorporation and bylaws and Delaware law may discourage, delay or prevent a merger, acquisition or other change in control that stockholders may consider favorable,

including transactions in which you might otherwise receive a premium for your shares. These provisions may also prevent or frustrate attempts by our stockholders to replace or remove our management. These provisions include:

- limitations on the removal of directors;
- advance notice requirements for stockholder proposals and nominations;
- the inability of stockholders to act by written consent or to call special meetings; and
- the ability of our board of directors to designate the terms of and issue new series of preferred stock without stockholder approval, which could be used to institute a rights plan, or a poison pill, that would work to dilute the stock ownership of a potential hostile acquirer, likely preventing acquisitions that have not been approved by our board of directors.

The affirmative vote of the holders of at least 75% of our shares of capital stock entitled to vote is necessary to amend or repeal the above provisions of our certificate of incorporation. In addition, absent approval of our board of directors, our bylaws may only be amended or repealed by the affirmative vote of the holders of at least 75% of our shares of capital stock entitled to vote.

In addition, Section 203 of the Delaware General Corporation Law prohibits a publicly held Delaware corporation from engaging in a business combination with an interested stockholder, generally a person which together with its affiliates owns, or within the last three years has owned, 15% of our voting stock, for a period of three years after the date of the transaction in which the person became an interested stockholder, unless the business combination is approved in a prescribed manner.

The existence of the foregoing provisions could limit the price that investors might be willing to pay in the future for shares of our common stock.

#### **Item 7A. Quantitative and Qualitative Disclosures about Market Risk**

##### *Foreign Currency Exchange Risk*

Our results of operations and cash flows are subject to fluctuations due to changes in foreign currency exchange rates, particularly changes in the Euro, British pound sterling, Australian dollar and Japanese yen. In 2003 and 2004, 39% and 43%, respectively of our revenues were generated in locations outside the United States. The majority of these revenues are denominated in currencies other than U.S. dollars, as are many of the associated expenses. Except for revenue transactions in Japan, we enter into transactions directly with substantially all of our foreign customers. This creates a foreign currency exchange risk for us.

As of December 31, 2003 and 2004 we had \$9.2 and \$6.5 million, respectively, of receivables denominated in currencies other than the U.S. dollar. If the foreign exchange rates fluctuated by 10% as of December 31, 2003 and 2004, our foreign exchange exposure would have fluctuated by approximately \$920,000 and \$650,000, respectively. In addition, our subsidiaries have intercompany accounts that eliminate upon consolidation; however, such accounts expose us to foreign currency rate movements. Exchange rate fluctuations on short-term intercompany accounts are recorded in our consolidated statements of operations under "other income (expense)", while exchange rate fluctuations on long-term intercompany accounts are recorded in our consolidated balance sheets under "accumulated other comprehensive loss" in stockholders' (deficit) equity. We also maintain cash accounts denominated in currencies other than the local currency which expose us to foreign exchange rate movements. We have implemented a risk management program under which we measure foreign currency exchange risk monthly and manage those exposures through the use of various internal controls and the use of forward foreign exchange contracts. This process is designed to minimize foreign currency translation exposures that could otherwise affect consolidated results of operations. As

of December 31, 2004 we hedged approximately \$12.8 million of receivables, intercompany accounts and cash balances denominated in currencies other than the U.S. dollar.

#### *Interest Rate Sensitivity*

We had unrestricted cash, cash equivalents and short term investments totaling \$58.2 million at December 31, 2004. These amounts were invested primarily in money market funds. The unrestricted cash and cash equivalents are held for working capital purposes. We do not enter into investments for trading or speculative purposes. Due to the short-term nature of these investments, we believe that we do not have any material exposure to changes in the fair value of our investment portfolio as a result of changes in interest rates. Declines in interest rates, however, would reduce future investment income.

We have a working capital line of credit which bears interest based upon the prime rate. At December 31, 2003 and 2004 the prime rate was 4.0% and 5.25%, respectively, and there was \$2.5 million and \$0, respectively, outstanding under our working capital line of credit. If the prime rate fluctuated by 10%, and based on amounts outstanding as of December 31, 2003 and 2004, interest expense would have fluctuated by approximately \$11 and \$0, respectively.

#### **Item 8. *Financial Statements and Supplementary Data***

The consolidated financial statements and supplementary data of Phase Forward Incorporated and subsidiaries are listed under Part IV, Item 15, in this Annual Report.

#### **Item 9. *Changes in and Disagreements With Accountants on Accounting and Financial Disclosure***

None.

#### **Item 9A. *Controls and Procedures***

We maintain disclosure controls and procedures that are designed to ensure that information required to be disclosed in our Securities Exchange Act reports is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission rules and forms, and that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure. In designing and evaluating the disclosure controls and procedures, management recognized that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives, as ours are designed to do, and management necessarily was required to apply its judgment in evaluating the cost-benefit relationship of possible controls and procedures.

As of December 31, 2004, we carried out an evaluation, under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures, as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934. Based upon that evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures are effective in enabling us to record, process, summarize and report information required to be included in our periodic Securities and Exchange Commission filings within the required time period.

There have been no changes in our internal control over financial reporting that occurred during the period covered by this report that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

**Item 9B. Other Information**

On March 7, 2005, we adopted the Phase Forward 2005 Management Incentive Compensation Plan (the "Plan"). The Plan is effective January 1, 2005. The Plan provides our Chief Executive Officer with an opportunity to earn a cash bonus of up to 75% of base salary, other executive management with an opportunity to earn a cash bonus of up to 40% of base salary, and certain other designated employees with an opportunity to earn a cash bonus of up to 25% of base salary, based in each case on the attainment of certain corporate financial goals and, in the case of non-executive Plan participants, certain individual performance objectives.

Also on March 7, 2005, we amended our form of Executive Agreement to provide for certain additional severance benefits to be calculated based on incentive compensation earned under our performance cash incentive plans prior to an executive's termination date, which compensation could have been payable but for the executive's termination. All other terms of the Executive Agreement remain unchanged by the amendment. We expect that each executive who is currently party to an Executive Agreement will execute a new Executive Agreement as amended, which is being filed as Exhibit 10.22 to this Annual Report. The amendment to the form of Executive Agreement is intended to better align the Executive Agreements with our cash incentive compensation plans in connection with the payments that an executive would be entitled to upon a specified change in control or employment termination.

**PART III**

Information required by Items 10, 11, 12, 13 and 14 of Part III is omitted from this Annual Report and will be filed in a definitive proxy statement or by an amendment to this Annual Report not later than 120 days after the end of the fiscal year covered by this Annual Report.

Our policy governing transactions in our securities by directors, officers and employees permits our officers, directors and certain other persons to enter into trading plans complying with Rule 10b5-1 under the Securities Exchange Act of 1934, as amended. We have been advised that our Vice President, General Counsel and Secretary, D. Ari Buchler, Vice President of Worldwide Sales, Stephen J. Powell, Vice President of Development, Steven J. Rosenberg, and our Chairman and Chief Strategy Officer, Paul A. Bleicher have each entered into a trading plan in accordance with Rule 10b5-1 and our policy governing transactions in our securities. We anticipate that, as permitted by Rule 10b5-1 and our policy governing transactions in our securities, some or all of our officers, directors and employees may establish trading plans in the future. We intend to disclose the names of executive officers and directors who establish a trading plan in compliance with Rule 10b5-1 and the requirements of our policy governing transactions in our securities in our future quarterly and annual reports on Form 10-Q and 10-K filed with the Securities and Exchange Commission. However, we undertake no obligation to update or revise the information provided herein, including for revision or termination of an established trading plan, other than in such quarterly and annual reports.

## PART IV

### Item 15. Exhibits, Financial Statements and Schedules

- (a) The following documents are filed as part of this report:
- (1) Financial Statements
- Report of Independent Registered Public Accounting Firm
- Consolidated Balance Sheets as of December 31, 2003 and 2004
- Consolidated Statements of Operations for the years ended December 31, 2002, 2003 and 2004
- Consolidated Statements of Stockholders' (Deficit) Equity and Comprehensive Income (Loss) for the years ended December 31, 2002, 2003 and 2004
- Consolidated Statements of Cash Flows for the years ended December 31, 2002, 2003 and 2004
- Notes to Consolidated Financial Statements
- (2) Financial Statement Schedules
- All schedules have been omitted because they are not required or because the required information is given in the Consolidated Financial Statements or Notes thereto
- (3) Exhibits

### EXHIBIT INDEX

Exhibit No.	Description
3.1(1)	Amended and Restated Certificate of Incorporation of the Registrant dated July 20, 2004.
3.2(1)	Amended and Restated Bylaws of the Registrant.
4.1(1)	Specimen Certificate for shares of the Registrant's Common Stock.
4.2	Description of Capital Stock (contained in the Certificate of Incorporation filed as Exhibits 3.1 and 3.2).
10.1+(1)	1997 Stock Option Plan.
10.2+(1)	Amended and Restated 2003 Non-Employee Director Stock Option Plan.
10.3+(1)	2004 Stock Option and Incentive Plan.
10.4+(1)	2004 Employee Stock Purchase Plan.
10.5(1)	Fifth Amended and Restated Investors' Rights Agreement, as amended by Amendments No. 1 and No. 2 thereto.
10.5.1(1)	Termination and Amendment Agreement between the Registrant and certain of its stockholders named therein.
10.6(1)	Loan Agreement between the Registrant and Silicon Valley Bank, as modified.
10.7#(1)	Software License Agreement between the Registrant and Eli Lilly and Company.
10.8#(1)	Consulting and Professional Services Agreement between the Registrant and Eli Lilly and Company.
10.9+(1)	Form of Executive Agreement between the Registrant and its officers.

10.10+(1)	Senior Executive's Service Agreement between Phase Forward Europe Limited and Stephen Powell.
10.11+(1)	Executive Service Agreement between Phase Forward Europe Limited and Martin Young.
10.12+	Agreement between the Registrant, Phase Forward Europe Limited and Martin Young.
10.13+(1)	Form of Indemnification Agreement between the Registrant and each of its directors.
10.14(1)	Sublease Agreement between the Registrant and BMC Software, Inc.
10.15#(2)	Software License and Services Agreement between the Registrant and GlaxoSmithKline Services Unlimited.
10.16+(3)	Letter agreement between the Company and John J. Schickling dated as of October 21, 2004.
10.17+(4)	Form of Incentive Stock Option Agreement.
10.18+(5)	Form of Non-Statutory Stock Option Agreement.
10.19+	2005 Global Sales Executive Incentive Compensation Plan.
10.20+	Summary of cash compensation practices for non-employee directors.
10.21+	2005 Management Incentive Plan.
10.22+	Form of Executive Agreement between the Registrant and its officers, as amended March 7, 2005.
23.1	Consent of Ernst & Young LLP, Independent Registered Public Accounting Firm.
31.1	Certification of CEO pursuant to Rule 13a-14(a) and 15d-14(s) under the Securities Exchange Act of 1934.
31.2	Certification of CFO pursuant to rules 13a-14(a) and 15d-14(s) under the Securities Exchange Act of 1934.
32.1	Certification of CEO pursuant to 18 U.S.C. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2	Certification of CFO pursuant to 18 U.S.C. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

+ Indicates a management contract or any compensatory plan, contract or arrangement.

# Confidential treatment requested for portions of this document.

(1) Incorporated by reference herein to the exhibits to the Company's Registration Statement on Form S-1 (File No. 333-113594), as amended.

(2) Incorporated by reference herein to Exhibit 10.1 of the Company's Report on Form 8-K dated as of July 23, 2004 (File No. 000-05839).

(3) Incorporated by reference herein to Exhibit 10.3 of the Company's Report on Form 10-Q dated as of November 10, 2004 (File No. 000-05839).

(4) Incorporated by reference herein to Exhibit 10.4 of the Company's Report on Form 10-Q dated as of November 10, 2004 (File No. 000-05839).

(5) Incorporated by reference herein to Exhibit 10.5 of the Company's Report on Form 10-Q dated as of November 10, 2004 (File No. 000-05839).

## SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, as amended, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized on the 9th day of March 2005.

### PHASE FORWARD INCORPORATED

By:           /s/ ROBERT K. WEILER          

Robert K. Weiler  
*President and Chief Executive Officer*

Pursuant to the requirements of the Securities Exchange Act of 1934, as amended, this Annual Report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

Signature	Title	Date
<u>          /s/ ROBERT K. WEILER          </u> Robert K. Weiler	President, Chief Executive Officer and Director (Principal Executive Officer)	March 9, 2005
<u>          /s/ RODGER WEISMANN          </u> Rodger Weismann	Senior Vice President and Chief Financial Officer (Principal Accounting and Financial Officer)	March 9, 2005
<u>          /s/ PAUL A. BLEICHER, M.D., PH.D.          </u> Paul A. Bleicher, M.D., Ph.D	Chairman of the Board	March 9, 2005
<u>          /s/ AXEL BICHARA          </u> Axel Bichara	Director	March 9, 2005
<u>          /s/ FRANKLYN A. CAINE          </u> Franklyn A. Caine	Director	March 9, 2005
<u>          /s/ JAMES I. CASH, JR., PH.D          </u> James I. Cash, Jr., Ph.D	Director	March 9, 2005
<u>          /s/ RICHARD A. D'AMORE          </u> Richard A. D'Amore	Director	March 9, 2005

**Phase Forward Incorporated and Subsidiaries**  
**Consolidated Financial Statements**

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## Report of Independent Registered Public Accounting Firm

To the Stockholders and Board of Directors  
Phase Forward Incorporated and Subsidiaries:

We have audited the accompanying consolidated balance sheets of Phase Forward Incorporated (a Delaware corporation) and Subsidiaries as of December 31, 2003 and 2004, and the related consolidated statements of operations, stockholders' (deficit) equity and comprehensive income (loss), and cash flows for each of the three years in the period ended December 31, 2004. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Phase Forward Incorporated and Subsidiaries as of December 31, 2003 and 2004, and the consolidated results of their operations and their cash flows for each of the three years in the period ended December 31, 2004, in conformity with U.S. generally accepted accounting principles.

/s/ ERNST & YOUNG LLP

Boston, Massachusetts  
February 4, 2005

Phase Forward Incorporated and Subsidiaries

Consolidated Balance Sheets

(in thousands, except per share amounts)

	As of December 31,	
	2003	2004
<b>Assets</b>		
Current assets:		
Cash and cash equivalents	\$ 19,046	\$ 53,485
Short-term investments	—	4,735
Accounts receivable, net of allowance of \$425 and \$391 in 2003 and 2004, respectively	22,947	19,682
Deferred set up costs, current portion	1,115	783
Prepaid commissions and royalties, current portion	2,192	3,035
Prepaid expenses and other current assets	1,434	2,335
<b>Total current assets</b>	<b>46,734</b>	<b>84,055</b>
Property and equipment, net	5,299	5,717
Restricted cash	1,611	—
Deferred set up costs, net of current portion	697	665
Prepaid commissions and royalties, net of current portion	2,527	2,756
Goodwill	23,780	21,817
Other assets	196	240
<b>Total assets</b>	<b>\$ 80,844</b>	<b>\$ 115,250</b>
<b>Liabilities and Stockholders' (Deficit) Equity</b>		
Current Liabilities:		
Lines of credit	\$ 2,500	\$ —
Current portion of notes payable	2,218	2,558
Accounts payable	947	1,619
Accrued expenses	10,973	11,658
Restructuring accrual	1,989	344
Deferred revenue, current portion	33,050	35,350
Deferred Rent, current portion	—	142
<b>Total current liabilities</b>	<b>51,677</b>	<b>51,671</b>
Notes payable, net of current portion	1,970	1,849
Restructuring accrual, net of current portion	497	—
Deferred revenue, net of current portion	4,738	1,002
Deferred rent, net of current portion	288	1,481
<b>Total liabilities</b>	<b>59,170</b>	<b>56,003</b>
Commitments and contingencies (Note 9)		
Redeemable convertible preferred stock, \$.01 par value, at redemption value:		
Authorized—22,884 and 0 shares in 2003 and 2004, respectively		
Issued—22,841 and 0 shares in 2003 and 2004, respectively	123,951	—
Redeemable convertible preferred stock warrant	169	—
Stockholders' (deficit) equity:		
Preferred stock, \$.01 par value:		
Authorized—0 and 5,000 shares in 2003 and 2004, respectively		
Issued—0 shares in 2003 and 2004	—	—
Common stock, \$.01 par value:		
Authorized—32,804 and 100,000 shares in 2003 and 2004, respectively		
Issued—3,602 and 32,399 shares in 2003 and 2004, respectively	36	324
Additional paid-in capital	—	165,462
Subscription receivable	(627)	(127)
Deferred stock-based compensation	(2,333)	(1,755)
Treasury stock, 37 shares at cost	(111)	(111)
Accumulated other comprehensive loss	(500)	(160)
Accumulated deficit	(98,911)	(104,386)
<b>Total stockholders' (deficit) equity</b>	<b>(102,446)</b>	<b>59,247</b>
<b>Total liabilities and stockholders' (deficit) equity</b>	<b>\$ 80,844</b>	<b>\$ 115,250</b>

See accompanying notes.

Phase Forward Incorporated and Subsidiaries

Consolidated Statements of Operations

(in thousands, except per share amounts)

	Year Ended December 31,		
	2002	2003	2004
Revenues:			
License	\$ 15,746	\$ 21,377	\$ 28,180
Service	44,826	40,648	45,550
Total revenues	60,572	62,025	73,730
Costs of revenues:			
License	2,157	2,300	1,875
Service(1)	30,870	28,466	27,782
Total cost of revenues	33,027	30,766	29,657
Gross margin:			
License	13,589	19,077	26,305
Service	13,956	12,182	17,768
Total gross margin	27,545	31,259	44,073
Operating expenses:			
Sales and marketing(1)	13,581	12,709	14,403
Research and development(1)	10,654	10,569	12,423
General and administrative(1)	10,447	10,138	13,246
Restructuring charge	—	4,503	(168)
Total operating expenses	34,682	37,919	39,904
Income (loss) from operations	(7,137)	(6,660)	4,169
Other income (expense):			
Interest income	307	111	518
Interest expense	(418)	(364)	(394)
Other income (expense)	729	721	(32)
Total other income (expense)	618	468	92
Income (loss) before provision for income taxes	(6,519)	(6,192)	4,261
Provision for income taxes	435	434	2,392
Net income (loss)	(6,954)	(6,626)	1,869
Accretion of preferred stock and dividend declared	8,068	7,672	8,953
Net loss applicable to common stockholders	\$ (15,022)	\$ (14,298)	\$ (7,084)
Net loss per share applicable to common stockholders—basic and diluted	\$ (5.05)	\$ (4.23)	\$ (0.43)
Weighted average number of common shares used in net loss per share calculations—basic and diluted	2,975	3,383	16,447

(1)

Amounts include stock-based expenses, as follows:

Costs of service revenues	\$ —	\$ 264	\$ 105
Sales and marketing	103	124	141
Research and development	—	184	312
General and administrative	—	155	1,553
Total stock based expenses	\$ 103	\$ 727	\$ 2,111

See accompanying notes.



Phase Forward Incorporated and Subsidiaries

Consolidated Statements of Stockholders' (Deficit)  
Equity and Comprehensive Income (Loss)

(in thousands, except per share amounts)

	Common Stock				
	Number of Shares	\$0.01 Par Value	Additional Paid-in Capital	Subscription Receivable	Deferred Stock-Based Compensation
Balance at December 31, 2001	3,356	\$ 34	\$ 1,955	\$ (1,167)	\$ (240)
Foreign currency translation adjustment	—	—	—	—	—
Payment of subscription receivable	—	—	—	44	—
Exercise of common stock options	164	2	76	—	—
Reduction of deferred stock-based compensation	—	—	(137)	—	137
Amortization of deferred stock-based compensation	—	—	—	—	103
Repurchase of restricted stock	(273)	(3)	(493)	496	—
Accretion of preferred stock to redemption value	—	—	(1,401)	—	—
Net loss	—	—	—	—	—
<b>Total comprehensive loss</b>					
Balance at December 31, 2002	3,247	33	—	(627)	—
Foreign currency translation adjustment	—	—	—	—	—
Exercise of common stock options	355	3	182	—	—
Purchase of common stock	—	—	—	—	—
Deferred stock-based compensation	—	—	3,060	—	(3,060)
Amortization of deferred stock-based compensation	—	—	—	—	727
Accretion of preferred stock to redemption value	—	—	(3,242)	—	—
Net loss	—	—	—	—	—
<b>Total comprehensive loss</b>					
Balance at December 31, 2003	3,602	36	—	(627)	(2,333)
Foreign currency translation adjustment	—	—	—	—	—
Payment of subscription receivable	—	—	—	500	—
Exercise of common stock options	361	4	743	—	—
Issuance of common stock under employee stock purchase plan	15	—	90	—	—
Accretion of preferred stock to redemption value	—	—	(1,613)	—	—
Accrual of dividend payable to Series B, C and D preferred stockholders	—	—	—	—	—
Issuance of common stock from public offering, net of costs	5,580	56	36,563	—	—
Conversion of redeemable convertible preferred stock	22,841	228	127,977	—	—
Conversion of preferred stock warrant into common stock warrant	—	—	169	—	—
Deferred stock-based compensation	—	—	1,533	—	(1,533)
Amortization of deferred stock-based compensation	—	—	—	—	2,111
Net income	—	—	—	—	—
<b>Total comprehensive income</b>					
Balance at December 31, 2004	32,399	\$ 324	\$ 165,462	\$ (127)	\$ (1,755)

	Treasury Stock	Accumulated Other Comprehensive income (loss)	Accumulated Deficit	Total Stockholders' (Deficit) Equity	Comprehensive Income (Loss)
Balance at December 31, 2001	—	\$ (326)	\$ (74,234)	\$ (73,978)	
Foreign currency translation adjustment		428	—	428	\$ 428
Payment of subscription receivable	—	—	—	44	—
Exercise of common stock options	—	—	—	78	—
Reduction of deferred stock-based compensation	—	—	—	—	—
Amortization of deferred stock-based compensation	—	—	—	103	—
Repurchase of restricted stock	—	—	—	—	—
Accretion of preferred stock to redemption value	—	—	(6,667)	(8,068)	—
Net loss	—	—	(6,954)	(6,954)	(6,954)
Total comprehensive loss					\$ (6,526)
Balance at December 31, 2002	—	102	(87,855)	(88,347)	
Foreign currency translation adjustment	—	(602)	—	(602)	\$ (602)
Exercise of common stock options	—	—	—	185	—
Purchase of common stock	(111)	—	—	(111)	—
Deferred stock-based compensation	—	—	—	—	—
Amortization of deferred stock-based compensation	—	—	—	727	—
Accretion of preferred stock to redemption value	—	—	(4,430)	(7,672)	—
Net loss	—	—	(6,626)	(6,626)	(6,626)
Total comprehensive loss					\$ (7,228)
Balance at December 31, 2003	(111)	(500)	(98,911)	(102,446)	
Foreign currency translation adjustment	—	340	—	340	\$ 340
Payment of subscription receivable	—	—	—	500	—
Exercise of common stock options	—	—	—	747	—
Issuance of common stock under employee stock purchase plan	—	—	—	90	—
Accretion of preferred stock to redemption value	—	—	(2,644)	(4,257)	—
Accrual of dividend payable to Series B, C and D preferred stockholders	—	—	(4,700)	(4,700)	—
Issuance of common stock from public offering, net of costs	—	—	—	36,619	—
Conversion of redeemable convertible preferred stock	—	—	—	128,205	—
Conversion of preferred stock warrant into common stock warrant	—	—	—	169	—
Deferred stock-based compensation	—	—	—	—	—
Amortization of deferred stock-based compensation	—	—	—	2,111	—
Net income	—	—	1,869	1,869	1,869
Total comprehensive income					\$ 2,209
Balance at December 31, 2004	\$ (111)	\$ (160)	\$ (104,386)	\$ 59,247	

See accompanying notes.

Phase Forward Incorporated and Subsidiaries

Consolidated Statements of Cash Flows

(in thousands)

	Year Ended December 31,		
	2002	2003	2004
<b>Operating activities</b>			
Net income (loss)	\$ (6,954)	\$ (6,626)	\$ 1,869
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:			
Depreciation and amortization	6,002	4,856	3,050
Stock-based compensation	103	727	2,111
Asset impairment due to restructuring	—	2,015	—
Loss (gain) on disposal of fixed assets	—	184	(34)
Foreign currency exchange (gain) loss	(803)	(906)	63
Provision for allowance for doubtful accounts	215	213	165
Non cash income tax expense	—	120	1,964
Other non-cash items	—	—	16
Changes in assets and liabilities:			
Accounts receivable	(2,461)	(8,580)	3,455
Deferred costs	1,863	(288)	(522)
Prepaid expenses and other current assets	(716)	(726)	(886)
Accounts payable	(2,990)	(362)	625
Accrued expenses	(1,182)	5,251	(1,818)
Deferred revenue	(3,117)	9,245	(1,550)
Deferred rent	281	(63)	1,318
Net cash (used in) provided by operating activities	(9,759)	5,060	9,826
<b>Investing activities</b>			
Purchase of short-term investments	—	—	(4,765)
Purchase of property and equipment	(3,544)	(4,095)	(3,382)
Decrease (increase) in restricted cash, net	313	(489)	1,611
Decrease (increase) in other assets	(897)	120	(37)
Net cash used in investing activities	(4,128)	(4,464)	(6,573)
<b>Financing activities</b>			
Proceeds from issuance of notes payable and borrowings under lines of credit	4,110	2,570	2,928
Payments on lines of credit and notes payable	(3,075)	(3,460)	(5,209)
Payment of dividend payable	—	—	(4,700)
Net proceeds from issuance of preferred stock	1,970	—	—
Repurchase of restricted common stock	(496)	(111)	—
Proceeds from issuance of common stock	78	185	42,687
Stock issuance costs	—	—	(5,231)
Proceeds from repayment of subscriptions receivable	540	—	500
Net cash provided by (used in) financing activities	3,127	(816)	30,975
Effect of exchange rate changes on cash and cash equivalents	1,120	1,306	211
Net (decrease) increase in cash and cash equivalents	(9,640)	1,086	34,439
Cash and cash equivalents at beginning of year	27,600	17,960	19,046
Cash and cash equivalents at end of period	\$ 17,960	\$ 19,046	\$ 53,485
<b>Supplemental disclosure of cash flow information</b>			
Cash paid for interest	\$ 368	\$ 234	\$ 313
Cash paid for income taxes	\$ 145	\$ 106	\$ 186
<b>Non-cash financing activities</b>			
Accretion of Series B, C, and D redeemable convertible preferred stock to redemption value	\$ 8,068	\$ 7,672	\$ 4,257

See accompanying notes.

**Phase Forward Incorporated and Subsidiaries**  
**Notes to Consolidated Financial Statements**  
**(in thousands, except share and per share amounts)**

**1. Organization and Operations**

Phase Forward Incorporated (the Company) is a provider of integrated enterprise-level electronic data capture, data management and adverse event reporting software solutions for use in the clinical trial component of our customers' global research and development initiatives. The Company offers software products, services and hosted solutions to pharmaceutical, biotechnology and medical device companies, as well as academic institutions, clinical research organizations and other entities engaged in clinical trials.

The Company is subject to a number of risks similar to those of other companies of similar size in its industry, including rapid technological changes, competition, limited number of suppliers, customer concentration, government regulations, management of international operations, protection of proprietary rights, patent litigation and dependence on key individuals.

The Company has operations in the United States, United Kingdom, France, Germany, Japan and Australia.

**2. Summary of Significant Accounting Policies**

The accompanying consolidated financial statements reflect the application of certain accounting policies as described in this note and elsewhere in the accompanying consolidated financial statements.

**Principles of Consolidation**

The consolidated financial statements include the accounts of the Company and its wholly owned subsidiaries. All significant intercompany balances and transactions have been eliminated in consolidation.

**Use of Estimates**

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

**Revenue Recognition and Deferred Setup Costs**

The Company derives revenues from software licenses and services. License revenue is derived principally from the sale of multi-year software term licenses of the Company's *InForm*, *Clintrial* and *Clintrace* software products. Service revenue is derived from the Company's delivery of the hosted solution of its *InForm* software product, consulting services and customer support, including training.

The components of revenue are as follows:

	Year Ended December 31,		
	2002	2003	2004
License	\$ 15,746	\$ 21,377	\$ 28,180
Application hosting services	22,003	20,217	27,444
Consulting services	4,932	6,107	4,976
Customer support	17,891	14,324	13,130
<b>Total</b>	<b>\$ 60,572</b>	<b>\$ 62,025</b>	<b>\$ 73,730</b>

The Company recognizes software license revenue in accordance with Statement of Position (SOP) No. 97-2, *Software Revenue Recognition*, as amended, issued by the American Institute of Certified Public Accountants, while revenues resulting from application hosting services are recognized in accordance with Emerging Issues Task Force (EITF) Issue No. 00-03, *Application of AICPA Statement of Position 97-2 to Arrangements that include the Right to Use Software Stored on Another Entity's Hardware*, Securities and Exchange Commission's (SEC) Staff Accounting Bulletin (SAB) Nos. 101 and No. 104, *Revenue Recognition*, and EITF Issue No. 00-21, *Revenue Arrangements with Multiple Deliverables*.

Customers generally have the ability to terminate application hosting, consulting and training service agreements upon 30 days notice to the Company. Multiple element arrangements, including license and services agreements, and certain application hosting services can generally be terminated by either party for material breach of obligations generally not corrected within 30 days after notice of the breach.

The Company recognizes revenue when all of the following conditions are satisfied: (1) there is persuasive evidence of an arrangement; (2) the service has been provided to the customer; (3) the collection of fees is probable; and (4) the amount of fees to be paid by the customer is fixed or determinable.

The Company generally enters into software term licenses with its customers for three to five year periods. These arrangements typically include multiple elements: a software license, consulting services and customer support. The Company bills its customers in accordance with the terms of the underlying contract. Generally, the Company bills the annual license fee for the first year of a multi-year contract in advance and bills the license fees for the subsequent years in advance on the anniversary date. The Company's payment terms are generally net 30 days.

The Company's software license revenue is earned from the sale of off-the-shelf software requiring no significant modification or customization subsequent to delivery to the customer. Consulting services, which can also be performed by third-party consultants, are deemed to be non-essential to the functionality of the software and typically are for trial configuration, implementation planning, loading of software, building simple interfaces and running test data and documentation of procedures.

The Company generally bundles customer support with the software license for the entire term of the license. As a result, the Company generally recognizes revenues for all elements, including consulting services, ratably over the term of the software license and support arrangement. The Company allocates the revenue recognized for these arrangements to the different elements based on management's estimate of the relative fair value of each element. For its term-based licenses, the

Company allocates to consulting services the anticipated service effort and value throughout the term of the arrangement at an amount that would have been allocated had those services been sold separately to the customer. The remaining value is allocated to license and support services, with 10% of this amount allocated to support services. The Company has allocated the estimated fair value to its multiple element arrangements to provide meaningful disclosures about each of its revenue streams. The costs associated with the consulting and customer support services are expensed as incurred. There are instances in which we sell software licenses based on usage levels. These software licenses can be based on estimated usage, in which case the license fee charged to the customer is fixed based on this estimate. When the fee is fixed, the revenue is recognized ratably over the contractual term of the arrangement. If the fee is based on actual usage, and therefore variable, the revenue is recognized in the period of use. Revenues from certain follow-on consulting services, which are sold separately to customers with existing software licenses and are not considered part of a multiple element arrangement, are recognized as the services are performed.

In addition to making its software products available to customers through licenses, the Company offers its *InForm* electronic data capture software product through a fully-hosted, turnkey deployment. Revenues resulting from application hosting services consist of three stages for each clinical trial. The first stage includes trial and application setup, including design of electronic case report forms and edit checks, implementation of the system and server configuration. The second stage consists of application hosting and related support services. The third stage, database lock, consists of services required to close out, or lock, the database for the clinical trial. Services provided for the first and third stages are provided on a fixed fee based upon the complexity of the trial and system requirements. Services for the second stage are charged separately as a fixed monthly fee. The Company recognizes revenue from application-hosting and related services over the hosting period. Fees charged and costs incurred for the trial system design, set up and implementation are deferred and capitalized as applicable, until the start of the hosting period. These revenues and costs are recognized and amortized, as applicable, ratably over the estimated hosting period. The capitalized costs include incremental direct costs with third parties and certain internal direct costs of the trial and application setup, as defined under Statement of Financial Accounting Standards (SFAS) No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Indirect Costs of Leases*. These costs include salary and benefits associated with direct labor costs incurred during trial setup, as well as third-party subcontract fees and other contract labor costs. Work performed outside the original scope of work is contracted for separately as an additional fee and is generally recognized over the remaining term of the hosting period.

In the event that an application hosting customer cancels a clinical trial and its related statement of work, all deferred revenue is recognized, all deferred set up costs are expensed and certain termination related fees may be charged.

The Company capitalized \$1,705, \$1,729 and \$1,606 of deferred set up costs and amortized \$2,858, \$1,716 and \$1,970 during the years ended December 31, 2002, 2003 and 2004, respectively. The amortization of deferred set up costs is a component of cost of services.

The Company continues to sell the *Clintrial* and *Clintrace* software products to certain existing customers as perpetual software licenses with the option to purchase customer support. The Company does not sell perpetual licenses to new customers. The Company has established vendor specific objective evidence of fair value for the customer support in these arrangements. Accordingly, the license revenue is recognized upon delivery of the software and when all other revenue recognition

criteria are met. The customer support is recognized ratably over the term of the underlying support arrangement. The Company continues to generate customer support and maintenance revenue from its perpetual license customer base. Training revenue is recognized as earned.

Deferred revenue represents amounts billed or cash received in advance of revenue recognition.

Provisions for estimated losses on uncompleted contracts are made on a contract-by-contract basis and are recognized in the period in which such losses become probable and can be reasonably estimated. To date, the Company has not experienced any material losses on uncompleted application hosting contracts.

In accordance with EITF Issue No. 01-14, *Income Statement Characterization of Reimbursements Received for "Out-of-Pocket" Expenses Incurred*, the Company included \$878, \$1,306 and \$674 of out of pocket expenses in service revenue and cost of service revenue in the years ended December 31, 2002, 2003 and 2004, respectively.

#### **Internal Use Software and Website Development Costs**

The Company follows the guidance of EITF Issue No. 00-2, *Accounting for Web Site Development Costs* which sets forth the accounting for website development costs based on the website development activity. The Company follows the guidance set forth in SOP No. 98-1, *Accounting for the Cost of Computer Software Developed or Obtained for Internal Use*, in accounting for the development of its on demand use systems. SOP No. 98-1 requires companies to capitalize qualifying computer software costs, which are incurred during the application development stage and amortize them over the software's estimated useful life of three years. The Company has not incurred any such costs to date.

#### **Computer Software Development Costs and Research and Development Expenses**

The Company has evaluated the establishment of technological feasibility of its products in accordance with SFAS No. 86, *Accounting for the Costs of Computer Software to Be Sold, Leased or Otherwise Marketed*. The Company sells products in a market that is subject to rapid technological change, new product development and changing customer needs; accordingly, the Company has concluded that technological feasibility is not established until the development stage of the product is nearly complete. The Company defines technological feasibility as the completion of a working model. The time period during which costs could be capitalized, from the point of reaching technological feasibility until the time of general product release, is very short, and consequently, the amounts that could be capitalized are not material to the Company's financial position or results of operations. Therefore, the Company has charged all such costs to research and development in the period incurred.

#### **Prepaid Sales Commissions and Royalties**

For arrangements where revenue is recognized over the relevant contract period, the Company capitalizes related commissions paid to sales people and royalties paid to third parties, and recognizes these expenses over the period that the related revenue is recognized. Commission payments are nonrefundable unless amounts due from a customer are determined to be uncollectible or if the customer subsequently changes or terminates the level of service, in which case commissions paid are recoverable by the Company. The Company's royalty obligation is based upon the license and customer support revenues earned for certain products in an arrangement. The Company has the right to recover

the royalties in the event the arrangement is cancelled. The Company capitalized \$2,326, \$3,967 and \$3,816 of commissions and amortized to sales and marketing expense \$1,676, \$1,652 and \$3,009 during the years ended December 31, 2002, 2003 and 2004, respectively. The Company capitalized \$1,689, \$1,674 and \$2,712 of royalties and amortized to cost of revenues \$1,713, \$2,016 and \$2,447 during the years ended December 31, 2002, 2003 and 2004, respectively.

### Warranties and Indemnification

The Company's hosting service is typically warranted to perform in a manner consistent with general industry standards that are reasonably applicable and substantially in accordance with the Company's online help documentation under normal use and circumstances. The Company's arrangements also include certain provisions for indemnifying customers against liabilities if its products or services infringe a third party's intellectual property rights.

The Company has entered into service level agreements with its hosted application customers warranting certain levels of uptime reliability and permitting those customers to receive credits against monthly hosting fees or terminate their agreements in the event that the Company fails to meet those levels.

To date, the Company has not incurred any material costs as a result of such indemnifications and has not accrued any liabilities related to such obligations in the accompanying consolidated financial statements.

### Net Loss Per Share

Basic and diluted net loss per share is presented in conformity with SFAS No. 128, *Earnings Per Share*. Basic net loss per common share was determined by dividing net loss applicable to common stockholders by the weighted average number of common shares outstanding during the period. Weighted average shares outstanding exclude unvested restricted common stock. The Company's potentially dilutive shares, which include outstanding common stock options, redeemable convertible preferred stock and warrants also have not been included in the computation of diluted net loss per share for all periods as the result would be anti-dilutive.

The calculation of basic and diluted net loss per share is as follows:

	Year Ended December 31,		
	2002	2003	2004
Net loss applicable to common stockholders	\$ (15,022)	\$ (14,298)	\$ (7,084)
Computation of basic and diluted net loss per share:			
Weighted average shares outstanding	3,215,714	3,451,410	16,471,096
Less weighted average unvested restricted common shares outstanding	(240,224)	(67,951)	(24,588)
Shares used in computing net loss per share	2,975,490	3,383,459	16,446,508
Net loss per share applicable to common stockholders—basic and diluted	\$ (5.05)	\$ (4.23)	\$ (0.43)

The following common share equivalents and unvested restricted shares have been excluded from the computation of diluted weighted average shares outstanding as of December 31, 2002, 2003 and 2004 respectively, as they would be anti-dilutive.

	As of December 31,		
	2002	2003	2004
Redeemable convertible preferred stock	22,841,157	22,841,157	—
Options outstanding	4,254,780	4,296,891	4,474,041
Unvested restricted shares	89,410	46,493	—
Warrant	34,330	34,330	34,330
<b>Foreign Currency Translation</b>			

The financial statements of the Company's foreign subsidiaries are translated in accordance with SFAS No. 52, *Foreign Currency Translation*. The reporting currency for the Company is the U.S. dollar. The functional currency of the Company's subsidiaries in the United Kingdom, France, Germany, Japan and Australia are the local currencies of those countries. Accordingly, the assets and liabilities of the Company's foreign subsidiaries are translated into U.S. dollars using the exchange rate in effect at each balance sheet date. Revenue and expense accounts are generally translated using an average rate of exchange during the period. Foreign currency translation adjustments are accumulated as a component of other comprehensive income (loss) as a separate component of stockholders' equity (deficit). Gains and losses arising from transactions denominated in foreign currencies are primarily related to intercompany accounts that have been determined to be temporary in nature and cash and accounts receivable denominated in non-functional currencies. The Company has recorded foreign currency gains (losses) of approximately \$803, \$906 and (\$63) for the years ended December 31, 2002, 2003 and 2004, respectively, and such gains are included in other income (expense) in the accompanying consolidated statements of operations.

### Derivative Instruments

The Company has adopted the accounting and disclosure requirements of SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*. SFAS No. 133 requires that all derivative instruments be recorded on the balance sheet at their fair value. Changes in the fair value of derivatives are recorded each period in current operations or in stockholders' equity as other comprehensive income (loss), depending upon whether the derivative is designated as part of a hedge transaction and, if it is the type of hedge transaction. Hedges of underlying exposures are designated and documented at the inception of the hedge and are evaluated for effectiveness at least quarterly. As the terms of the derivative are generally matched at inception with the underlying exposure, hedging effectiveness is calculated by comparing the change in fair value of the derivative to the change in fair value of the underlying exposure.

In certain instances, the Company enters into forward contracts to hedge against foreign currency fluctuations. Forward contracts are used to position an economic hedge against transactions denominated in currencies other than the functional currencies of the Company or its subsidiaries. These forward contracts are used to reduce the Company's risk associated with foreign currency exchange rate changes, as the gains or losses on these contracts are intended to offset the gains or losses on the underlying exposures. The Company does not engage in foreign currency speculation.

## Cash, Cash Equivalents and Short-term Investments

The Company accounts for its investments in accordance with SFAS No. 115, *Accounting for Certain Investments in Debt and Equity Securities*. Under SFAS No. 115, securities that the Company has the intent and ability to hold to maturity are reported at amortized cost, which approximates market value, and are classified as held-to-maturity. The Company considers all highly liquid investments with original maturities of 90 days or less at the time of purchase to be cash equivalents and investments with original maturities of between 91 days and one year to be short term investments. At December 31, 2003 and 2004, cash equivalents primarily consisted of money market funds that were readily convertible to cash. At December 31, 2004, short-term investments consisted of U.S. agency notes and corporate debentures.

At December 31, 2003, the Company had approximately \$1,611 of restricted cash held in certificates of deposit as collateral for letters of credit related to facility leases. The certificates of deposit matured and the collateral for the letters of credit is now reflected as a reduction in the amount available under the line of credit.

Cash, cash equivalents and short-term investments as of December 31, 2003 and 2004 were as follows:

December 31, 2003			
Description	Contracted Maturity	Amortized Cost	Fair Market Value
Cash and cash equivalents	Demand	\$ 14,927	\$ 14,927
Money market funds	Demand	4,119	4,119
<b>Total cash and cash equivalents</b>		<b>\$ 19,046</b>	<b>\$ 19,046</b>
December 31, 2004			
Description	Contracted Maturity	Amortized Cost	Fair Market Value
Cash and cash equivalents	Demand	\$ 13,138	\$ 13,138
Investments less than 90 days	34-90 days	3,390	3,390
Money market funds	Demand	35,014	35,014
Certificate of deposit	30 days	1,943	1,943
<b>Total cash and cash equivalents</b>		<b>\$ 53,485</b>	<b>\$ 53,485</b>
Short-term investments	147-356 days	\$ 4,735	\$ 4,728

The Company has had no realized or unrealized gains or losses to date on the sale of money market funds or short term investments.

## Depreciation and Amortization

Property and equipment are stated at cost. Depreciation and amortization are computed using the straight-line method based on the estimated useful lives of the related assets as follows:

Asset Classification	Estimated Useful Life
Office and computer equipment	3-5 years
Purchased computer software	3-5 years
Furniture and fixtures	5 years
Leasehold improvements	Life of lease

Repair and maintenance costs are expensed as incurred.

Intangible assets, which consist of customer contracts and developed technology, are amortized over 8 and 24 months, respectively. Intangible assets were fully amortized during the year ended December 31, 2003.

## Long-Lived Assets

In accordance with SFAS No. 144, *Accounting for the Impairment Disposal of Long-Lived Assets*, the Company continually evaluates whether events or circumstances have occurred that indicate that the estimated remaining useful life of its long-lived assets, including intangible assets, except goodwill, may warrant revision or that the carrying value of these assets may be impaired. The Company evaluates the realizability of its long-lived assets based on profitability and cash flow expectations for the related asset. Any write-downs are to be treated as permanent reductions in the carrying amount of the assets. The Company believes that, as of each of the balance sheet dates presented, none of the Company's long-lived assets were impaired.

## Concentration of Credit Risk

The Company has no significant off-balance-sheet risk or credit risk concentrations except as described below. Financial instruments that subject the Company to potential credit risks are principally cash and cash equivalents, accounts receivable and forward foreign exchange contracts. The Company maintains its cash and cash equivalents and forward foreign exchange contracts with accredited financial institutions. Concentrated credit risk with respect to accounts receivable is limited to large, creditworthy customers. The Company has not experienced significant losses related to receivables from individual customers or groups of customers in any specific industry or geographic area. Due to these factors, no additional credit risk, beyond amounts provided for collection losses, is believed by management to be probable in the Company's accounts receivable. The Company does not require collateral or enter into master netting agreements to mitigate credit risk.

The following table summarizes the number of customers who individually comprise greater than 10% of total revenue and/or total accounts receivable and their aggregate percentage of the Company's total revenue and gross accounts receivable.

	Revenue		Accounts Receivable	
	Number of Customers	Percent of Total Revenue	Number of Customers	Percent of Total Accounts Receivable
Year ended December 31:				
2002	—	—	1	14%
2003	1	10%*	1	18%
2004	2	22%*	1	22%

\*

Includes a customer (Eli Lilly and Company) that is the holder of record of approximately one percent of the Company's outstanding common stock.

The Company serves all of its hosting customers from third-party web hosting facilities located in California and Virginia. The Company does not control the operation of these facilities, and they are vulnerable to damage or interruption. The Company maintains redundant systems that can be used to provide service in the event the third-party web hosting facilities becomes unavailable, although in such circumstances, the Company's service may be interrupted during the transition.

The following table summarizes activity in the Company's allowance for doubtful accounts.

	Year Ended December 31,		
	2002	2003	2004
Beginning of period	\$ 103	\$ 212	\$ 425
Bad debt expense	215	213	165
Write-offs	(106)	—	(199)
End of period	\$ 212	\$ 425	\$ 391

#### Disclosure of Fair Value of Financial Instruments

The Company's financial instruments mainly consist of cash and cash equivalents, short-term investments, accounts receivable, accounts payable, forward foreign exchange contracts, lines of credit and notes payable. The estimated fair values of these financial instruments approximate their carrying values.

#### Comprehensive Income

SFAS No. 130, *Reporting Comprehensive Income*, establishes standards for reporting and displaying comprehensive income (loss) and its components in the consolidated financial statements. Comprehensive loss is defined as the change in equity of a business enterprise during a period from transactions and other events and circumstances from nonowner sources. Comprehensive income (loss) solely consists of foreign currency translation adjustments and is disclosed in the accompanying consolidated statements of stockholders' (deficit) equity and comprehensive income (loss).

#### Stock-Based Compensation

In January 2003, the FASB issued SFAS No. 148, *Accounting for Stock-Based Compensation—Transition and Disclosure, an amendment of FASB Statement No. 123*, which provides alternative methods of transition for a voluntary change to a fair-value-based method of accounting for stock-based

employee compensation. In addition, SFAS No. 148 amends the disclosure requirements of SFAS No. 123, *Accounting for Stock-Based Compensation*, to require prominent disclosures in annual financial statements about the method of accounting for stock-based employee compensation and the effect of the method used on reported results. The Company accounts for options granted under its stock-based compensation plans for employees (see Note 11) under Accounting Principles Board (APB) Opinion No. 25, *Accounting for Stock Issued to Employees*, and has elected the disclosure-only alternative under SFAS No. 123 and the enhanced disclosures as required by SFAS No. 148. Under APB Opinion No. 25, when the exercise price of options granted under these plans equals or exceeds the market price of the underlying stock on the date of grant, no compensation expense is required.

The following tables illustrate the assumptions used and the effect on net loss if the Company had applied the fair value recognition provisions of SFAS No. 123 to stock-based employee compensation. The Company has computed the pro forma disclosures required under SFAS No. 123 for all employee stock options granted using the Black-Scholes option pricing model prescribed by SFAS No. 123.

The assumptions used and weighted average information are as follows:

	Year Ended December 31,		
	2002	2003	2004
Average risk-free interest rate	4.14%	3.58%	3.66%
Expected dividend yield	—	—	—
Expected life	7 years	7 years	4–7 years
Expected volatility	—	—	0% – 90%
Weighted average fair value at grant date	\$0.75	\$3.79	\$5.50

The first purchase period under the Company's 2004 Employee Stock Purchase Plan began in September 2004. See Note 11 for further details. Accordingly, the Company has calculated the SFAS No. 123 pro forma expense for shares purchased under the 2004 Employee Stock Purchase Plan using the following assumptions:

	Year Ended
	December, 31
	2004
Average risk-free interest rate	1.80%
Expected dividend yield	—
Expected life	0.25 years
Expected volatility	65%

Had compensation costs been determined consistent with SFAS No. 123, the Company's net loss would have been the following pro forma amounts:

	Year Ended December 31,		
	2002	2003	2004
Net loss applicable to common stockholders, as reported	\$ (15,022)	\$ (14,298)	\$ (7,084)
Add: Stock-based compensation expense included in reported net income (loss)	103	727	2,111
Less: Total stock-based employee compensation expense determined under fair-value-based method for all awards	1,217	2,491	2,727
Pro forma net loss	(16,136)	(16,062)	\$ (7,700)
Pro forma net loss per share applicable to common stockholders	\$ (5.42)	\$ (4.75)	\$ (0.47)

### Income Taxes

The Company accounts for income taxes under the asset and liability method, which recognizes deferred tax assets and liabilities for the expected future tax consequences of temporary differences between the tax bases of assets and liabilities and their financial statement reported amounts. The Company records a valuation allowance against deferred tax assets when it is probable that such asset will not be realized.

### Advertising Expenses

Advertising costs are expensed as incurred. Advertising expenses totaled \$407, \$180 and \$73 for the years ended December 31, 2002, 2003 and 2004, respectively.

### Recently Issued Accounting Pronouncements

On December 16, 2004, the Financial Accounting Standards Board (FASB) issued SFAS No. 123 (revised 2004), *Share-Based Payment*, which is a revision of SFAS No. 123, *Accounting for Stock-Based Compensation*. SFAS No. 123(R) supersedes APB Opinion No. 25, *Accounting for Stock Issued to Employees*, and amends SFAS No. 95, *Statement of Cash Flows*. Generally, the approach in SFAS No. 123(R) is similar to the approach described in Statement 123. However, SFAS No. 123(R) *requires* all share-based payments to employees, including grants of employee stock options, to be recognized in the income statement based on their fair values. Pro forma disclosure is no longer an alternative.

SFAS No. 123(R) must be adopted no later than July 1, 2005 for calendar year-end companies. Early adoption will be permitted in periods in which financial statements have not yet been issued.

SFAS No. 123(R) permits public companies to adopt its requirements using one of two methods:

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A "modified prospective" method in which compensation cost is recognized beginning with the effective date (a) based on the requirements of SFAS No. 123(R) for all share-based payments granted after the effective date and (b) based on the requirements of SFAS No. 123 for all awards granted to employees prior to the effective date of SFAS No. 123(R) that remain unvested on the effective date.

A "modified retrospective" method which includes the requirements of the modified prospective method described above, but also permits entities to restate based on the amounts previously recognized under SFAS No. 123 for purposes of pro forma disclosures either (a) all prior periods presented or (b) prior interim periods of the year of adoption.

The Company will be reviewing the two alternative adoption methods in the first quarter of 2005 and the resulting impact of fair valuing awards in its financial statements. The Company will also be reviewing various option valuation techniques and may use a valuation method other than the Black Scholes model upon adoption of SFAS No. 123(R).

The adoption of SFAS No. 123(R)'s fair value method will likely have a significant impact on our results of operations, although it will have no impact on our overall financial position. The impact of adoption of SFAS No. 123(R) cannot be predicted at this time because it will depend in part on levels of share-based payments granted in the future. However, had we adopted SFAS No. 123(R) in prior periods, the impact of that standard would have approximated the impact of SFAS No. 123 as described in the disclosure of pro forma net income and earnings per share in Note 2 to our consolidated financial statements.

### 3. Goodwill and Intangible Assets

On August 14, 2001, the Company acquired Clinsoft Corporation, which developed and sold the *Clintrial* and *Clintrace* products. The acquisition of the Clinsoft business was accounted for as a purchase under SFAS No. 141, *Business Combinations*. Accordingly, the total purchase price was allocated to the acquired assets resulting in goodwill of approximately \$24,400 and intangible assets of approximately \$4,000, consisting of developed technology and customer contracts.

Customer contracts were existing contracts that relate to underlying customer relationships pertaining to the services provided by Clinsoft. The developed technology related to certain technology incorporated in the *Clintrace* and *Clintrial* products. The Company amortized the developed technology and customer contracts on a straight line basis over 24 and 8 months, respectively. Amortization of developed technology is included in cost of license revenue and amortization of customer contracts is included in sales and marketing expenses in the accompanying statements of operations. The intangible assets were fully amortized as of December 31, 2003. Amortization expense for the years ended December 31, 2002, 2003 and 2004 was \$1,950, \$1,000 and \$0, respectively.

A rollforward of the net carrying amount of goodwill is as follows:

	Year Ended December 31,	
	2003	2004
Balance at beginning of year	\$ 23,900	\$ 23,780
Utilization of acquired net deferred tax assets	(120)	(1,963)
Balance at end of year	\$ 23,780	\$ 21,817

The utilization of acquired net losses reflects a reduction in cash payments to local taxing authorities for income taxes that are not reflected as a benefit in the income tax provision for financial statement purposes.

The goodwill resulting from the acquisition is reviewed for impairment on an annual basis in accordance with SFAS No. 142, *Goodwill and Other Intangible Assets*. The Company performed its annual impairment test as of October 1, 2003 and 2004, and determined that no impairment of goodwill or intangible assets existed.

#### 4. Property and Equipment

Property and equipment consists of the following:

	As of December 31,	
	2003	2004
Office and computer equipment	\$ 14,240	\$ 16,041
Purchased computer software	2,843	4,347
Furniture and fixtures	515	634
Leasehold improvements	553	630
	<u>18,151</u>	<u>21,652</u>
Less accumulated depreciation and amortization	(12,852)	(15,935)
	<u>\$ 5,299</u>	<u>\$ 5,717</u>

Depreciation expense for the years ended December 31, 2002, 2003 and 2004 was approximately \$4,052, \$3,856 and \$3,050, respectively. In connection with the relocation of the Company's corporate headquarters in December 2003, the Company wrote off \$2,017 which consisted of abandoned leasehold improvements and fixed assets from the previous facility.

#### 5. Accrued Expenses

Accrued expenses consist of the following:

	As of December 31,	
	2003	2004
Accrued payroll and related benefits	\$ 4,682	\$ 4,791
Accrued other expenses	3,768	3,200
Accrued royalties	1,597	2,378
Accrued income taxes	926	1,289
	<u>\$ 10,973</u>	<u>\$ 11,658</u>

#### 6. Restructuring Charge

The Company recorded a \$4,503 restructuring charge for the year ended December 31, 2003 that related to the relocation of the Company's corporate headquarters in December 2003. Of this charge, \$2,486 represents the loss on a facilities lease and \$2,017 related to the abandonment of the related fixed assets and leasehold improvements. The facility lease loss represents 15 months of rent remaining under an existing lease and related operating expenses. The Company does not anticipate any sublease income over the remaining term of the lease agreement.

The components of the restructuring charges are as follows:

	<u>Lease Loss</u>
Provision for lease loss	\$ 2,486
Payments made during the year ended December 31, 2003	—
Balance as of December 31, 2003	\$ 2,486
Payments made during the year ended December 31, 2004	(1,974)
Reduction to provision for lease loss	(168)
Balance as of December 31, 2004	\$ 344

The December 31, 2003 balance included \$497 which was classified as a long term liability. The Company anticipates that the lease loss will be settled by March 2005.

## 7. Income Taxes

Income (loss) before the provision for income taxes consists of the following:

	<u>Year Ended December 31,</u>		
	<u>2002</u>	<u>2003</u>	<u>2004</u>
Domestic	\$ (7,109)	\$ (6,537)	\$ 2,861
Foreign	590	345	1,400
Total	\$ (6,519)	\$ (6,192)	\$ 4,261

The provision for income taxes in the accompanying consolidated financial statements consists of the following:

	<u>Year Ended December 31,</u>		
	<u>2002</u>	<u>2003</u>	<u>2004</u>
Current provision:			
Federal	\$ —	\$ —	\$ 1,496
State	25	35	243
Foreign	410	399	653
Total	\$ 435	\$ 434	\$ 2,392
Deferred provision:			
Federal	\$ —	\$ —	\$ —
State	—	—	—
Foreign	—	—	—
Total	\$ —	\$ —	\$ —
Total provision	\$ 435	\$ 434	\$ 2,392

The foreign tax provision includes withholding taxes. The provision for income taxes in 2004 represents income tax expense that cannot be offset through the use of acquired net operating losses

for financial statement purposes. The oldest net operating losses must be utilized first. As a result, the net operating losses in the Clinsoft acquisition are being used first.

The utilization of the acquired net operating losses will reduce the amount of income tax payable to local tax authorities. This cash benefit is reflected as a reduction to goodwill (see Note 3). In addition the effective tax rate exceeds the statutory tax rate due to the current non-deductibility of the stock-based compensation expense.

A reconciliation of the federal statutory rate to the Company's effective tax rate is as follows:

	Year Ended December 31,		
	2002	2003	2004
Federal statutory rate	(34)%	(34)%	34%
State tax	(3)	(4)	6
Foreign rate differential	4	5	(4)
Increase (decrease) in valuation allowance	40	40	(5)
Stock-based compensation	—	—	14
Other	—	—	11
<b>Effective tax rate</b>	<b>7%</b>	<b>7%</b>	<b>56%</b>

The approximate income tax effect of each type of temporary difference and carryforward as of December 31, 2003 and 2004 is as follows:

	As of December 31,	
	2003	2004
Net operating loss carryforwards	\$ 37,142	\$ 32,967
Nondeductible reserves and other	4,548	2,220
Research and development credits	4,028	4,787
Valuation allowance	(45,718)	(39,974)
	<b>\$ —</b>	<b>\$ —</b>

Due to the Company's history of operating losses, there is significant uncertainty surrounding the Company's ability to utilize its net operating loss and tax credit carryforwards. Accordingly, the Company has provided a full valuation allowance against its net deferred tax assets as of December 31, 2003 and 2004. The Company recorded as part of purchase accounting in the Clinsoft acquisition a deferred tax liability for the difference between the book and tax basis of separately identified intangible assets.

At December 31, 2004, the Company had net operating loss carryforwards of approximately \$88,384, which may be used to offset future U.S. federal taxable income, if any, and \$4,787 of federal research and development tax credit carryforwards. In addition, the Company has \$5,640 of net operating losses relating to its non-U.S. jurisdictions. Of these amounts, approximately \$26,939 and \$2,952 of net operating loss carryforwards and tax credit carryforwards, respectively, relate to amounts acquired as part of the Clinsoft acquisition. These tax carryforwards may reduce the Company's future cash payments to the taxing authorities. The cash benefits of the acquired carryforwards will be reflected as an adjustment through goodwill and not a reduction in the effective tax rate. The carryforwards expire beginning in 2008 through 2023 and are subject to review and possible adjustment

by the taxing authorities. The Internal Revenue Code contains provisions that may limit the net operating loss and tax credit carryforwards available to be used in any given year in the event of certain changes in the ownership interests of significant stockholders.

We have a reserve for taxes that may become payable in future years as previously filed tax returns are audited. The Company established the reserve based upon management's assessment of potential exposure associated with permanent tax differences and interest applied to both permanent and temporary differences. All tax reserves are analyzed periodically and adjustments made as events occur to warrant modifying the reserve.

The American Jobs Creation Act of 2004 (the Act) introduced a special one-time dividends received deduction on the repatriation of certain foreign earnings to a U.S. taxpayer (repatriation provision), provided certain criteria are met. On October 22, 2004, the Act was signed into law by the President. Even in light of the Act, our current intention is to reinvest the total amount of our unremitted earnings in the local jurisdiction or to repatriate the earnings only when tax-effective. As such, we have not provided U.S. tax expense on the unremitted earnings of our foreign subsidiaries.

## **8. Debt**

### **Lines of Credit**

Between April 2000 and September 2004, the Company entered into several equipment lines of credit with a bank. All advances under these equipment lines of credit are payable in 30 to 36 equal monthly installments of principal, plus accrued interest. The interest that accrues under these notes ranges from prime rate (4.0% and 5.25% at December 31, 2003 and 2004, respectively) to prime rate plus 1.0%. As of December 31, 2003 and 2004, there was a total of \$4,188 and \$4,407, respectively, outstanding under all of the Company's equipment lines of credit. At December 31, 2003 and 2004, there was \$2,155 and \$3,177, respectively, available under the equipment lines of credit.

In 2003, the Company renewed its \$2,500 working capital line of credit with a bank. Interest accrued at prime rate plus 0.25%. Effective March 31, 2004, the Company renewed its working capital line of credit with a bank and increased the amount under which it can borrow to \$5,000. Interest accrues at prime rate. All advances made under the working capital line shall be immediately due and payable on March 31, 2006. As of December 31, 2003 and 2004, respectively, \$2,500 and \$0 was outstanding under the working capital line of credit. At December 31, 2004, there was \$3,389 available under the working capital line of credit, which reflects amounts used to replace the restricted cash associated with the Company's leased facilities.

Borrowings under these agreements are secured by substantially all assets of the Company, excluding intellectual property. The Company has entered into a negative pledge agreement that, subject to certain exceptions, generally prohibits the Company from pledging its intellectual property to others. Under the terms of the agreements, as amended in March, 2004, the Company is required to comply with certain financial covenants, including attainment of minimum revenues, minimum earnings and financial ratios. At December 31, 2003, the Company was in violation of the financial covenant related to minimum revenue levels in the fourth quarter of 2003, and received a waiver from the bank. At December 31, 2004, the Company was in compliance with all financial covenants.

At December 31, 2004, the future principal payments under these obligations are as follows:

	<u>Amount</u>
<b>Year</b>	
2005	\$ 2,558
2006	1,364
2007	485
	<u>\$ 4,407</u>

## 9. Commitments and Contingencies

### Operating Leases

The Company conducts its operations in facilities under noncancelable operating leases expiring through February 2009. Under the terms of the leases, including the lease of the former corporate headquarters, the Company is required to make the following payments:

	<u>Amount</u>
<b>Year</b>	
2005	\$ 2,699
2006	2,622
2007	2,252
2008	2,047
2009	346
	<u>\$ 9,966</u>
<b>Total minimum lease payments</b>	<u>\$ 9,966</u>

Certain of the Company's leases have escalating rent payments. The Company records rent expense on a straight line basis over the term of the lease. Rent expense for the periods ended December 31, 2002, 2003 and 2004 was approximately \$3,221, \$3,163, \$2,719, respectively.

The Company does not have any special purpose entities or any off balance sheet financing arrangements.

### Contingencies

From time to time and in the ordinary course of business, the Company may be subject to various claims, charges and litigation.

On April 26, 2004, Datasci, LLC ("Datasci") filed suit (Civil Action No. 04-1328 (MJG)) in the United States District Court for the District of Maryland (Greenbelt Division) against Phase Forward Incorporated and Quintiles Inc., one of the Company's customers. Datasci had asserted that the Company's *InForm*, *Clintrial* and *Clintrial Integration Solution* products and its services, and the products and services of Quintiles, infringe a United States patent claimed to be owned by Datasci (Patent No. 6,496,827). Datasci sought an injunction and unspecified damages from each of the Company and Quintiles.

On May 4, 2004, the Company filed an Answer and Counterclaim to Datasci's complaint denying that it infringes the patent which Datasci claimed to own. The Answer also challenged the validity of

the patent and asserted numerous affirmative defenses. The Company's Counterclaim sought a declaratory judgment that the Company does not infringe the patent claimed to be owned by Datasci. Datasci responded by denying all the allegations in the Company's Counterclaim. On or about June 7, 2004, Datasci filed a motion to dismiss its complaint against Phase Forward and Quintiles. In its filing, Datasci disclosed that it did not exist when its complaint against Phase Forward and Quintiles was filed. That motion was granted and, thus, the entire action was dismissed on August 5, 2004.

Also on or about June 7, 2004, Dr. Mark L. Kozam, doing business under the name MLK Software and claiming to be the owner of the patent, filed suit (Civil Action No. 04-1787 (MJG)) in the same court where Datasci filed its initial complaint against Phase Forward and Quintiles. Dr. Kozam's complaint contains the same allegations and seeks the same remedies that were contained in the Datasci complaint. On June 22, 2004, the Company filed an Answer and Counterclaim to Dr. Kozam's complaint denying that it infringes the patent, challenging the validity of the patent, asserting numerous affirmative defenses, and counterclaiming for a declaratory judgment that the Company does not infringe any valid claim of the patent. Dr. Kozam responded by denying all the allegations in the Company's Counterclaim. The Court has added Datasci as a co-plaintiff with Kozam.

This action is ongoing and the Company is prepared to vigorously defend the claims and pursue its Counterclaims and any other remedies available to the Company. Due to the preliminary nature of this action, the Company is unable to assess whether its outcome will have a material adverse effect on its results of operations.

The Company accepts standard indemnification provisions in the ordinary course of business, whereby it may be required to indemnify its customers for certain costs and damages arising from third-party claims in connection with alleged or actual infringement of intellectual property. The term of these indemnification provisions generally coincides with the customer's use of the Company's products. The Company has never incurred significant costs to settle claims related to these indemnification provisions. As a result, the Company believes the estimated fair value of these provisions is minimal.

#### **10. Redeemable Convertible Preferred Stock**

In January 2002, the Company issued 307,693 shares of Series D redeemable convertible preferred stock to an investor who is also a vendor at \$6.50 per share for cash proceeds of \$1,970.

On June 1, 2004, the Company's board of directors declared a special cash dividend of \$4,700, which was paid on September 15, 2004, to the holders of record of Series B, C and D redeemable convertible preferred stock as of June 15, 2004. This distribution is included in net loss applicable to common stockholders for the year ended December 31, 2004.

Accretion of Series B, C and D redeemable convertible preferred stock for the years ended December 31, 2002, 2003 and 2004 was \$8,068, 7,672 and \$4,257, respectively.

In connection with the closing of the Company's IPO on July 20, 2004, all outstanding shares of Series A, B, C and D redeemable convertible preferred stock were converted into 22,841,157 shares of common stock.

In August 2000, the Company issued a warrant for the purchase of 34,330 shares of Series C redeemable preferred stock in connection with a line of credit agreement. The warrant was fully vested and exercisable and would expire in August 2010. In July 2004, in connection with the Company's IPO, the warrant was converted into a warrant to purchase 34,330 shares of common stock.

## 11. Stockholders' Equity

### Common Stock

On July 20, 2004, the Company completed its IPO of 5,250,000 shares of common stock at \$7.50 per share. In connection with the IPO, all of the outstanding shares of the Company's Series A, B, C and D redeemable convertible preferred stock (and a warrant to purchase preferred stock) were converted into an equal number of shares of common stock (and a warrant to purchase common stock). On August 19, 2004, the Company sold an additional 330,000 shares of common stock at \$7.50 per share as a result of the exercise of the over-allotment option by the underwriters of the IPO. A summary of the terms of the offering can be found in the Company's Registration Statement No. 333-113594 on Form S-1, as amended, as filed with the SEC.

The sale of the 5,580,000 shares of common stock in connection with the IPO resulted in net proceeds to the Company of \$36,619 after deducting underwriters' discounts and offering-related expenses.

For the year ending December 31, 2004, the Company issued 361,050 shares of common stock resulting in proceeds of \$747 from the exercise of common stock options.

On March 11, 2004, the Board of Directors approved an increase to the number of authorized shares of the capital stock to 105 million shares, consisting of 100 million shares of common stock and 5 million shares of preferred stock. Also on March 11, 2004, the Board of Directors approved the 2004 Stock Option and Incentive Plan and the 2004 Employee Stock Purchase Plan, each to become effective upon the closing of the Company's IPO, and an amendment to the 2003 Non-Employee Director Stock Option Plan, all of which were approved by the stockholders on April 20, 2004. The Company has reserved for issuance an aggregate of 1,500,000 shares of common stock under the 2004 Stock Option and Incentive Plan which will be the successor equity incentive program to the 1997 Stock Option Plan. For the 2003 Non-Employee Director Stock Option Plan, the Company has reserved for issuance an aggregate of 562,000 shares of common stock.

During November and December 2001, the Company executed full recourse notes receivable in consideration for the payment of the exercise of options. The notes are reflected as subscriptions receivable, a component of stockholders' (deficit) equity. There was \$627 and \$127 of these notes receivable outstanding at December 31, 2003 and 2004, respectively. At December 31, 2004, the notes outstanding were from one individual that is no longer an employee of the Company.

### Employee Stock Purchase Plan

The Company's 2004 Employee Stock Purchase Plan, as amended from time to time (the "2004 Purchase Plan"), became effective upon the completion of the initial public offering on July 20, 2004. The 2004 Purchase Plan allows eligible employees the opportunity to purchase shares of the Company's common stock through payroll deductions, up to 15% of a participant's annual compensation with a maximum of 5,000 shares available per participant during each purchase period. The option price per share for each purchase period shall be the lesser of (i) 85% of the average market price of the common stock on the first business day of the purchase period and (ii) 85% of the average market price of the Common stock on the last business day of the purchase period. The first purchase period began on September 2, 2004 and ended on November 30, 2004. Future purchase periods shall consist of six-month periods commencing on December 1 and June 1 and ending on the last days of November and May of each calendar year. A total of approximately 305,000 shares of common stock remain

reserved for issuance under the 2004 Purchase Plan. Approximately 15,000 shares were issued under this plan during 2004.

### **Stock Option Plans**

In 1997, the Company adopted the Phase Forward Incorporated 1997 Stock Option Plan, as amended (the "1997 Option Plan"), under which the Board of Directors may grant incentive and nonqualified stock options to purchase an aggregate of 6,599,880 shares of common stock to employees of the Company and non-employees. The exercise price of each option is determined by the Board of Directors. Incentive stock options may not be granted with an exercise price less than the fair market value of the stock on the date of grant, as defined by the Board of Directors. Options granted under the 1997 Option Plan generally vest over four or five year periods and expire ten years from the grant date. In March 2004, the Company granted options to purchase 205,000 shares of common stock that vest upon the earlier of 7 years from date of grant or the attainment of specified milestones. Upon completion of an initial public offering, 61,250 options vested automatically which accelerated \$290,000 in stock-based compensation expense. As of December 31, 2004, the Company had 42,909 shares available for future grant under this plan.

In 2004, the Board of Directors approved the 2004 Stock Option and Incentive Plan (the "2004 Option Plan") which became effective upon the closing of the Company's IPO, which was approved by the stockholders on April 20, 2004. The Company has reserved for issuance an aggregate of 1,500,000 shares of common stock under the 2004 Option Plan which will be the successor equity incentive program to the 1997 Option Plan. Under the 2004 Option Plan, the Board of Directors may grant incentive and nonqualified stock options to purchase shares of common stock to employees and non-employees of the Company. The exercise price of each option is determined by the Board of Directors. Incentive stock options may not be granted with an exercise price less than the fair market value of the stock on the date of grant, as defined by the Board of Directors. Options granted under the 2004 Option Plan generally vest over a four to seven year period and expire ten years from the grant date. As of December 31, 2004, the Company had 1,199,000 shares available for future grant under this plan.

### **2003 Non-employee Director Stock Option Plan**

In 2003, the Board of Directors and stockholders adopted the Phase Forward Incorporated 2003 Non Employee Director Stock Option Plan (the Non Employee Plan), under which the Company may grant up to 362,000 shares of common stock to certain members of the Board of Directors. The Non Employee Plan, provides solely for the automatic, one-time grant of an option to purchase 100,000 shares of common stock upon initial election to the Board of Directors. The exercise price of the options must not be less than 100% of the fair market value on the grant date. Options vest on the fifth anniversary of the date of grant, so long as the non-employee director has continuously served on the Board of Directors through such vesting date. If the director meets certain board attendance criteria, options may vest at a rate of one-twentieth per quarter. Effective April 20, 2004 the Non Employee Plan, was amended to increase the number of shares the Company may grant under the Non Employee Plan to 562,000 shares. As of December 31, 2004, the Company had 300,000 shares available for future grant under this plan.

Information with respect to activity under the 1997 Plan, the 2004 Plan and the Non Employee Plan are as follows:

	Number of Shares	Exercise Price per Share	Weighted Average Price per Share
Outstanding at December 31, 2001	3,726,511	\$ 0.10 – 5.00	\$ 2.36
Granted	1,902,401	3.00	3.00
Exercised	(164,211)	0.10 – 5.00	0.44
Canceled	(1,209,921)	0.10 – 5.00	2.82
Outstanding at December 31, 2002	4,254,780	0.10 – 5.00	2.59
Granted	823,300	3.00	3.00
Exercised	(355,348)	0.10 – 5.00	0.52
Canceled	(425,841)	0.10 – 5.00	2.91
Outstanding, December 31, 2003	4,296,891	0.10 – 5.00	2.81
Granted	684,805	3.00 – 7.55	6.01
Exercised	(361,050)	0.10 – 5.00	2.07
Canceled	(146,605)	0.20 – 5.00	2.96
Outstanding December 31, 2004	4,474,041	\$ 0.10 – 7.55	\$ 3.35
Exercisable at December 31, 2002	1,569,756	\$ 0.10 – 5.00	\$ 2.11
Exercisable at December 31, 2003	1,973,410	\$ 0.10 – 5.00	\$ 2.64
Exercisable at December 31, 2004	2,643,439	\$ 0.10 – 6.00	\$ 2.91

The following tables summarize information regarding the Company's stock options outstanding and exercisable at December 31, 2004:

Range of Exercise Prices	Options Outstanding			Options Exercisable	
	Number of Shares	Weighted Average Remaining Contractual Life (in Years)	Weighted Average Exercise Price	Number of Shares	Weighted Average Exercise Price
\$0.00 – 0.60	186,643	3.8	\$ 0.15	186,643	\$ 0.15
0.61 – 1.20	82,467	4.8	1.00	82,467	1.00
1.80 – 2.40	33,726	4.2	2.00	33,726	2.00
2.41 – 3.00	3,427,600	7.4	3.00	2,109,578	3.00
3.01 – 4.80	173,250	9.1	4.50	46,155	4.50
4.81 – 5.40	128,800	5.4	5.00	128,800	5.00
5.41 – 6.00	140,555	6.9	6.00	56,070	6.00
6.01 – 7.55	301,000	9.7	7.55	—	—
	4,474,041	7.3	3.35	2,643,439	2.91

Weighted average remaining contractual life of options outstanding was 7.7 years, 8.1 years and 7.3 years for 2002, 2003 and 2004, respectively.

In 2001, the Company issued options to purchase 50,000 shares of common stock, to a consultant. The Company recorded stock-based compensation expense of \$103 for these options for the year ended December 31, 2002.

The Company records deferred stock-based compensation in the amount by which the exercise price of an option is less than the deemed fair value of its common stock at the date of grant. Because there had been no public market for the Company's stock prior to the IPO, the Company's Board of Directors had determined the fair value of the common stock on the date of grant based upon several factors, including, but not limited to, the Company's operating and financial performance, the issuances of convertible preferred stock, the rights and preferences of all securities senior to common stock and the anticipated offering price of the common stock in connection with the Company's IPO. During 2003, all stock options were granted with an exercise price of \$3.00 per share, while the estimated per share fair value of the Company's common stock ranged from \$3.00 to \$4.00 in the first quarter of 2003, \$4.00 to \$5.00 in the second quarter of 2003, \$5.00 to \$7.50 in the third quarter of 2003 and \$7.50 to \$9.00 in the fourth quarter of 2003. During the six months ended June 30, 2004, options were granted at exercise prices ranging from \$4.50 to \$6.00 per share while the estimated fair value of the Company's common stock was \$10 per share. During the six months ended December 31, 2004 options were granted at a price of \$7.55 per share, which was the fair market value of our common stock at the date of grant. The Company recorded deferred compensation of \$3,060 and \$2,111 in the years ended December 31, 2003 and December 31, 2004, respectively. In the three month period ended March 31, 2004, the Company granted options to purchase 205,000 shares of common stock that vest upon the earlier of 7 years from date of grant or the attainment of specified milestones. As a result of the Company's IPO completed on July 20, 2004, 61,250 of these options were accelerated and became vested and exercisable, resulting in the acceleration of \$264,300 in stock-based compensation expense in the twelve months ended December 31, 2004. As of December 31, 2004, there was an aggregate of \$1.8 million of deferred stock-based compensation remaining to be amortized approximately as follows: \$929,000 in the year ending December 31, 2005; \$511,000 in the year ending December 31, 2006; \$220,000 in the year ending December 31, 2007; \$94,000 in the year ending December 31, 2007 and \$111 through December 31, 2011. The Company amortizes the deferred compensation charges over the vesting period of the underlying option awards in accordance with FIN 28.

## **12. Forward Foreign Exchange Contracts**

The Company enters into transactions in currencies other than the U.S. dollar and holds cash in foreign currencies which expose the Company to transactions gains and losses as foreign currency exchange rates fluctuate against the U.S. dollar. In October 2004, the Company began to enter into forward foreign exchange contracts to hedge the foreign currency exposure of non-U.S. dollar denominated third-party and intercompany receivables and cash balances. The contracts which relate to the British pound, Euro, and the Japanese yen, generally have terms of one month. These hedges are deemed economic hedges and have not been designated for hedge accounting. The gains or losses on the forward foreign exchange contracts along with the associated losses and gains on the revaluation and settlement of the intercompany balances, accounts receivable and cash balances are recorded in current operations.

The following table summarizes the outstanding forward foreign exchange contracts held by the Company at December 31, 2004:

As of December 31, 2004	
Local Currency Amount	Approximate U.S. Dollar Equivalent
British pound	4,900 \$ 9,403
European euro	1,700 2,293
Japanese yen	110,000 1,061
	\$ 12,757

As of December 31, 2004 the fair value of these forward foreign exchange contracts was insignificant.

Realized and unrealized gains (loses), net of hedging are accounted for in non-operating income (expense). Gains and (loses), net of hedging were \$803, \$906 and \$(63) for the years December 31, 2002, 2003 and 2004, respectively. The Company entered into forward foreign exchange contracts beginning in October 2004 and settles these contacts in cash.

### 13. Business Segments and Geographic Information

SFAS No. 131, *Disclosures about Segments of an Enterprise and Related Information*, establishes standards for reporting information regarding operating segments in annual financial statements and requires selected information of those segments to be presented in interim financial reports issued to stockholders. Operating segments are identified as components of an enterprise about which separate discrete financial information is available for evaluation by the chief operating decision-maker, or decision-making group, in making decisions on how to allocate resources and assess performance. The Company's chief decision maker, as defined under SFAS No. 131, is the chief executive officer. The Company views its operations and manages its business as one operating segment.

#### Geographic Data

Financial information by geographic area for the three years ended December 31, 2002, 2003 and 2004 were as follows:

The following table summarizes sales recorded in each of the Company's principal sales office locations:

	Year Ended December 31,		
	2002	2003	2004
Revenues:			
United States	\$ 39,552	\$ 37,859	\$ 42,172
United Kingdom	12,341	12,670	18,143
France	6,016	7,737	8,604
Asia Pacific	2,663	3,759	4,811
	\$ 60,572	\$ 62,025	\$ 73,730

The following table summarizes property and equipment, net by location within and outside the U.S.:

	As of December 31,	
	2003	2004
Property and equipment, net:		
United States	\$ 4,309	\$ 4,782
Other	990	935
	<u>\$ 5,299</u>	<u>\$ 5,717</u>

#### 14. Employee Benefit Plan

On January 1, 1998, the Company adopted the Phase Forward Incorporated 401(k) Plan (the 401(k) Plan). The 401(k) Plan allows employees to make pretax contributions up to the maximum allowable amount set by the IRS. Under the 401(k) Plan, the Company may match a portion of the employee contribution up to a defined maximum. The Company may, but is not obligated to, provide profit sharing to employees. The Company has made no contributions to date to the 401(k) Plan.

#### 15. Quarterly Financial Data (unaudited)

The following table presents a summary of quarterly results of operations for 2003 and 2004:

	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
<b>Year ended December 31, 2003:</b>				
Total revenues	\$ 14,947	\$ 14,676	\$ 16,203	\$ 16,199
Gross margin	6,949	7,158	8,270	8,882
Net loss	(1,755)	(922)	(108)	(3,841)
Net loss applicable to common stockholders	(3,673)	(2,840)	(2,026)	(5,759)
Net loss per share applicable to common stockholders—basic and diluted	\$ (1.11)	\$ (0.85)	\$ (0.60)	\$ (1.66)
<b>Year ended December 31, 2004:</b>				
Total revenues	\$ 16,962	\$ 17,693	\$ 19,009	\$ 20,066
Gross margin	9,759	10,403	11,618	12,293
Net income (loss)	383	430	322	734
Net income (loss) applicable to common stockholders	(1,535)	(6,188)	(95)	734
Net income (loss) per share applicable to common stockholders—basic and diluted	\$ (0.43)	\$ (1.70)	\$ —	\$ 0.02

Net income (loss) for the quarterly periods ending December 31, 2003 and 2004 include restructuring expense of \$4,503 and \$(168), respectively.

## EXHIBIT INDEX

Exhibit No.	Description
3.1(1)	Amended and Restated Certificate of Incorporation of the Registrant dated July 20, 2004.
3.2(1)	Amended and Restated Bylaws of the Registrant.
4.1(1)	Specimen Certificate for shares of the Registrant's Common Stock.
4.2	Description of Capital Stock (contained in the Certificate of Incorporation filed as Exhibits 3.1 and 3.2).
10.1+(1)	1997 Stock Option Plan.
10.2+(1)	Amended and Restated 2003 Non–Employee Director Stock Option Plan.
10.3+(1)	2004 Stock Option and Incentive Plan.
10.4+(1)	2004 Employee Stock Purchase Plan.
10.5(1)	Fifth Amended and Restated Investors' Rights Agreement, as amended by Amendments No. 1 and No. 2 thereto.
10.5.1(1)	Termination and Amendment Agreement between the Registrant and certain of its stockholders named therein.
10.6(1)	Loan Agreement between the Registrant and Silicon Valley Bank, as modified.
10.7#(1)	Software License Agreement between the Registrant and Eli Lilly and Company.
10.8#(1)	Consulting and Professional Services Agreement between the Registrant and Eli Lilly and Company.
10.9+(1)	Form of Executive Agreement between the Registrant and its officers.
10.10+(1)	Senior Executive's Service Agreement between Phase Forward Europe Limited and Stephen Powell.
10.11+(1)	Executive Service Agreement between Phase Forward Europe Limited and Martin Young.
10.12+	Agreement between the Registrant, Phase Forward Europe Limited and Martin Young.
10.13+(1)	Form of Indemnification Agreement between the Registrant and each of its directors.
10.14(1)	Sublease Agreement between the Registrant and BMC Software, Inc.
10.15#(2)	Software License and Services Agreement between the Registrant and GlaxoSmithKline Services Unlimited.
10.16+(3)	Letter agreement between the Company and John J. Schickling dated as of October 21, 2004.
10.17+(4)	Form of Incentive Stock Option Agreement.
10.18+(5)	Form of Non–Statutory Stock Option Agreement.
10.19+	2005 Global Sales Executive Incentive Compensation Plan.
10.20+	Summary of cash compensation practices for non–employee directors.
10.21+	2005 Management Incentive Plan.
10.22+	Form of Executive Agreement between the Registrant and its officers, as amended March 7, 2005.

- 23.1 Consent of Ernst & Young LLP, Independent Registered Public Accounting Firm.
- 31.1 Certification of CEO pursuant to Rule 13a-14(a) and 15d-14(s) under the Securities Exchange Act of 1934.
- 31.2 Certification of CFO pursuant to rules 13a-14(a) and 15d-14(s) under the Securities Exchange Act of 1934.
- 32.1 Certification of CEO pursuant to 18 U.S.C. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- 32.2 Certification of CFO pursuant to 18 U.S.C. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- 

+ Indicates a management contract or any compensatory plan, contract or arrangement.

# Confidential treatment requested for portions of this document.

(1) Incorporated by reference herein to the exhibits to the Company's Registration Statement on Form S-1 (File No. 333-113594), as amended.

(2) Incorporated by reference herein to Exhibit 10.1 of the Company's Report on Form 8-K dated as of July 23, 2004 (File No. 000-05839).

(3) Incorporated by reference herein to Exhibit 10.3 of the Company's Report on Form 10-Q dated as of November 10, 2004 (File No. 000-05839).

(4) Incorporated by reference herein to Exhibit 10.4 of the Company's Report on Form 10-Q dated as of November 10, 2004 (File No. 000-05839).

(5) Incorporated by reference herein to Exhibit 10.5 of the Company's Report on Form 10-Q dated as of November 10, 2004 (File No. 000-05839).

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[Phase—Forward (TM) Logo]

July 20, 2004

Mr. Martin Young  
Little Timbers  
Riversdale  
Bourne End  
Bucks SL8 5EA

Dear Martin:

I am pleased to confirm my offer to you for the position of Vice President, Services North America reporting to me. You will provide services to Phase Forward Incorporated, via a secondment arrangement (the "Secondment") between PFI and your current employer, Phase Forward Europe Limited ("PFEL"). The terms of the Secondment are embodied in this letter agreement, which is countersigned by PFEL. During the Secondment, the terms and conditions of your current Executive Services Agreement dated 28 July 1999 (the "ESA") with PFEL will be suspended, as more fully detailed below.

The Secondment will be for an initial period of 36 months commencing on May 17, 2004 and ending on May 16, 2007 (the "Initial Secondment Period"), subject to earlier expiration of your visa if it is not renewed. The secondment arrangements envisaged by this letter agreement may be extended beyond the Initial Secondment Period by our mutual written agreement. Notwithstanding the foregoing, you may terminate the Secondment on the first anniversary date (*i.e.*, May 17, 2005) and elect to return to the UK; provided that you give PFI written notice of your intent to terminate the Secondment no later than March 18, 2005. If you elect to terminate the Secondment in accordance with the previous sentence, PFI will reimburse you for the reasonable costs of relocating to the UK, subject to the Phase Forward Travel and Expense Policy applicable to U.S. employees. The Initial Secondment Period together with any extension will collectively be known as the Secondment Period.

The base salary for this position will be comprised of two elements as follows: \$11,875.00 and £2,500.00 monthly (without regard to any currency exchange rates). These amounts will be paid from the U.S. and UK operations, respectively, in accordance with the regularly established payroll policies for those operations. You will also be eligible to participate in the Phase Forward Corporate bonus program with the opportunity to earn up to 27.5% of your annual base salary, computed separately for each of the U.S. (\$) and UK (£) portions thereof, for delivery on certain financial and personal objectives. Phase Forward reserves the right to modify your compensation in future years.

In addition, Phase Forward will continue to contribute to your UK pension scheme at 15% of both the U.S. (\$) and UK (£) components of your base salary during the initial term of your employment visa. You will also be eligible to participate in the benefits plans available to U.S. employees for the duration of your assignment in the U.S., except for the PFI 401(k) plan, for which you are not eligible. Any benefits computed on the basis of salary will reflect only the U.S. portion of your base salary.

You will also be eligible, on a one-time basis only, to receive a management override percentage payment, in accordance with the 2004 Sales Management Compensation Plan (the "Comp Plan"), for GSK business that you are actively involved with that is booked (in accordance with the definition of "booking" in the Comp Plan) before December 31, 2004. This amount will be paid in local currency from the UK office. Any disputes concerning the compensation for which you are eligible under this one-time arrangement will be resolved by me.

880 Winter Street  
Waltham, MA 02451  
P: 781.890.7878  
F: 781.890.4848  
[www.phaseforward.com](http://www.phaseforward.com)

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You will also be entitled to receive an additional option to purchase shares of Common Stock of the company in the amount of 35,000 (thirty five thousand shares), which has been approved by the Board of Directors subject to your acceptance of the position.

Acceptance of this position will necessitate a move by you and your family to the greater Waltham, Massachusetts, U.S. area. To assist you with this move, Phase Forward will provide you with the following relocation benefits, subject to the Phase Forward Travel and Expense Policy applicable to U.S. employees:

- Up to \$15,000 to be used for temporary living expenses in the U.S.
- Payment of the reasonable costs associated with the movement of your personal goods.
- Flights for you and your family to relocate to the area.
- A flat payment of \$5,000 net, to use as needed to assist with the relocation.
- Closing costs associated with a home purchase in the U.S. (not to include points).
- Realtor "finders fee" associated with securing a rental property in the U.S.
- Reasonable tax preparation costs for your U.S. and any incremental UK tax filing requirements related to your assignment in the U.S.

The above amounts are guidelines and will be adjusted accordingly based upon your needs upon discussion with Vic Becker, Vice President of Human Resources, subject in each case to the Company's Signature and Approval Authority Policy and the Company's Travel and Expense Policy.

At the end of the Secondment you may return to the UK and recommence duties pursuant to the ESA with PFEL, as suspended, provided a suitable position exists at such time. For the avoidance of doubt, you have no absolute right to return to any particular position. Nevertheless, PFEL and PFI will make every reasonable effort to find a suitable alternative position for you.

At the end of the Secondment Period if no suitable position exists for you with either PFEL and/or PFI and your employment has to be terminated, then you will be entitled to the separation benefits provided for in the Executive Agreement ("EA") annexed hereto as Appendix 1, subject to your execution of the EA. By signing this letter agreement, you accept that the separation benefits provided for in the EA will be deemed to be in full and final settlement of all rights and remedies, whatsoever and howsoever, arising out of your employment with PFEL and PFI pursuant to the ESA, this letter agreement and the EA, and their terminations.

During the Secondment Period, the terms and conditions of the ESA will be suspended (including but not limited to the accrual of continuity of service with PFEL) in their entirety and will have no effect save as expressly provided for in this letter agreement. Accordingly, by entering into this letter agreement, you expressly waive any contractual rights and remedies arising pursuant to the ESA. Notwithstanding the foregoing, for purposes of determining your service with PFI under PFI's employee benefit plans or programs, you will be given full service credit for the term of your employment with PFEL prior to the Secondment Period. Likewise, if you return to be employed by PFEL in the UK under the ESA, for purposes of determining your service with PFEL under PFEL's employee benefit plans or programs, you will be given full service credit for the term of your employment with PFI during the Secondment Period.

During the Secondment Period, your employment is "at will" and, accordingly, either you or we may terminate your employment. Termination of your employment by either party will also operate as a

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termination of this letter agreement and the ESA. Any such termination will be subject to the terms of the EA, to the extent the provisions of the EA are triggered by the circumstances of termination. Without limiting any rights you may have under the EA, should you choose to relocate to the UK if PFI terminates your employment without Cause (as defined in the EA), or should you terminate your employment as a result of a "Resignation for Good Reason Upon a Change in Control" (as defined in the EA), PFI will reimburse you for the reasonable costs of relocating to the UK, subject to the Phase Forward Travel and Expense Policy applicable to U.S. employees.

This offer is contingent upon the successful attainment of your L1 visa authorizing you to work in the United States, and your continued eligibility therefor. Phase Forward will pay for all costs, legal and administrative, associated with obtaining this authorization. The laws of the Commonwealth of Massachusetts and the United States of America and –company policies applicable to U.S.–domiciled employees will govern all matters relating to our arising out your service during the Secondment. All parties submit to the jurisdiction of the courts of the Commonwealth of Massachusetts and the U.S. situated in Boston, Massachusetts for all purposes relating to this letter agreement.

This letter agreement, together with any Appendices, constitutes the entire Agreement between the parties and supersedes all prior agreements, understandings and arrangements between them, and representations by them, whether oral or written, which relate to the subject matter of this letter agreement unless the contrary is expressly stated herein. Any variation of the terms and conditions of this letter agreement will be in writing in a form agreed and signed by the Parties. This letter agreement will be subject to any tax totalization agreement in force from time to time between the U.S. and the UK.

We have agreed that you will begin work upon receipt of your employment authorization. I am extremely pleased to extend this offer and am looking forward to working with you. If the terms described in this letter agreement accurately reflect your understanding regarding the Secondment please indicate your agreement by signing in the space below on both copies and returning one copy of this letter agreement in the envelope provided no later than July 25, 2004. Please retain the other copy for your records.

Sincerely,

PHASE FORWARD INCORPORATED

/s/ Robert K. Weiler

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Robert Weiler

**Accepted and Agreed:**

/s/ Martin A. Young

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Martin A. Young

Date:

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**Accepted and Agreed:**

PHASE FORWARD EUROPE LIMITED

By: /s/ Robert K. Weiler

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Date: 1-11-05

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## Attachment to Assignment Letter Dated July 20, 2004

Martin, as per your assignment letter dated July 20, 2004 you are eligible for a one-time basis only, to receive a management override percentage payment, in accordance with the 2004 Sales Management Compensation Plan (the "Comp Plan"), for GSK business that you are actively involved with that is booked (in accordance with the definition of "booking" in the Comp Plan) before December 31, 2004. This amount will be paid in local currency from the UK office. The following comp plan definitions apply to this override.

### Definitions

#### (a) Commissionable Orders

These are Orders that are accepted by the company, net of pass-through items and net of royalty/license payments made to any 3<sup>rd</sup> party, in the following categories:

- *Software licenses*: software fees or usage fees relating to any Phase Forward products.
- *Services*:
  - *ASP Services*: study preparation, eCRF design, server hosting, CDD formatting, provisioning, site assessment, custom reports.
  - *Consulting Services*: project management, training, integration services, custom reports.
- *Customer Support*:
  - Maintenance and customer support agreements for software transactions.
  - Server hosting, help desk.

#### (b) Commission Accrued

For Orders that are fixed in nature, a commission is accrued upon acceptance of an Order by the company, which is evidenced by signing of the Order by the designated authority in the company. For Orders that are variable in nature, such as estimated usage fees or future service commitments, commission is accrued at the time the Order becomes fixed (as usage occurs or committed amount is determinable).

#### (c) Pass-Through Items

Products or services provided at cost. Pass-through items are not commissionable.

#### (d) Negative Booking

A Negative Booking is a change to an Order, which results in the reduction of the net amount of a commissionable Order, the reversal of previously recognized revenue, the uncollectability of an account receivable related to previously recognized revenue, or an indication of hold status or suspension for a period greater than 6 months.

#### (e) Split Orders

Sales Management Personnel will designate Global accounts as either Support Accounts or Split Accounts.

The Commission Rate on the GSK override is .4% of bookings as defined above and commissions will be earned and paid by the end of the month following the quarter in which the order was booked. Commissions paid that subsequently have events which result in a negative booking will have a reversal in payment in the month or months following the quarter they become a negative booking until full repayment is achieved. Negative bookings will be reversed at the commission rate that was applied at the time of the transaction.

In addition the company reserves the right to make adjustments to the terms in its sole discretion in specific instances based on unusual or special circumstances.

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[PHASE—FORWARD (TM) LOGO]

880 Winter Street  
 Waltham, MA 02451, U.S.A.  
 Tel. (781) 890-7878  
 Fax. (781) 890-4848

This Executive Agreement (the "Agreement"), by and among Phase Forward Incorporated, a Delaware corporation (the "Company"), and the executive name below ("Executive"), sets forth the terms and conditions by which the Company will provide certain benefits for Executive under certain circumstances in the event of a termination of Executive's employment with the Company. The effective date of this Agreement shall be the date of last execution as set forth below (the "Execution Date").

**PHASE FORWARD INCORPORATED**

**EXECUTIVE**

By: \_\_\_\_\_

By: \_\_\_\_\_

Name: \_\_\_\_\_

Name: \_\_\_\_\_

Title: \_\_\_\_\_

Address: \_\_\_\_\_

Date: \_\_\_\_\_

Date: \_\_\_\_\_

WHEREAS, Executive currently is an employee of the Company and an Officer (as hereinafter defined), and has made and is expected to continue to make significant contributions to the business, growth and financial strength of the Company;

WHEREAS, the Company recognizes that the uncertainty regarding the consequences of a termination in Executive's employment as an Officer of the Company adversely affects the Company's ability to retain Executive;

WHEREAS, the Company further recognizes that, as is the case for most publicly held companies, the possibility of a Change in Control (as hereinafter defined) exists, which may alter the nature and structure of the Company, and recognizes that the uncertainty regarding the consequences of such an event adversely affects the Company's ability to retain Executive as an Officer;

WHEREAS, the Company desires to more closely align Executive's interests with those of the shareholders of the Company with respect to any Change in Control that may benefit the shareholders;

WHEREAS, the Company desires to assure itself of both present and future continuity of management in the event of a Change in Control, and desires to induce Executive to remain employed with the Company by establishing certain benefits for Executive applicable under certain circumstances in the event of a Change in Control, and Executive desires to be so induced; and

WHEREAS, the parties desire to set forth in writing the terms and conditions of their agreement with respect to the provision of benefits for Executive applicable under certain circumstances in the event of a Change in Control;

NOW, THEREFORE, in consideration of the premises and the mutual covenants and obligations herein contained, it is agreed among the parties hereto as follows:

1. *Term.* This Agreement shall continue for a term commencing on the Execution Date and ending on the date two years thereafter ("Initial Term"), and shall be automatically renewed from year to year thereafter for successive one-year terms (each a "Renewal Term") unless ninety (90) days prior to the expiration of the initial term or any renewal term, a party gives written notice of non-renewal to the other party; provided that any such notice provided by the Company any time during the period beginning on the date that is forty-five (45) days prior to the date upon which a definitive agreement for a Change in Control is publicly announced as having been executed by the Company (the "Announcement Date") and ending on the first anniversary of the effective date of a Change in Control, shall have no effect whatsoever, and the Agreement shall continue in force until such time as otherwise terminated in accordance with the terms hereof. If an effective notice of non-renewal is given as permitted hereunder, this Agreement will expire at the conclusion of either the initial term or the renewal term, whichever is applicable, unless terminated earlier in accordance with Section 2 hereof. The "Term" of this Agreement shall include the Initial Term, as well as any Renewal Term, if applicable, subject to termination at any time prior to the expiration of the Term as provided in Section 2 hereof; provided, however, that in the event of the first Change in Control to occur during the Term (including after any notice of non-renewal is given), the Term shall automatically continue through the first anniversary of the effective date of such Change in Control.

2. *At-Will Status.* Notwithstanding any provision of this Agreement, Executive will remain employed at-will, so that Executive or the Company may terminate Executive's employment at any time, with or without notice, for any or no reason, and this Agreement shall not create or imply any right or duty of Executive or the Company to have Executive remain in the employ thereof for any period of time. This Agreement shall automatically terminate on the earliest date of (a) Executive's Termination Date (as hereinafter defined) if Executive's employment ceases for any reason other than due to an Involuntary Termination Upon a Change in Control or a Resignation for Good Reason Upon a Change in Control (as such terms are hereinafter defined); or (b) the date immediately following the one-year anniversary of the effective date of the first Change in Control to occur during the Term; provided, that, notwithstanding any provision in this Agreement to the contrary, if Executive's employment is terminated by the Company prior to a Change in Control for any reason other than for Cause, or ceases due to an Involuntary Termination Upon a Change in Control or a Resignation for Good Reason Upon a Change in Control, this Agreement shall remain in effect until all obligations of the parties hereunder have been fully satisfied.

3. *Definitions.* As used in this Agreement, the following terms shall have the meanings set forth herein:

a. "Cause" shall mean any one or more of the following: (i) Executive's willful failure or refusal (except due to Disability (as hereinafter defined) or a condition reasonably likely to be deemed a Disability with the passage of time) to perform substantially his/her duties on behalf of the Company for a period of thirty (30) days after receiving written notice identifying in reasonable detail the nature of such failure or refusal; (ii) Executive's conviction of, entry of a plea of guilty or nolo contendere to, or admission of guilt in connection with a felony; (iii) disloyalty, willful misconduct or breach of fiduciary duty by Executive which causes material harm to the Company; or (iv) Executive's willful violation of any confidentiality, developments or non-competition agreement which causes material harm to the Company. Notwithstanding the foregoing, Executive shall not be deemed to have been terminated for Cause unless and until there shall have been delivered to him a copy of a resolution duly adopted by the Company's Board of Directors (the "Board") (excluding Executive if he is a Director) at a meeting of the Board called and held for (but not necessarily exclusively for) that purpose (after reasonable notice to Executive and an opportunity for Executive, together with counsel of his choice, to be heard by the Board)

finding that Executive has, in the good faith opinion of the Board, engaged in conduct constituting Cause and specifying the particulars thereof in reasonable detail.

b. "Change in Control" shall mean the occurrence of any of the following events:

(i) The Company is merged or consolidated or reorganized into or with another corporation or other legal person, and as a result of such merger, consolidation or reorganization less than fifty percent (50%) of the combined voting power of the then-outstanding securities of such surviving, resulting or reorganized corporation or person immediately after such transaction is held in the aggregate by the holders of the then-outstanding securities entitled to vote generally in the election of directors of the Company ("Voting Stock") immediately prior to such transaction;

(ii) The Company sells or otherwise transfers all or substantially all of its assets to any other corporation or other legal person, and as a result of such sale or transfer less than fifty percent (50%) of the combined voting power of the then-outstanding securities of such corporation or person immediately after such sale or transfer is held in the aggregate by the holders of Voting Stock of the Company immediately prior to such sale or transfer;

(iii) Any corporation or other legal person, pursuant to a tender offer, exchange offer, purchase of stock (whether in a market transaction or otherwise) or other transaction or event acquires securities representing 30% or more of the Voting Stock of the Company, or there is a report filed on Schedule 13D or Schedule 14D-1 (or any successor schedule, form or report), each as promulgated pursuant to the U.S. Securities Exchange Act of 1934, as amended (the "Exchange Act"), disclosing that any "person" (as such term is used in Section 13(d)(3) or Section 14(d)(2) of the Exchange Act) has become the "beneficial owner" (as such term is used in Rule 13d-3 under the Exchange Act) of securities representing 30% or more of the Voting Stock of the Company;

(iv) The Company files a report or proxy statement with the Securities and Exchange Commission pursuant to the Exchange Act disclosing under or in response to Form 8-K or Schedule 14A (or any successor schedule, form or report or item therein) that a change in control of the Company has occurred; or

(v) If during any period of two consecutive years, individuals who at the beginning of any such period constitute the Board cease for any reason to constitute at least a majority thereof, unless the election, or the nomination for election by the Company's stockholders, of each director of the Company first elected during such period was approved by a vote of at least a majority of the directors then still in office who were directors of the Company at the beginning of any such period;

provided, however, that a "Change in Control" shall not be deemed to have occurred for purposes of this Agreement solely because (i) the Company, (ii) an entity in which the Company directly or indirectly beneficially owns 50% or more of the Voting Stock, or (iii) any Company-sponsored employee stock ownership plan or any other employee benefit plan of the Company, either files or becomes obligated to file a report or a proxy statement under or in response to Schedule 13D, Schedule 14D-1, Form 8-K or Schedule 14A (or any successor schedule, form or report) under the Exchange Act, disclosing beneficial ownership by it of shares of Voting Stock or because the Company reports that a change in control of the Company has occurred by reason of such beneficial ownership.

c. "Company" shall mean Phase Forward Incorporated, its assigns, and its Successors.

d. "Disability" shall mean any physical or mental disability that renders Executive unable to perform his/her essential job responsibilities for a cumulative period of 180 days in any twelve-month period, where such disability cannot be reasonably accommodated absent undue hardship.

e. "Executive Office" shall mean those offices of the Company domiciled in the United States that the Board in its reasonable discretion may designate from time to time as constituting an officer position pursuant to Section 16 of the Exchange Act; provided, that for purposes of this Agreement, Executive Office shall also be deemed to include, without limitation, the Chief Executive Officer, Chief Financial Officer, Vice President of Finance, Vice President of Development, Vice President of North American Sales, Vice President of Marketing, Vice President—Human Resources, Vice President—General Counsel and/or such other officers of the Company as the Board shall designate from time to time. Any person holding an Executive Office shall be an "Officer."

f. "Incentive Pay Eligibility" shall mean the aggregate amount of any cash compensation derived from any bonus, incentive, performance, profit-sharing or similar agreement, policy, plan or arrangement of the Company that Executive is eligible to receive based upon the attainment of 100% target or quota with respect to any one calendar year; provided, however that Incentive Pay Eligibility shall exclude any commission or bonus that Executive is eligible to received under the Company's 2004 Global Sales Incentive Compensation Plan or any successor plan thereto.

g. "Involuntary Termination Upon a Change in Control" shall mean the termination of the employment of Executive by the Company without Cause at any time within the period beginning on the date that is forty-five (45) days prior to the Announcement Date and ending on the first anniversary of the effective date of a Change in Control. "Involuntary Termination Upon Change in Control" shall not include any termination of Executive's employment (a) for Cause; (b) as a result of Executive's Disability; (c) as a result of Executive's death; or (d) by Executive for any reason.

h. "Resignation for Good Reason Upon a Change in Control" shall occur upon the receipt by the Company of Executive's notice specified below, if any of the following "Events" occur without Executive's prior written consent during the one-year period beginning on the effective date of a Change in Control:

(i) The substantial reduction of (1) Executive's aggregate base salary, or (2) Executive's Incentive Pay Eligibility, or (3) the benefits for which Executive was eligible, in each case, in effect immediately prior to a Change in Control, unless, however, in the case of Subclause (3) only, such reduction is due to an across-the-board reduction applicable to all senior executives of the Company and any Successor, and the benefits available to Executive after such across-the-board reductions are no less favorable than those available to similarly-situated executives of the Company and such Successor;

(ii) The permanent relocation of Executive's primary workplace to a location more than thirty (30) miles away from Executive's workplace in effect immediately prior to a Change in Control; or

(iii) Failure of any Successor to, or assignee of, the Company to assume the duties and obligations of the Company under this Agreement pursuant to Section 14 hereof; and

Within sixty (60) days after any such Event, Executive provides written notice to the Company describing with reasonable specificity the Event and stating his/her intention to resign from employment due to such Event.

j. "Severance Benefits" shall mean:

(i) payment of an amount equal to 50% (i.e., 6 months) of the Executive's base salary, at the highest annualized rate in effect during the one year period immediately prior to the Termination Date payable, at Executive's election, either (x) in a lump sum payment on the Vesting Date or on any other date designated by Executive; or (y) in equal monthly installments over the twelve (12) month period following the Vesting Date; and

(ii) In the event Executive elects after the Termination Date to continue health, vision and/or dental coverage pursuant to the Consolidated Omnibus Budget Reconciliation Act of 1985 ("COBRA"), the Company will pay, on a monthly basis, Executive's monthly premium payments for each such coverage elected by Executive for Executive and his or her eligible dependents, if applicable, until the earliest of the following dates to occur with respect to each such elected coverage: (A) the six month anniversary of the Termination Date; (B) the date upon which Executive becomes covered under a comparable group plan for such applicable coverage; or (C) the date upon which Executive ceases to be eligible for COBRA continuation for such applicable coverage.

k. "Stock Plans" shall mean the Phase Forward Incorporated Amended and Restated 1997 Stock Option Plan, the Phase Forward Incorporated 2004 Stock Option and Incentive Plan and any other stock plans or stock option plans established and maintained by the Company at any time during the Term and pursuant to which Executive holds any options, stock, awards and/or purchase rights, each as may be or may have been amended, excluding the 2004 Employee Stock Purchase Plan and any other plan adopted by the Company pursuant to Section 423 of the U.S. Internal Revenue Code of 1986, as amended (the "Code").

l. "Successor" shall mean any successor to the Company (whether direct or indirect, by Change in Control, operation of law or otherwise), including but not limited to any successor (whether direct or indirect, by Change in Control, operation of law or otherwise) to, or ultimate parent entity of any successor to, the Company.

m. "Termination Date" shall mean Executive's last date of employment with the Company.

4. *Effect of a Termination without Cause.* If Executive's employment is terminated at any time prior to a Change in Control for any reason that does not constitute Cause, Executive shall be entitled to receive the following, subject to Section 8 hereof; provided, however that if such termination constitutes an Involuntary Termination Upon a Change in Control or a Resignation for Good Reason Upon a Change in Control, Executive shall instead be entitled to the Change in Control Benefits described in Section 5.a of this Agreement.

(a) the Severance Benefits; provided, however that if such termination constitutes an Involuntary Termination Upon a Change in Control or a Resignation for Good Reason Upon a Change in Control, in lieu of the Severance Benefits, Executive shall be entitled to the Change in Control Benefits described in Section 5.a of this Agreement.

(b) Executive shall also be entitled to any unpaid compensation and benefits, and unused vacation accrued, through the Termination Date. Executive shall also be entitled to receive reimbursement for final expenses that Executive reasonably and necessarily incurred on behalf of the Company prior to the Termination Date, provided that Executive submits expense reports and supporting documentation of such expenses as required by the practice or policy in effect at that time. Executive shall not be eligible for or entitled to any severance payments or benefits pursuant to a severance plan, program, arrangement, practice or policy of the Company, if any, that may be in effect as of the Termination Date, including without limitation any other agreement that Executive may have with the Company regarding the subject matter hereof.

5. *Effect of Involuntary Termination Upon a Change in Control or Resignation for Good Reason Upon a Change in Control.* In the event of an Involuntary Termination Upon a Change in Control or a Resignation for Good Reason Upon a Change in Control during the Term, Executive shall be entitled to the following:

a. "Change in Control Benefits" as follows, subject to Section 8 hereof:

(i) Payment of an amount equal to 100% (i.e., 12 months) of the Executive's base salary, at the highest annualized rate in effect during the period between the date immediately prior to the effective date of a Change in Control and the Termination Date, payable in accordance with Section 5.a(v) below;

(ii) Payment of an amount equal to 50% of the highest amount of Executive's Incentive Pay Eligibility with respect to any one calendar year in the period beginning in the calendar year prior to that in which the Change in Control occurs and ending in the calendar year in which Executive's employment is terminated, payable in accordance with Section 5.a(v) below; and

(iii) In the event Executive elects after the Termination Date to continue health, vision and/or dental coverage pursuant to the Consolidated Omnibus Budget Reconciliation Act of 1985 ("COBRA"), the Company will pay Executive's monthly premium payments for each such coverage elected by Executive for Executive and his or her eligible dependents, if applicable, until the earliest of the following dates to occur with respect to each such elected coverage: (A) the first anniversary of the Termination Date; (B) the date upon which Executive becomes covered under a comparable group plan for such applicable coverage; or (C) the date upon which Executive ceases to be eligible for COBRA continuation for such applicable coverage.

(iv) Any and all unvested stock, stock options, awards and rights that were granted to Executive under any of the Stock Plans prior to the Termination Date shall immediately become fully vested and exercisable as of the Termination Date or, if Executive's employment was terminated within the three-month period prior to the Announcement Date, as of the Announcement Date (whichever may apply, the "Vesting Date"). Notwithstanding any contrary provision of any agreement relating to then outstanding stock, stock options, awards and rights granted to Executive under any of the Stock Plans after the Execution Date, all such stock, stock options, awards and rights granted after the Execution Date may be exercised by Executive (or Executive's heirs, estate, legatees, executors, administrators, and legal representatives) at any time during the period ending on the earlier of (A) the later of (i) three (3) months after the Vesting Date and (ii) if Executive dies within the three-month period after the Vesting Date, the first anniversary of the date of Executive's death, and (B) the scheduled expiration of such stock, stock option, award or right, as the case may be. Executive hereby acknowledges and agrees that, as a result of the operation of Section 4 and this subsection 5.a(ii), some or all of the "incentive stock options" (as defined in the Code) granted to Executive under the Stock Plans may no longer qualify as "incentive stock options" for U.S. federal income tax purposes, and Executive hereby consents to any such disqualification.

(v) Each of the payments set forth in subsections 5.a(i)–(iii) above (the "Cash Severance Benefits") shall be payable, at Executive's election, either (x) in a lump sum payment on the Vesting Date or on any other date designated by Executive; or (y) in equal monthly installments over the twelve (12) month period following the Vesting Date; provided that the payments described in Section 5.a(iii) hereof shall be paid on a monthly basis.

b. Executive shall also be entitled to any unpaid compensation and benefits, and unused vacation accrued, through the Termination Date. Executive shall also be entitled to receive

reimbursement for final expenses that Executive reasonably and necessarily incurred on behalf of the Company prior to the Termination Date, provided that Executive submits expense reports and supporting documentation of such expenses as required by the practice or policy in effect at that time. Executive shall not be eligible for or entitled to any severance payments or benefits pursuant to a severance plan, program, arrangement, practice or policy of any member of the Company, if any, that may be in effect as of the Termination Date, including without limitation any other agreement, entered into prior to the date hereof, that Executive may have with the Company regarding the subject matter hereof.

6. *Effect of a Change in Control.* If a Change in Control occurs during the Term, then 25% of all stock, options, awards and purchase rights granted to Executive under the Phase Forward Incorporated 2004 Stock Option and Incentive Plan prior to such Change in Control shall immediately become fully vested and exercisable as of the effective date of a Change in Control. The 25% specified in the previous sentence is in addition to any stock, options, awards and purchase rights granted to Executive under any plan that were already vested and exercisable as of the effective date of the Change in Control.

7. *Liquidated Damages.* The parties hereto expressly agree that provision of the Severance Benefits or Change in Control Benefits to Executive in accordance with the terms of this Agreement will be liquidated damages, and that Executive shall not be required to mitigate the amount of any payments provided for in this Agreement by seeking other employment or otherwise, nor shall any profits, income, earnings or other benefits from any source whatsoever create any mitigation, offset, reduction or any other obligation on the part of Executive hereunder or otherwise.

8. *Conditions of Severance Benefits and Change in Control Benefits.* Executive shall receive Severance Benefits and/or Change in Control Benefits only if Executive: (a) executes a separation agreement, which includes a general mutual release, in a form and of a scope reasonably acceptable to the parties hereto; (b) returns all property, equipment, confidential information and documentation of the Company; (c) has complied and continues to comply in all material respects with any noncompetition, inventions and/or nondisclosure obligations that Executive may owe to the Company, whether pursuant to an agreement or applicable law; and (d) provides a signed, written resignation of Executive's status as an officer, including, without limitation, an Executive Officer, and director (if applicable) of the Company and, if applicable, its subsidiaries. In the event that Executive has breached any obligations described in Section 8(c), then (x) the Cash Severance Benefits shall terminate and Executive shall no longer be entitled to them; (y) Executive shall promptly repay to the Company any Cash Severance Benefits previously received by Executive; and (z) all options, awards and purchase rights held by Executive shall no longer be exercisable as of the date of Executive's breach. Such termination and repayment of Cash Severance Benefits and cessation of the right to exercise shall be in addition to, and not in lieu of, any and all available legal and equitable remedies, including injunctive relief.

9. *Taxes.* All payments and benefits described in this Agreement shall be subject to any and all applicable federal, state, local and foreign withholding, payroll, income and other taxes.

10. *Certain Reduction of Payments.* If (a)(i) the Severance Benefits, (ii) the Change in Control Benefits, (iii) the benefits received under Section 6 hereof and/or (iv) any payment or benefit received or to be received by Executive pursuant to any other plan, arrangement or agreement (collectively, the "Total Payments") would constitute (in whole or in part) an "excess parachute payment" within the meaning of Section 280G(b) of the Code, and (b) Executive would retain more of the Total Payments (after the payment of applicable tax liabilities imposed on the Total Payments) in the event that the Cap (defined below) is imposed, then the amount of the Total Payments shall be reduced until the aggregate "present value" (as that term is defined in Section 280G(d)(4) of the Code using the applicable federal rate in effect on the date of this Agreement) of the Total Payments is such that no

part of the Total Payments constitutes an "excess parachute payment" within the meaning of Section 280G(b) of the Code (the "Cap").

11. *Exclusive Remedy.* Except as expressly set forth herein or otherwise required by law, Executive shall not be entitled to any compensation, benefits, or other payments as a result of or in connection with the termination or resignation of Executive's employment at any time, for any reason. The payments and benefits set forth in Section 4, 5 and 6 hereof shall constitute liquidated damages and shall be Executive's sole and exclusive remedy for any claims, causes of action or demands arising under or in connection with this Agreement or its alleged breach, the termination or resignation of Executive's employment relationship, or the cessation of holding an Executive Office.

12. *Governing Law/Forum.* The parties agree that any claims arising out of or in connection with this Agreement shall be governed by and construed in accordance with the laws of The Commonwealth of Massachusetts, and this Agreement shall in all respects be interpreted, enforced and governed under the internal and domestic laws of such State, without giving effect to the principles of conflicts of laws thereof. In addition, each of the parties, by its or his execution hereof, hereby irrevocably submits to the exclusive jurisdiction of the state or federal courts of Massachusetts with respect to any claims arising out of or in connection with this Agreement and agrees not to commence any such claims or actions other than in such courts. The prevailing party in any action arising out of or in connection with this Agreement shall be entitled to payment, by the other party, of the prevailing party's reasonable expenses and attorneys' fees incurred in connection with such action.

13. *Entire Agreement.* This Agreement shall constitute the sole and entire agreement among the parties with respect to the subject matter hereof, and supersedes and cancels all prior, concurrent and/or contemporaneous arrangements, understandings, promises, programs, policies, plans, practices, offers, agreements and/or discussions, whether written or oral, by or among the parties regarding the subject matter hereof, including, but not limited to, those constituting or concerning employment agreements, change in control benefits and/or severance benefits; provided, however, that this Agreement is not intended to, and shall not, supersede, affect, limit, modify or terminate any of the following, all of which shall remain in full force and effect in accordance with their respective terms: (i) any written agreements, programs, policies, plans, arrangements or practices of the Company that do not relate to the subject matter hereof; (ii) any written stock or stock option agreements between Executive and the Company (except as expressly modified hereby); and (iii) any written agreements between Executive and the Company concerning noncompetition, nonsolicitation, inventions and/or nondisclosure obligations.

14. *Successors and Assignment.* Executive may not assign any rights or delegate any duties or obligations under this Agreement. The Company will require its respective assigns and Successors to expressly assume this Agreement and to agree to perform hereunder in the same manner and to the same extent that the Company would be required to perform if no such succession or assignment had taken place. Regardless of whether such an agreement is executed, this Agreement shall inure to the benefit of, and be binding upon, the Company's Successors and assigns and Executive's heirs, estate, legatees, executors, administrators, and legal representatives.

15. *Notices.* All notices required hereunder shall be in writing and shall be delivered in person, by facsimile or by certified or registered mail (or similar means for non-U.S. addresses), return receipt requested, and shall be effective upon receipt if by personal delivery or facsimile or three (3) business days after mailing if sent by certified or registered mail (or similar means for non-U.S. addresses). All notices shall be addressed as specified on the first page of this Agreement or to such other address as the parties may later provide in writing.

16. *Severability/Reformation.* If any provision of this Agreement or the application of any provision hereof to any person or circumstances is held invalid, unenforceable or otherwise illegal, the remainder of this Agreement and the application of such provision to any other person or

circumstances shall not be affected, and the provision so held to be invalid, unenforceable or otherwise illegal shall be reformed to the extent (and only to the extent) necessary to make it enforceable, valid and legal. The language of all parts of this Agreement shall in all cases be construed as a whole according to its fair meaning and not strictly for or against any of the parties.

17. *Modification.* This Agreement may be modified or waived only in accordance with this Section 17. No waiver by any party of any breach by the other or any provision hereof shall be deemed to be a waiver of any later or other breach thereof or as a waiver of any other provision of this Agreement. This Agreement and its terms may not be waived, changed, discharged or terminated orally or by any course of dealing between or among the parties, but only by a written instrument signed by the party against whom any waiver, change, discharge or termination is sought. No modification or waiver by the Company is effective without written consent of the Chairman of the Board of the Company.

18. *Survival of Obligations and Rights.* Notwithstanding anything to the contrary in this Agreement, provisions herein shall survive the termination of Executive's employment by the Company prior to a Change in Control, or due to an Involuntary Termination Upon a Change in Control or a Resignation for Good Reason Upon a Change in Control or, other expiration or termination of this Agreement, if so provided herein or if necessary or desirable to fully accomplish the purposes of such provisions, including the obligations and rights contained in Sections 4 through 20 hereof.

19. *Counterparts.* This Agreement may be executed in two or more counterparts, each of which shall be deemed to be an original, but all of which together shall constitute one and the same instrument.

20. *Section Headings.* The descriptive section headings herein have been inserted for convenience only and shall not be deemed to define, limit, or otherwise affect the construction of any provision hereof.

QuickLinks

[Attachment to Assignment Letter Dated July 20, 2004](#)

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**PHASE FORWARD INCORPORATED**

**2005  
Global Sales Executive Incentive  
Compensation Plan**

**Effective Date January 1, 2005**

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**Phase Forward**  
**2005 Global Sales Executive**  
**Incentive Compensation Plan**  
**Effective: January 1, 2005**

**1) Purpose:**

The Phase Forward Incorporated 2005 Global Sales Executive Incentive Compensation Plan is established to incent and reward the Participant to achieve certain Company sales and financial goals. The base salary and incentive opportunity outlined in this plan is intended to reward the Participant with total cash compensation that is equal to or above what is paid for similar positions by similar companies upon achievement of the expected level of performance.

**2) Effective Date:**

This plan is effective on January 1, 2005 and applies to all contracts entered into between January 1, 2005 and December 31, 2005 and supercedes all plans and terms previously in effect.

**3) Participation:**

Global Sales Executives who are eligible to participate will receive a plan document with a personalized schedule as Attachment A.

**4) Definitions:**

**(a) Base Salary**

The Participant's base salary is a fixed amount that is determined by the Management Development and Compensation Committee who will take into consideration the competitive market, qualifications for the position, and past performance. The base salary is paid in accordance with the company's normal payroll practices. No other "annual reviews" or other salary adjustments will occur for participants during the course of the fiscal year.

**(b) Bookings**

These are Orders that are accepted by the company, net of pass-through items.

**(c) Accrued Bonus**

For Orders that are fixed in nature, a bonus is accrued upon acceptance of an Order by the company, which is evidenced by signing of the Order by the designated authority in the company. For Orders that are variable in nature, such as estimated usage fees or future service commitments, bonus is accrued at the time the Order becomes fixed (as usage occurs or committed amount is fixed and determinable).

**(d) Pass-Through Items**

Products or services provided at cost. Pass-through items are not compensated under the plan

**(e) Negative Booking**

A Negative Booking is a change to an Order, which results in the reduction of the net amount of an Order, the reversal of previously recognized revenue, the uncollectability of an account receivable related to previously recognized revenue, or an indication of hold status or suspension for a period greater than (six) 6 months. Bonuses paid that subsequently have events which result in a negative booking will have a reversal in payment in the month or months following the quarter they become a negative booking until full repayment is achieved. Negative bookings will be reversed at the bonus amount that was applied at the time of the transaction, and only for the original sales executive paid.

**5) Sales Quota:**

One global annual quota will be set for participants in this plan.

**6) Incentive Payments:**

The payment schedule and plan components are outlined on Attachment A.

**7) Termination:**

Upon termination of employment, voluntary or involuntary, the Participant will be paid the applicable base salary through the agreed upon termination date. Any additional payments will be in accordance with the terms and conditions of any Executive Agreement or Employment Agreement between the employee and the Company (or a subsidiary) in effect at the time of termination. The Participant must also return all company documents and property.

**8) Administration and Other Matters:**

Administration of this policy will be the responsibility of the Vice President, Finance and the Vice President, Human Resources of the company in consultation with the the CEO. In the case of a dispute, interpretation of the terms, conditions, goals, or payments from this plan will be made solely by the Vice President of Human Resources after a full review of the facts, input from affected parties, and appreciation of the overall intent of the Plan. The decision of company management on all matters under this policy will be final, and the company reserves the right to amend, modify, or terminate this policy at any time without notice. Any change will be made in writing as far in advance as possible, of the effective date of such change. In addition the company reserves the right to make adjustments to the policy in its sole discretion in specific instances based on unusual or special circumstances.

If any term or condition of this Plan is found to be in non-conformance with a given state, federal, or country law, that term or condition will be non-enforceable but will not negate other terms and conditions of the Plan. However, Phase Forward Incorporated will review and modify the overall plan to conform to such law.

Eligibility and participation in this Plan in no way infers or reflects any guarantee of a contract of employment. Except as expressly set forth in any employee's agreement signed by the company and employee, all of the employees of the company are employees "at will". Participation in this plan does not confer any right to continue in Phase Forward's employ or limit the right of Phase Forward to terminate the Participant at any time, with or without cause or notice.

Phase Forward Incorporated is an Equal Opportunity Employer committed to a diverse workforce. The company will not discriminate on the basis of race, color, religion, age, sexual orientation, national origin, physical or mental disability, or veteran status.

**9) Extraordinary Events:**

Any event deemed extraordinary by the Vice President, HR or the CEO, may result in, changes to the terms and conditions of the plan, changes in the payment structure and other events up to and including termination of this plan, and the creation of a new plan. It should not be expected by the Participant that events resulting in a revenue or bookings windfall would be counted in determining performance as it relates to the goals and quota and any payments resulting from this may be appropriately adjusted.

I acknowledge that I have read this document, including the Attachment A, and agree to the terms and conditions of the plan.

Date

\_\_\_\_\_  
Signature

\_\_\_\_\_  
Printed Name

## FY2005 Global Bookings Target—[Redacted]

## Steve Powell—International

Base Salary:	£160,000
Target Bonus:	£120,000
TAE:	£280,000

## Compensation Plan

50%	Quarterly bookings performance	£60,000	Paid quarterly
20%	YTD bookings performance	£24,000	Paid quarterly
30%	Phase Forward Profitability	£36,000	Paid annually (Earned Quarterly)

Quarterly Quota		YTD Targets		Profitability	
Q-1	[Redacted]	Q-1	[Redacted]	Q-1	[Redacted]
Q-2	[Redacted]	Q-2	[Redacted]	Q-2	[Redacted]
Q-3	[Redacted]	Q-3	[Redacted]	Q-3	[Redacted]
Q-4	[Redacted]	Q-4	[Redacted]	Q-4	[Redacted]

## Payment Schedule Bookings components\*

Achievement %	Payout %
<60%	0%
>60% – 80%	.5% for each % Achieved
>80% – 100%	Actual %
>100% – 125%	3% for each % achieved
>125%	2% for each % achieved (Maximum Payout 250%)

\*

Minimum achievement of 80% required for Profitability component paid in accordance with the Management Incentive Plan, up to a maximum of 125% achievement of Company Targets.

## FY2005 Global Bookings Target—[Redacted]

## John Hamilton—North America

Base Salary:	\$225,000
Target Bonus:	\$135,000
TAE:	\$360,000

## Compensation Plan

50%	Quarterly bookings performance	\$	67,500	Paid quarterly
20%	YTD bookings performance	\$	27,000	Paid quarterly
30%	Phase Forward Profitability	\$	40,500	Paid annually (Earned Quarterly)

Quarterly Quota		YTD Targets		Profitability	
Q-1	[Redacted]	Q-1	[Redacted]	Q-1	[Redacted]
Q-2	[Redacted]	Q-2	[Redacted]	Q-2	[Redacted]
Q-3	[Redacted]	Q-3	[Redacted]	Q-3	[Redacted]
Q-4	[Redacted]	Q-4	[Redacted]	Q-4	[Redacted]

## Payment Schedule Bookings components\*

Achievement %	Payout %
<60%	0%
>60% – 80%	.5% for each % Achieved
>80% – 100%	Actual %
>100% – 125%	3% for each % achieved
>125%	2% for each % achieved (Maximum Payout 250%)

\*

Minimum achievement of 80% required for Profitability component, paid in accordance with the Management Incentive Plan, up to a maximum of 125% achievement of Company targets.

QuickLinks

[Phase Forward 2005 Global Sales Executive Incentive Compensation Plan Effective: January 1, 2005](#)

Phase Forward Incorporated

Summary of Cash Compensation Practices for Non-Employee Directors  
(Effective January 1, 2005)

Annual retainer for Board membership*:	\$10,000
Annual retainer for each standing Board committee membership:	\$2,000
Additional annual retainer for each standing Board committee chair:	\$2,000
Board meeting attendance:	\$1,500 per Board meeting attended in person \$1,000 per Board meeting attended telephonically
Committee meeting attendance:	\$500 for each standing Board committee meeting attended in person or telephonically

All meeting fees and a quarterly installment of annual retainer fees are paid in arrears. In addition, all directors are reimbursed for reasonable out-of-pocket expenses incurred in attending meetings of the Board of Directors.

\*

To be eligible for the annual retainer for Board membership, Directors are required to attend at least 75% of the Board meetings by phone or in person, and at least 50% of the meetings in person. The Company's Chief Financial Officer may exercise discretion in determining whether certain absences are excusable in determining whether the attendance thresholds are met.

QuickLinks

[Summary of Cash Compensation Practices for Non-Employee Directors \(Effective January 1, 2005\)](#)

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**Phase Forward Incorporated**

**Management Incentive Plan**

Effective January 1, 2005

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**Phase Forward Incorporated  
Management Incentive Plan (MIP)  
Plan Document  
Effective January 1, 2005**

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**Management Incentive Plan (MIP)  
Plan Document**

***I. Purpose***

The objective of the Management Incentive Plan (MIP) is to recognize and to reward the achievement of financial and individual performance goals that are essential to the success of Phase Forward. This program, in conjunction with base salary, is designed to offer designated employees of Phase Forward Incorporated and/or its subsidiaries (the "Company") total cash compensation opportunities that are fully competitive with market levels.

***II. Effective Date of Plan***

The effective date for implementation of the Plan shall be January 1, 2005. A Plan year is equivalent to a calendar year. The Plan may be modified or terminated at any time by the Management Development and Compensation Committee or their designee in its or their sole discretion, without notice or consent of the Participants.

***III. Eligibility***

Certain employees, designated by executive management in its sole discretion, whose roles and responsibilities are deemed by executive management to be critical to operations and who are at a management level in the organization are eligible for participation in the MIP. Target Participation Percentage, Plan Components and Component Weighting are defined by the position.

***IV. MIP Target Payout***

Participants will be assigned a target payout for the MIP, expressed as a percentage of total base salary, set forth in Exhibit C. This percentage represents the potential dollar award that could be earned at 100% achievement of goals for all Plan components. The target payout percentage will vary according to the Participant's position. Actual Plan payments will vary based on performance.

***V. Measurement***

The MIP consists of one component for designated Executives (defined for purposes of the plan as an employee with a title of Vice President or higher), and two components for other Participants. The Participant will be assigned a target payout for each component, expressed as a percentage of base salary, to be used to calculate an amount (i.e. 10% of \$90,000 base salary equals \$9,000). The weightings of the components and the resultant target percentages will vary according to the Participant's position. Each Plan component may have a different weighting. Plan components are set forth in Exhibit A and the MBO process is set forth in Exhibit B.

***Transition Issues***

A Participant in the Plan must be actively employed by the company through payment dates to receive any payout on plan components. Payment dates are typically during the month of March following the end of the Plan year. Since the annual components are calculated on base salary as of December 31 of the plan year, payouts for annual components will be pro-

rated for those eligible Participants who join the plan during the year, prior to October 1. Employees who transfer out of an eligible position during the year into a non-eligible position in the company, but who are still employed as of the payment date, will be considered for an award based on the number of months in the eligible position and earnings accrued during those months.

Employees hired or promoted for the first time into bonus eligible positions after October 1 will not be eligible to participate in any component of the Plan for that plan year.

#### ***VII. Administration***

The adoption, eligibility and participation in this Plan in no way infers or reflects any guarantee of a contract of employment. Except as expressly set forth in any Participant's employee agreement signed by the company and employee, all of the employees of the company are employees "at will". Participation in this plan does not confer any right to continue in the company's employ or limit the right of the company to terminate the participant at any time, with or without cause or notice.

The financial targets assigned and recognized as goals on any of the performance factors may be revised or otherwise modified by the executive management of the company at any time to account for any material change in the business of the company. Any such revisions or modifications will be made in writing to all Participants as soon as possible after the need for such change is determined.

If any term or condition of this Plan is found to be in non-conformance with a given state, federal, or country law, that term or condition will be non-enforceable but will not negate other terms and conditions of the Plan. However, the company will review and modify the overall plan to conform to such law.

The company is an Equal Opportunity Employer committed to a diverse workforce. The company will not discriminate on the basis of race, color, religion, age, sexual orientation, national origin, physical or mental disability, or veteran status.

All matters of MIP interpretation should be directed to the VP, Human Resources, and will be resolved at his/her discretion subject to the approval of the CEO and where necessary the Management Development and Compensation Committee.

**Exhibit A**  
**Plan Components**

**The Components are:**

**1. Operating Income before Bonus and Stock Based Expenses**

The first component relates to the global performance by the Company against the Company's planned earnings for the fiscal year corresponding to the Plan year, as established by the Board at the beginning of the Plan year. The specific criteria upon which any bonuses may be earned during the Plan year is based on operating income before bonus and stock based expenses. The achievement of performance targets will be measured when or shortly after the Company publicly reports its financial results for the applicable period. All Participants are measured on this component. The targets may change as approved by the Board of Directors in its sole discretion, for items such as an acquisition or other extraordinary corporate event.

This component is earned on a quarterly basis but paid annually, by the end of the March following the end of the plan year. A minimum achievement or "threshold" of 80% of global performance in each quarter is required for payout of the component applicable to that quarterly. Payments are paid according to the following schedule and factored by the weighting assigned to this component:

Achievement %	Payout %
<80%	0%
80% – 99.9%	50% + 2.5% for each % achieved
100% – 125%	Actual % achieved

For Participants with two components (*i.e.*, non-Executives) this component is weighted such that it accounts for 80% of a Participant's targeted MIP award.

**2. Personal MBOs (Management By Objectives)**

The second component is tied to individual performance against goals established by the Participant and his/her manager. Participants other than designated Executives have an MBO component. These objectives may be adjusted throughout the year based on business needs

Performance against the assigned MBOs will be evaluated by the Participant's manager and an overall rating between 0 – 110% in 5% increments will be assigned after the plan year-end. The rating manager determines the weighting of the various MBOs.

This component is measured on an annual basis with payout determined at year-end. This component is not subject to the financial performance of the Company.

A Participant must be actively employed in the eligible position as of the payment date to receive a payout under this component. For this component the Participant's base salary on December 31 of the plan year will be used to calculate the payment.

**Exhibit B**  
**Management by Objectives (MBO) Process**  
**–Overview & Instructions –**

**Overview:**

The MIP incorporates an annual Management By Objectives component (MBO) for designated Participants. The MBO component is weighted such that it accounts for 20% of a Participant's targeted MIP award. All bonus eligible employees will be accountable for delivery against key strategic business objectives and/or major business initiatives.

**Instructions:**

- I. *Communicate the overall strategy and major initiatives of the company and specific objectives of function.* A participant's objectives must tie directly into the broader business plan where possible. Communicating this link explicitly helps to enhance the participant's understanding of the overall business and of the climate/environment in which his/her own objectives are set.
- II. *Develop no more than 3–4 strategic or major business–related objectives for the position.* Work with the Participant to develop objectives that involve significant positive change beyond the core responsibilities of the position.
- III. *Clearly identify:*
  - The goal in **measurable** terms (e.g., improvements in service, timeliness or accuracy, improved financial performance).
  - The **time–frames** and essential milestones to meet; and
  - **Specific factors/behaviors** likely to influence achievement of the objective. These may be internal or external in nature.
- IV. *Discuss how and when the participant's performance against the MBOs will be reviewed and measured.*  
Establish specific follow–up dates for progress reviews, at which time, you need to craft any changes necessary.
- V. *Discuss the year–end evaluation process.* Review the MBO rating scale and impact of each MBO as it relates to determining the percentage payout achieved based on the weighting.
- VI. *Submit final MBO's to Human Resources.* Managers should forward MBO's for each participant on their team to Human Resources by March 31 of the plan year or within 30 days of becoming a participant. Participants who have not submitted MBO's by this date will not participate in this portion of the plan for the given plan year.
- VII. *Meet with Participants when final approval is received.* Discuss any changes or confirm final MBO's.



*Exhibit C*  
*Participant Notification Sheet*  
*Certificate of Acknowledgement*

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**Operating Income before Bonus and Stock Based Expenses Target: [Redacted]**

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**Certificate of Acknowledgement**

I, \_\_\_\_\_, hereby certify that I have read the Phase Forward Incorporated Management Incentive Plan. I understand and agree to the terms of the plan.

\_\_\_\_\_  
Signature

\_\_\_\_\_  
Date

## QuickLinks

[Phase Forward Incorporated Management Incentive Plan \(MIP\) Plan Document Effective January 1, 2005](#)

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[Management Incentive Plan \(MIP\) Plan Document](#)

[Management By Objective \(MBO\) Plan Participant's Name](#)

**PHASE FORWARD**

880 Winter Street  
Waltham, MA 02451, U.S.A.  
Tel. (781) 890-7878  
Fax. (781) 890-4848

This Executive Agreement (the "*Agreement*"), by and among Phase Forward Incorporated, a Delaware corporation (the "*Company*"), and the executive name below ("*Executive*"), sets forth the terms and conditions by which the Company will provide certain benefits for Executive under certain circumstances in the event of a termination of Executive's employment with the Company. The effective date of this Agreement shall be the date of last execution as set forth below (the "*Execution Date*").

PHASE FORWARD INCORPORATED

EXECUTIVE

By:

By:

Name:

Name:

Title:

Address:

Date:

Date:

**WHEREAS**, Executive currently is an employee of the Company and an Officer (as hereinafter defined), and has made and is expected to continue to make significant contributions to the business, growth and financial strength of the Company;

**WHEREAS**, the Company recognizes that the uncertainty regarding the consequences of a termination in Executive's employment as an Officer of the Company adversely affects the Company's ability to retain Executive;

**WHEREAS**, the Company further recognizes that, as is the case for most publicly held companies, the possibility of a Change in Control (as hereinafter defined) exists, which may alter the nature and structure of the Company, and recognizes that the uncertainty regarding the consequences of such an event adversely affects the Company's ability to retain Executive as an Officer;

**WHEREAS**, the Company desires to more closely align Executive's interests with those of the shareholders of the Company with respect to any Change in Control that may benefit the shareholders;

**WHEREAS**, the Company desires to assure itself of both present and future continuity of management in the event of a Change in Control, and desires to induce Executive to remain employed with the Company by establishing certain benefits for Executive applicable under certain circumstances in the event of a Change in Control, and Executive desires to be so induced; and

**WHEREAS**, the parties desire to set forth in writing the terms and conditions of their agreement with respect to the provision of benefits for Executive applicable under certain circumstances in the event of a Change in Control;

**NOW, THEREFORE**, in consideration of the premises and the mutual covenants and obligations herein contained, it is agreed among the parties hereto as follows:

1. *Term.* This Agreement shall continue for a term commencing on the Execution Date and ending on the date two years thereafter ("*Initial Term*"), and shall be automatically renewed from year to year thereafter for successive one-year terms (each a "*Renewal Term*") unless ninety (90) days prior to

the expiration of the initial term or any renewal term, a party gives written notice of non-renewal to the other party; provided that any such notice provided by the Company any time during the period beginning on the date that is forty-five (45) days prior to the date upon which a definitive agreement for a Change in Control is publicly announced as having been executed by the Company (the "*Announcement Date*") and ending on the first anniversary of the effective date of a Change in Control, shall have no effect whatsoever, and the Agreement shall continue in force until such time as otherwise terminated in accordance with the terms hereof. If an effective notice of non-renewal is given as permitted hereunder, this Agreement will expire at the conclusion of either the initial term or the renewal term, whichever is applicable, unless terminated earlier in accordance with Section 2 hereof. The "Term" of this Agreement shall include the Initial Term, as well as any Renewal Term, if applicable, subject to termination at any time prior to the expiration of the Term as provided in Section 2 hereof; *provided, however*, that in the event of the first Change in Control to occur during the Term (including after any notice of non-renewal is given), the Term shall automatically continue through the first anniversary of the effective date of such Change in Control.

2. *At-Will Status.* Notwithstanding any provision of this Agreement, Executive will remain employed at-will, so that Executive or the Company may terminate Executive's employment at any time, with or without notice, for any or no reason, and this Agreement shall not create or imply any right or duty of Executive or the Company to have Executive remain in the employ thereof for any period of time. This Agreement shall automatically terminate on the earliest date of (a) Executive's Termination Date (as hereinafter defined) if Executive's employment ceases for any reason other than due to an Involuntary Termination Upon a Change in Control or a Resignation for Good Reason Upon a Change in Control (as such terms are hereinafter defined); or (b) the date immediately following the one-year anniversary of the effective date of the first Change in Control to occur during the Term; provided, that, notwithstanding any provision in this Agreement to the contrary, if Executive's employment is terminated by the Company prior to a Change in Control for any reason other than for Cause, or ceases due to an Involuntary Termination Upon a Change in Control or a Resignation for Good Reason Upon a Change in Control, this Agreement shall remain in effect until all obligations of the parties hereunder have been fully satisfied.

3. *Definitions.* As used in this Agreement, the following terms shall have the meanings set forth herein:

a. "*Cause*" shall mean any one or more of the following: (i) Executive's willful failure or refusal (except due to Disability (as hereinafter defined) or a condition reasonably likely to be deemed a Disability with the passage of time) to perform substantially his/her duties on behalf of the Company for a period of thirty (30) days after receiving written notice identifying in reasonable detail the nature of such failure or refusal; (ii) Executive's conviction of, entry of a plea of guilty or *nolo contendere* to, or admission of guilt in connection with a felony; (iii) disloyalty, willful misconduct or breach of fiduciary duty by Executive which causes material harm to the Company; or (iv) Executive's willful violation of any confidentiality, developments or non-competition agreement which causes material harm to the Company. Notwithstanding the foregoing, Executive shall not be deemed to have been terminated for Cause unless and until there shall have been delivered to him a copy of a resolution duly adopted by the Company's Board of Directors (the "*Board*") (excluding Executive if he is a Director) at a meeting of the Board called and held for (but not necessarily exclusively for) that purpose (after reasonable notice to Executive and an opportunity for Executive, together with counsel of his choice, to be heard by the Board) finding that Executive has, in the good faith opinion of the Board, engaged in conduct constituting Cause and specifying the particulars thereof in reasonable detail.

b. "*Change in Control*" shall mean the occurrence of any of the following events:

(i) The Company is merged or consolidated or reorganized into or with another corporation or other legal person, and as a result of such merger, consolidation or reorganization

less than fifty percent (50%) of the combined voting power of the then-outstanding securities of such surviving, resulting or reorganized corporation or person immediately after such transaction is held in the aggregate by the holders of the then-outstanding securities entitled to vote generally in the election of directors of the Company ("*Voting Stock*") immediately prior to such transaction;

(ii) The Company sells or otherwise transfers all or substantially all of its assets to any other corporation or other legal person, and as a result of such sale or transfer less than fifty percent (50%) of the combined voting power of the then-outstanding securities of such corporation or person immediately after such sale or transfer is held in the aggregate by the holders of Voting Stock of the Company immediately prior to such sale or transfer;

(iii) Any corporation or other legal person, pursuant to a tender offer, exchange offer, purchase of stock (whether in a market transaction or otherwise) or other transaction or event acquires securities representing 30% or more of the Voting Stock of the Company, or there is a report filed on Schedule 13D or Schedule 14D-1 (or any successor schedule, form or report), each as promulgated pursuant to the U.S. Securities Exchange Act of 1934, as amended (the "*Exchange Act*"), disclosing that any "person" (as such term is used in Section 13(d)(3) or Section 14(d)(2) of the Exchange Act) has become the "beneficial owner" (as such term is used in Rule 13d-3 under the Exchange Act) of securities representing 30% or more of the Voting Stock of the Company;

(iv) The Company files a report or proxy statement with the Securities and Exchange Commission pursuant to the Exchange Act disclosing under or in response to Form 8-K or Schedule 14A (or any successor schedule, form or report or item therein) that a change in control of the Company has occurred; or

(v) If during any period of two consecutive years, individuals who at the beginning of any such period constitute the Board cease for any reason to constitute at least a majority thereof, unless the election, or the nomination for election by the Company's stockholders, of each director of the Company first elected during such period was approved by a vote of at least a majority of the directors then still in office who were directors of the Company at the beginning of any such period;

*provided, however*, that a "Change in Control" shall not be deemed to have occurred for purposes of this Agreement solely because (i) the Company, (ii) an entity in which the Company directly or indirectly beneficially owns 50% or more of the Voting Stock, or (iii) any Company-sponsored employee stock ownership plan or any other employee benefit plan of the Company, either files or becomes obligated to file a report or a proxy statement under or in response to Schedule 13D, Schedule 14D-1, Form 8-K or Schedule 14A (or any successor schedule, form or report) under the Exchange Act, disclosing beneficial ownership by it of shares of Voting Stock or because the Company reports that a change in control of the Company has occurred by reason of such beneficial ownership.

c. "*Company*" shall mean Phase Forward Incorporated, its assigns, and its Successors.

d. "*Disability*" shall mean any physical or mental disability that renders Executive unable to perform his/her essential job responsibilities for a cumulative period of 180 days in any twelve-month period, where such disability cannot be reasonably accommodated absent undue hardship.

e. "*Executive Office*" shall mean those offices of the Company domiciled in the United States that the Board in its reasonable discretion may designate from time to time as constituting an officer position pursuant to Section 16 of the Exchange Act and/or such other officers of the Company as the Board shall designate from time to time. Any person holding an Executive Office shall be an "*Officer*."

f. *"Incentive Pay Eligibility"* shall mean the aggregate amount of any cash compensation derived from any bonus, incentive, performance, profit-sharing or similar agreement, policy, plan or arrangement of the Company that Executive is eligible to receive based upon the attainment of 100% target or quota with respect to any one year; provided, however that Incentive Pay Eligibility shall exclude any commission or bonus calculated on the basis of sales or bookings that Executive is eligible to received under the Company's 2004 Global Sales Incentive Compensation Plan or any successor plan thereto ("Sales Plan"), but will include any bonus calculated on the basis of (i) corporate objectives applicable to all executives of the Company (if specified in the Sales Plan) and (ii) any quarterly bonus calculated on the basis of quarterly quota achievement specified in the Sales Plan, assuming achievement of the greater of (x) 100% of the quarterly quota or (y) the actual percentage of the quarterly quota achieved prior to the Termination Date.

g. *"Involuntary Termination Upon a Change in Control"* shall mean the termination of the employment of Executive by the Company without Cause at any time within the period beginning on the date that is forty-five (45) days prior to the Announcement Date and ending on the first anniversary of the effective date of a Change in Control. "Involuntary Termination Upon Change in Control" shall not include any termination of Executive's employment (a) for Cause; (b) as a result of Executive's Disability; (c) as a result of Executive's death; or (d) by Executive for any reason.

h. *"Resignation for Good Reason Upon a Change in Control"* shall occur upon the receipt by the Company of Executive's notice specified below, if any of the following "Events" occur without Executive's prior written consent during the one-year period beginning on the effective date of a Change in Control:

(i) The substantial reduction of (1) Executive's aggregate base salary, (2) Executive's Incentive Pay Eligibility, or (3) the benefits for which Executive was eligible, in each case, in effect immediately prior to a Change in Control; unless, however, in the case of subclause (3) only, such reduction is due to an across-the-board reduction applicable to all senior executives of the Company and any Successor, and the benefits available to Executive after such across-the-board reduction are no less favorable than those available to similarly-situated executives of the Company and such Successor;

(ii) The permanent relocation of Executive's primary workplace to a location more than thirty (30) miles away from Executive's workplace in effect immediately prior to a Change in Control; or

(iii) Failure of any Successor to, or assignee of, the Company to assume the duties and obligations of the Company under this Agreement pursuant to Section 14 hereof; and

Within sixty (60) days after any such Event, Executive provides written notice to the Company describing with reasonable specificity the Event and stating his/her intention to resign from employment due to such Event.

j. *"Severance Benefits"* shall mean:

(i) payment of an amount equal to 50% (*i.e.*, six (6) months) of the Executive's base salary, at the highest annualized rate in effect during the one year period immediately prior to the Termination Date payable, at Executive's election, either (x) in a lump sum payment on the Termination Date (subject to the expiration of any applicable revocation period required by law) or on any other later date designated by Executive; or (y) in equal monthly installments over the six (6) month period following the Termination Date; and

(ii) In the event Executive elects after the Termination Date to continue health, vision and/or dental coverage pursuant to the Consolidated Omnibus Budget Reconciliation Act of 1985 ("COBRA"), the Company will pay, on a monthly basis, Executive's monthly premium payments for each such coverage elected by Executive for Executive and his or her eligible dependents, if applicable, until the earliest of the following dates to occur with respect to each such elected coverage: (A) the six month anniversary of the Termination Date; (B) the date upon which Executive becomes covered under a comparable group plan for such applicable coverage; or (C) the date upon which Executive ceases to be eligible for COBRA continuation for such applicable coverage; and

(iii) At the sole discretion of the Company's Chief Executive Officer, (A) payment up to an amount determined by reference to what an Executive's Incentive Pay Eligibility for the periods preceding the Termination Date could have been but for the Executive's termination, and (B) payment up to an amount determined by reference to the commission or bonus (calculated on the basis of sales or bookings prior to the Termination Date) that the Executive could have received under the Sales Plan but for the Executive's termination.

k. "*Stock Plans*" shall mean the Phase Forward Incorporated Amended and Restated 1997 Stock Option Plan, the Phase Forward Incorporated 2004 Stock Option and Incentive Plan and any other stock plans or stock option plans established and maintained by the Company at any time during the Term and pursuant to which Executive holds any options, stock, awards and/or purchase rights, each as may be or may have been amended, excluding the 2004 Employee Stock Purchase Plan and any other plan adopted by the Company pursuant to Section 423 of the U.S. Internal Revenue Code of 1986, as amended (the "*Code*").

l. "*Successor*" shall mean any successor to the Company (whether direct or indirect, by Change in Control, operation of law or otherwise), including but not limited to any successor (whether direct or indirect, by Change in Control, operation of law or otherwise) to, or ultimate parent entity of any successor to, the Company.

m. "*Termination Date*" shall mean Executive's last date of employment with the Company.

n. "*Vesting Date*" shall have the meaning specified in Section 5.a.(iv) hereof.

4. *Effect of a Termination without Cause.* If Executive's employment is terminated at any time prior to a Change in Control for any reason that does not constitute Cause, Executive shall be entitled to receive the following, subject to Section 8 hereof; provided, however that if such termination constitutes an Involuntary Termination Upon a Change in Control or a Resignation for Good Reason Upon a Change in Control, Executive shall instead be entitled to the Change in Control Benefits described in Section 5.a of this Agreement.

a. The Severance Benefits

b. Executive shall also be entitled to any unpaid compensation and benefits, and unused vacation accrued, through the Termination Date. Executive shall also be entitled to receive reimbursement for expenses that Executive reasonably and necessarily incurred on behalf of the Company prior to the Termination Date, provided that Executive submits expense reports and supporting documentation of such expenses as required by the practice or policy in effect at that time. Executive shall not be eligible for or entitled to any severance payments or benefits pursuant to a severance plan, program, arrangement, practice or policy of the Company, if any, that may be in effect as of the Termination Date, including without limitation any other agreement, entered into prior to the date hereof, that Executive may have with the Company regarding the subject matter hereof.

5. *Effect of Involuntary Termination Upon a Change in Control or Resignation for Good Reason Upon a Change in Control.* In the event of an Involuntary Termination Upon a Change in Control or a Resignation for Good Reason Upon a Change in Control during the Term, Executive shall be entitled to the following:

a. "*Change in Control Benefits*" as follows, subject to Section 8 hereof:

(i) Payment of an amount equal to 100% (*i.e.*, 12 months) of the Executive's base salary, at the highest annualized rate in effect during the period between the date immediately prior to the effective date of a Change in Control and the Termination Date, payable in accordance with Section 5.a(v) below;

(ii) Payment of an amount equal to 50% of the highest amount of Executive's Incentive Pay Eligibility with respect to the period beginning in the year prior to that in which the Change in Control occurs and ending in the year in which Executive's employment is terminated, payable in accordance with Section 5.a(v) below; and

(iii) In the event Executive elects after the Termination Date to continue health, vision and/or dental coverage pursuant to the Consolidated Omnibus Budget Reconciliation Act of 1985 ("COBRA"), the Company will pay Executive's monthly premium payments for each such coverage elected by Executive for Executive and his or her eligible dependents, if applicable, until the earliest of the following dates to occur with respect to each such elected coverage: (A) the first anniversary of the Termination Date; (B) the date upon which Executive becomes covered under a comparable group plan for such applicable coverage; or (C) the date upon which Executive ceases to be eligible for COBRA continuation for such applicable coverage.

(iv) Any and all unvested stock, stock options, awards and rights that were granted to Executive under any of the Stock Plans prior to the Termination Date shall immediately become fully vested and exercisable as of the Termination Date or, if Executive's employment was terminated within the three-month period prior to the Announcement Date, as of the Announcement Date (whichever may apply, the "*Vesting Date*"). Notwithstanding any contrary provision of any agreement relating to then outstanding stock, stock options, awards and rights granted to Executive under any of the Stock Plans after the Execution Date, all such stock, stock options, awards and rights granted after the Execution Date may be exercised by Executive (or Executive's heirs, estate, legatees, executors, administrators, and legal representatives) at any time during the period ending on the earlier of (A) the later of (i) three (3) months after the Vesting Date and (ii) if Executive dies within the three-month period after the Vesting Date, the first anniversary of the date of Executive's death, and (B) the scheduled expiration of such stock, stock option, award or right, as the case may be. Executive hereby acknowledges and agrees that, as a result of the operation of Section 4 and this subsection 5.a(ii), some or all of the "incentive stock options" (as defined in the Code) granted to Executive under the Stock Plans may no longer qualify as "incentive stock options" for U.S. federal income tax purposes, and Executive hereby consents to any such disqualification.

(v) Each of the payments set forth in subsections 5.a(i)–(iii) above (the "*Cash Severance Benefits*") shall be payable, at Executive's election, either (x) in a lump sum payment on the Vesting Date (subject to the expiration of any applicable revocation period required by law) or on any other later date designated by Executive; or (y) in equal monthly installments over the twelve (12) month period following the Vesting Date; provided that the payments described in Section 5.a(iii) hereof shall be paid on a monthly basis.

b. Executive shall also be entitled to any unpaid compensation and benefits, and unused vacation accrued, through the Termination Date. Executive shall also be entitled to receive

reimbursement for final expenses that Executive reasonably and necessarily incurred on behalf of the Company prior to the Termination Date, provided that Executive submits expense reports and supporting documentation of such expenses as required by the practice or policy in effect at that time. Executive shall not be eligible for or entitled to any severance payments or benefits pursuant to a severance plan, program, arrangement, practice or policy of the Company, if any, that may be in effect as of the Termination Date, including without limitation any other agreement, entered into prior to the date hereof, that Executive may have with the Company regarding the subject matter hereof.

6. *Effect of a Change in Control.* If a Change in Control occurs during the Term, then 25% of all stock, options, awards and purchase rights granted to Executive under the Phase Forward Incorporated 2004 Stock Option and Incentive Plan prior to such Change in Control shall immediately become fully vested and exercisable as of the effective date of a Change in Control. The 25% specified in the previous sentence is in addition to any stock, options, awards and purchase rights granted to Executive under any plan that were already vested and exercisable (or were otherwise scheduled to become vested and exercisable) as of the effective date of the Change in Control.

7. *Liquidated Damages.* The parties hereto expressly agree that provision of the Severance Benefits or Change in Control Benefits to Executive in accordance with the terms of this Agreement will be liquidated damages, and that Executive shall not be required to mitigate the amount of any payments provided for in this Agreement by seeking other employment or otherwise, nor shall any profits, income, earnings or other benefits from any source whatsoever create any mitigation, offset, reduction or any other obligation on the part of Executive hereunder or otherwise.

8. *Conditions of Severance Benefits and Change in Control Benefits.* Executive shall receive Severance Benefits and/or Change in Control Benefits only if Executive: (a) executes a separation agreement, which includes a general mutual release, in a form and of a scope reasonably acceptable to the parties hereto; (b) returns all property, equipment, confidential information and documentation of the Company; (c) has complied and continues to comply in all material respects with any noncompetition, inventions and/or nondisclosure obligations that Executive may owe to the Company, whether pursuant to an agreement or applicable law; and (d) provides a signed, written resignation of Executive's status as an officer, including, without limitation, an Executive Officer, and director (if applicable) of the Company and, if applicable, its subsidiaries. In the event that Executive has breached any obligations described in Section 8(c), then (x) the Cash Severance Benefits shall terminate and Executive shall no longer be entitled to them; (y) Executive shall promptly repay to the Company any Cash Severance Benefits previously received by Executive; and (z) all options, awards and purchase rights held by Executive shall no longer be exercisable as of the date of Executive's breach. Such termination and repayment of Cash Severance Benefits and cessation of the right to exercise shall be in addition to, and not in lieu of, any and all available legal and equitable remedies, including injunctive relief. Notwithstanding anything in this Agreement to the contrary, any payment dates will be delayed until after the separation agreement referred to in clause (a) above is executed by Executive, and any applicable revocation periods required by law have expired.

9. *Taxes.* All payments and benefits described in this Agreement shall be subject to any and all applicable federal, state, local and foreign withholding, payroll, income and other taxes.

10. *Certain Reduction of Payments.* If (a)(i) the Severance Benefits, (ii) the Change in Control Benefits, (iii) the benefits received under Section 6 hereof and/or (iv) any payment or benefit received or to be received by Executive pursuant to any other plan, arrangement or agreement (collectively, the "*Total Payments*") would constitute (in whole or in part) an "excess parachute payment" within the meaning of Section 280G(b) of the Code, and (b) Executive would retain more of the Total Payments (after the payment of applicable tax liabilities imposed on the Total Payments) in the event that the Cap (defined below) is imposed, then the amount of the Total Payments shall be reduced until the

aggregate "present value" (as that term is defined in Section 280G(d)(4) of the Code using the applicable federal rate in effect on the date of this Agreement) of the Total Payments is such that no part of the Total Payments constitutes an "excess parachute payment" within the meaning of Section 280G(b) of the Code (the "Cap").

11. *Exclusive Remedy.* Except as expressly set forth herein or otherwise required by law, Executive shall not be entitled to any compensation, benefits, or other payments as a result of or in connection with the termination or resignation of Executive's employment at any time, for any reason. The payments and benefits set forth in Section 4, 5 and 6 hereof shall constitute liquidated damages and shall be Executive's sole and exclusive remedy for any claims, causes of action or demands arising under or in connection with this Agreement or its alleged breach, the termination or resignation of Executive's employment relationship, or the cessation of holding an Executive Office.

12. *Governing Law/Forum.* The parties agree that any claims arising out of or in connection with this Agreement shall be governed by and construed in accordance with the laws of The Commonwealth of Massachusetts, and this Agreement shall in all respects be interpreted, enforced and governed under the internal and domestic laws of such State, without giving effect to the principles of conflicts of laws thereof. In addition, each of the parties, by its or his execution hereof, hereby irrevocably submits to the exclusive jurisdiction of the state or federal courts of Massachusetts with respect to any claims arising out of or in connection with this Agreement and agrees not to commence any such claims or actions other than in such courts. The prevailing party in any action arising out of or in connection with this Agreement shall be entitled to payment, by the other party, of the prevailing party's reasonable expenses and attorneys' fees incurred in connection with such action.

13. *Entire Agreement.* This Agreement shall constitute the sole and entire agreement among the parties with respect to the subject matter hereof, and supersedes and cancels all prior, concurrent and/or contemporaneous arrangements, understandings, promises, programs, policies, plans, practices, offers, agreements and/or discussions, whether written or oral, by or among the parties regarding the subject matter hereof, including, but not limited to, those constituting or concerning employment agreements, change in control benefits and/or severance benefits; *provided, however*, that this Agreement is not intended to, and shall not, supersede, affect, limit, modify or terminate any of the following, all of which shall remain in full force and effect in accordance with their respective terms: (i) any written agreements, programs, policies, plans, arrangements or practices of the Company that do not relate to the subject matter hereof; (ii) any written stock or stock option agreements between Executive and the Company (except as expressly modified hereby); and (iii) any written agreements between Executive and the Company concerning noncompetition, nonsolicitation, inventions and/or nondisclosure obligations.

14. *Successors and Assignment.* Executive may not assign any rights or delegate any duties or obligations under this Agreement. The Company will require its respective assigns and Successors to expressly assume this Agreement and to agree to perform hereunder in the same manner and to the same extent that the Company would be required to perform if no such succession or assignment had taken place. Regardless of whether such an agreement is executed, this Agreement shall inure to the benefit of, and be binding upon, the Company's Successors and assigns and Executive's heirs, estate, legatees, executors, administrators, and legal representatives.

15. *Notices.* All notices required hereunder shall be in writing and shall be delivered in person, by facsimile or by certified or registered mail (or similar means for non-U.S. addresses), return receipt requested, and shall be effective upon receipt if by personal delivery or facsimile or three (3) business days after mailing if sent by certified or registered mail (or similar means for non-U.S. addresses). All notices shall be addressed as specified on the first page of this Agreement or to such other address as the parties may later provide in writing.

16. *Severability/Reformation.* If any provision of this Agreement or the application of any provision hereof to any person or circumstances is held invalid, unenforceable or otherwise illegal, the remainder of this Agreement and the application of such provision to any other person or circumstances shall not be affected, and the provision so held to be invalid, unenforceable or otherwise illegal shall be reformed to the extent (and only to the extent) necessary to make it enforceable, valid and legal. The language of all parts of this Agreement shall in all cases be construed as a whole according to its fair meaning and not strictly for or against any of the parties.

17. *Modification.* This Agreement may be modified or waived only in accordance with this Section 17. No waiver by any party of any breach by the other or any provision hereof shall be deemed to be a waiver of any later or other breach thereof or as a waiver of any other provision of this Agreement. This Agreement and its terms may not be waived, changed, discharged or terminated orally or by any course of dealing between or among the parties, but only by a written instrument signed by the party against whom any waiver, change, discharge or termination is sought. No modification or waiver by the Company is effective without written consent of the Chairman of the Board of the Company.

18. *Survival of Obligations and Rights.* Notwithstanding anything to the contrary in this Agreement, provisions herein shall survive the termination of Executive's employment by the Company prior to a Change in Control, or due to an Involuntary Termination Upon a Change in Control or a Resignation for Good Reason Upon a Change in Control or, other expiration or termination of this Agreement, if so provided herein or if necessary or desirable to fully accomplish the purposes of such provisions, including the obligations and rights contained in Sections 4 through 20 hereof.

19. *Counterparts.* This Agreement may be executed in two or more counterparts, each of which shall be deemed to be an original, but all of which together shall constitute one and the same instrument.

20. *Section Headings.* The descriptive section headings herein have been inserted for convenience only and shall not be deemed to define, limit, or otherwise affect the construction of any provision hereof.



**CONSENT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

We consent to the reference to our firm under the caption "Selected Consolidated Financial Data" and to the incorporation by reference in the Registration Statements (Form S-8, No. 333-117464) pertaining to the Amended and Restated 2004 Employee Stock Purchase Plan, and (Form S-8, No. 333-117464) pertaining to the 1997 Stock Option Plan, the 2003 Non-Employee Director Stock Option Plan, and the 2004 Stock Option and Incentive Plan, of our report dated February 4, 2005, with respect to the consolidated financial statements of Phase Forward Incorporated and Subsidiaries included in the Annual Report (Form 10-K) for the year ended December 31, 2004.

Boston, Massachusetts  
March 7, 2005

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[Exhibit 23.1](#)

[CONSENT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM](#)

**CERTIFICATION PURSUANT TO RULE 13a-14(a) OF THE EXCHANGE ACT,  
AS ADOPTED PURSUANT TO SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002**

I, Robert K. Weiler, certify that:

1. I have reviewed this Annual Report on Form 10-K of Phase Forward Incorporated (the "registrant");
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the registrant and have:
  - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - (b) [Paragraph omitted in accordance with SEC transition instructions contained in SEC Release 34-47986.]
  - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
  - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: March 9, 2005

By: /s/ ROBERT K. WEILER

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Robert K. Weiler  
Chief Executive Officer

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[Exhibit 31.1](#)

**CERTIFICATION PURSUANT TO RULE 13a-14(a) OF THE EXCHANGE ACT,  
AS ADOPTED PURSUANT TO SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002**

I, Rodger Weismann, certify that:

1. I have reviewed this Annual Report on Form 10-K of Phase Forward Incorporated (the "registrant");
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the registrant and have:
  - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - (b) [Paragraph omitted in accordance with SEC transition instructions contained in SEC Release 34-47986.]
  - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
  - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: March 9, 2005

By: /s/ RODGER WEISMANN

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Rodger Weismann  
Chief Financial Officer

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[Exhibit 31.2](#)

**CERTIFICATION PURSUANT TO 18 U.S.C. 1350, AS ADOPTED PURSUANT TO  
SECTION 906 OF THE SARBANES–OXLEY ACT OF 2002**

The undersigned, Robert K. Weiler, Chief Executive Officer of Phase Forward Incorporated (the "Company"), in connection with the Company's Annual Report on Form 10–K for the period ended December 31, 2004 (the "Report"), as filed with the Securities and Exchange Commission on the date hereof, hereby certifies pursuant to the requirements of 18 U.S.C. 1350, as adopted pursuant to Section 906 of the Sarbanes–Oxley Act of 2002, that

- the Report fully complies with the requirements of Section 13(a) or 15(d), as applicable, of the Securities Exchange Act of 1934, as amended, and
- the information in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

This certification is being provided pursuant to 18 U.S.C. 1350 and is not to be deemed a part of the Report, nor is it to be deemed to be "filed" for any purpose whatsoever.

By: /s/ ROBERT K. WEILER

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Robert K. Weiler  
Chief Executive Officer  
Phase Forward Incorporated  
March 9, 2005

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[Exhibit 32.1](#)

**CERTIFICATION PURSUANT TO 18 U.S.C. 1350, AS ADOPTED PURSUANT TO  
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

The undersigned, Rodger Weismann, Chief Financial Officer of Phase Forward Incorporated (the "Company"), in connection with the Company's Annual Report on Form 10-K for the period ended December 31, 2004 (the "Report"), as filed with the Securities and Exchange Commission on the date hereof, hereby certifies pursuant to the requirements of 18 U.S.C. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that

- the Report fully complies with the requirements of Section 13(a) or 15(d), as applicable, of the Securities Exchange Act of 1934, as amended, and
- the information in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

This certification is being provided pursuant to 18 U.S.C. 1350 and is not to be deemed a part of the Report, nor is it to be deemed to be "filed" for any purpose whatsoever.

By: /s/ RODGER WEISMANN

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Rodger Weismann  
Chief Financial Officer  
Phase Forward Incorporated  
March 9, 2005

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QuickLinks

[Exhibit 32.2](#)

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