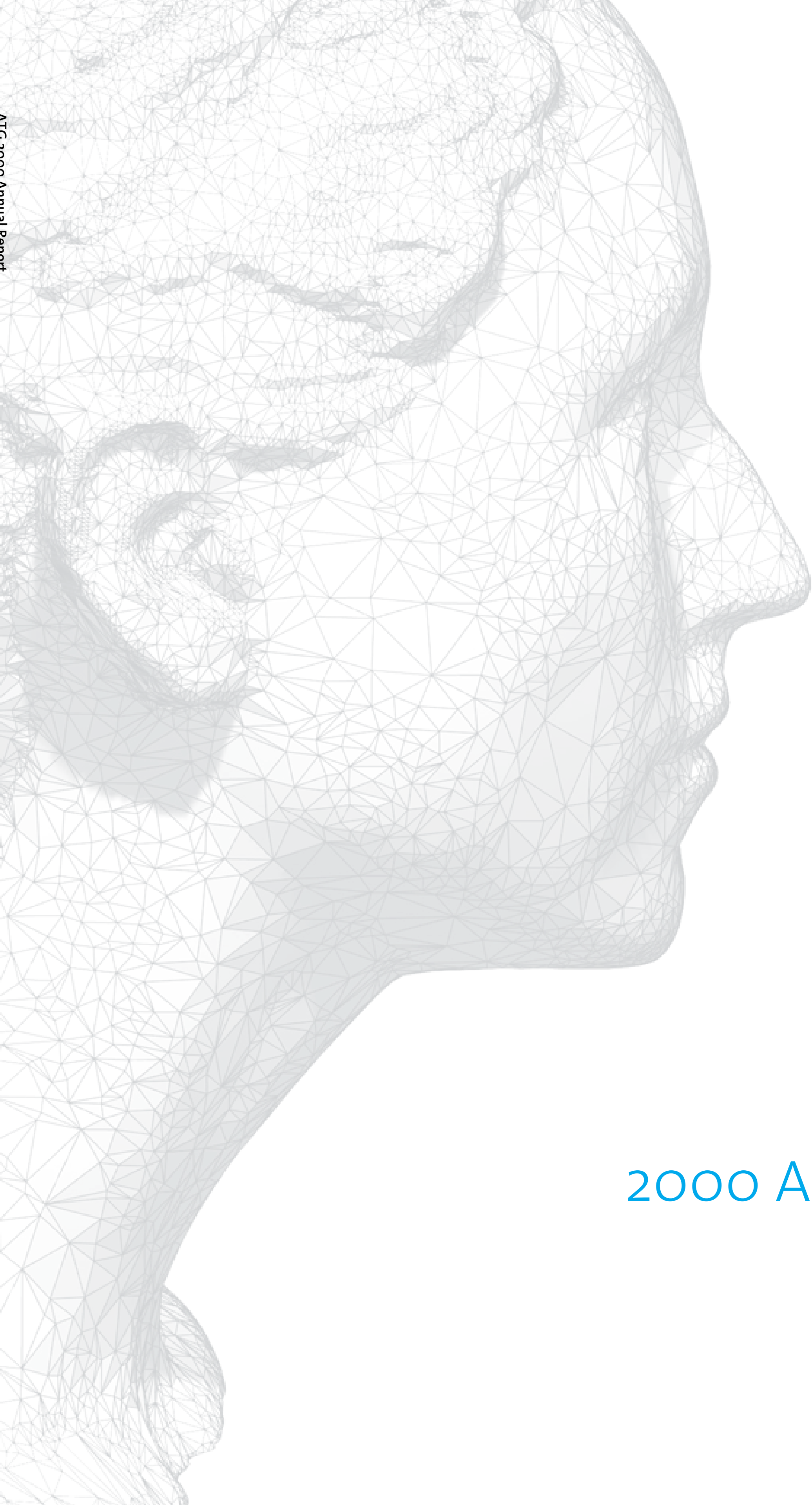
ATG 2000 Annual Report



atg®

2000 Annual Report

ATG Executive Committee, left to right

Bernard Bailey, Senior Vice President Global Services; **Ann Brady,** Chief Financial Officer; **Joe Chung,** Chairman and Chief Technology Officer; **Lauren Kelly,** Senior Vice President Worldwide Sales; **Ian Reid,** Senior Vice President Worldwide Marketing; **Paul Shorthose,** President and Chief Operating Officer; **Jeet Singh,** Chief Executive Officer; **Bill Wittenberg,** Senior Vice President Product Development

About ATG

Who we are
Art Technology Group (ATG) is one of the world's leading providers of e-commerce and customer management software. Based in Cambridge, Massachusetts, we have more than 1,000 employees located in 20 offices around the world, a network of over 250 partners, and more than 670 customers across a wide range of industries.

What we sell
ATG provides advanced, innovative Web technology, applications, and services that enable organizations to manage and build online relationships with customers, partners, suppliers, and employees more effectively and efficiently than ever before.

Why we are different
Since the beginning of the online revolution, ATG has charted the future of Web-based commerce and customer management. Our ongoing success comes from an unequalled combination of elements:

Technological leadership. ATG Dynamo® — our powerful Java-based commerce, personalization, and customer management application suite — leads the industry and serves as the core of our company.
Comprehensive services. Our comprehensive services — from application prototyping to management consulting — help our customers reach their business goals.
Outstanding people. Our global organization provides the creativity and commitment that help us achieve technological breakthroughs, exceptional customer focus, and ongoing growth.
Powerful partnerships. Our extensive ATG Global Alliance Network brings ATG solutions to the world.
Visionary customers. The world's leading global organizations turn to us for greater efficiency and a competitive advantage, as well as for the unrelenting dedication we show to our customers.

The following pages highlight the qualities that make ATG a different breed of company. Inside, you'll find out more about why 2000 was such a phenomenal year for our employees, partners, customers, and shareholders.

To Our Shareholders

In 2000, ATG emerged as one of the premier vendors in our competitive, promising marketplace. Years from now, we will remember 2000 as a year of landmark growth for ATG in all areas. We grew financially, charting record revenues and achieving profitability. Our customer base grew, jumping from 262 to 670 — including many large enterprise wins. In terms of alliances, we ended the year with a powerful network of more than 250 partners. We expanded internationally, establishing offices in 20 locations throughout the world. And finally, our organization tripled to include over 1000 employees, including important new additions to the senior management team.

A year of growth and change

In short, 2000 was a year of rapid growth and change for ATG, one paralleled by major changes in our marketplace. In 2000, the Web evolved and matured, and our customers shifted the focus of their online efforts to reducing costs, raising efficiency, and generating a strong return on investment. This market shift paralleled our Q3 introduction of ATG Dynamo 5 e-Business Platform — the latest release of our powerful, Java-based solution for e-commerce and customer management — which furthered our technological lead in the marketplace. We expanded the extensive capabilities and power of ATG Dynamo via two new product suites:

- The ATG Dynamo Commerce Suite brings new efficiency and flexibility to even the most extensive commerce solutions.
- The ATG Dynamo Customer Management Suite allows companies to measure, analyze, and fine-tune customer management for maximum profitability and return on investment.

Both suites include our exclusive ATG Dynamo e-Business Scenarios, which take personalization to new levels of flexibility and control. Now our customers can create dynamic strategies that streamline and maximize relationships with customers, suppliers, partners, and other key groups over time — achieving new levels of efficiency and ensuring a competitive advantage.

A successful transition

Our well-executed launch of ATG Dynamo 5 brought powerful new capabilities to our customers, who quickly embraced and adopted the latest Dynamo platform. In fact, more than 60 percent of our new customers adopted the ATG Dynamo Scenario Server™ in its first full quarter. It's clear that ATG Dynamo 5 is the right product at the right time — offering tangible proof of our ability to meet the changing needs of the marketplace.

Comprehensive services complete the picture

In 2000, we launched significant service offerings that helped us ensure the success of our customers — from Customer Management Consulting to the innovative ATG Discovery Lab, which enables the rapid development of prototype ATG Dynamo applications. We support our partners and customers with a full family of service offerings — from identifying initial business requirements to deployment to support. These professional services will continue to play an important role in our future, as more partners and customers seek to maximize the benefits of ATG Dynamo.

The focus on efficiency will continue

Organizations recognize the potential of the Web to raise organizational efficiency and competitiveness. Our ATG Dynamo solutions are the most robust available, and are well-positioned to provide the major efficiency gains that organizations are demanding from the Web.

Moving forward

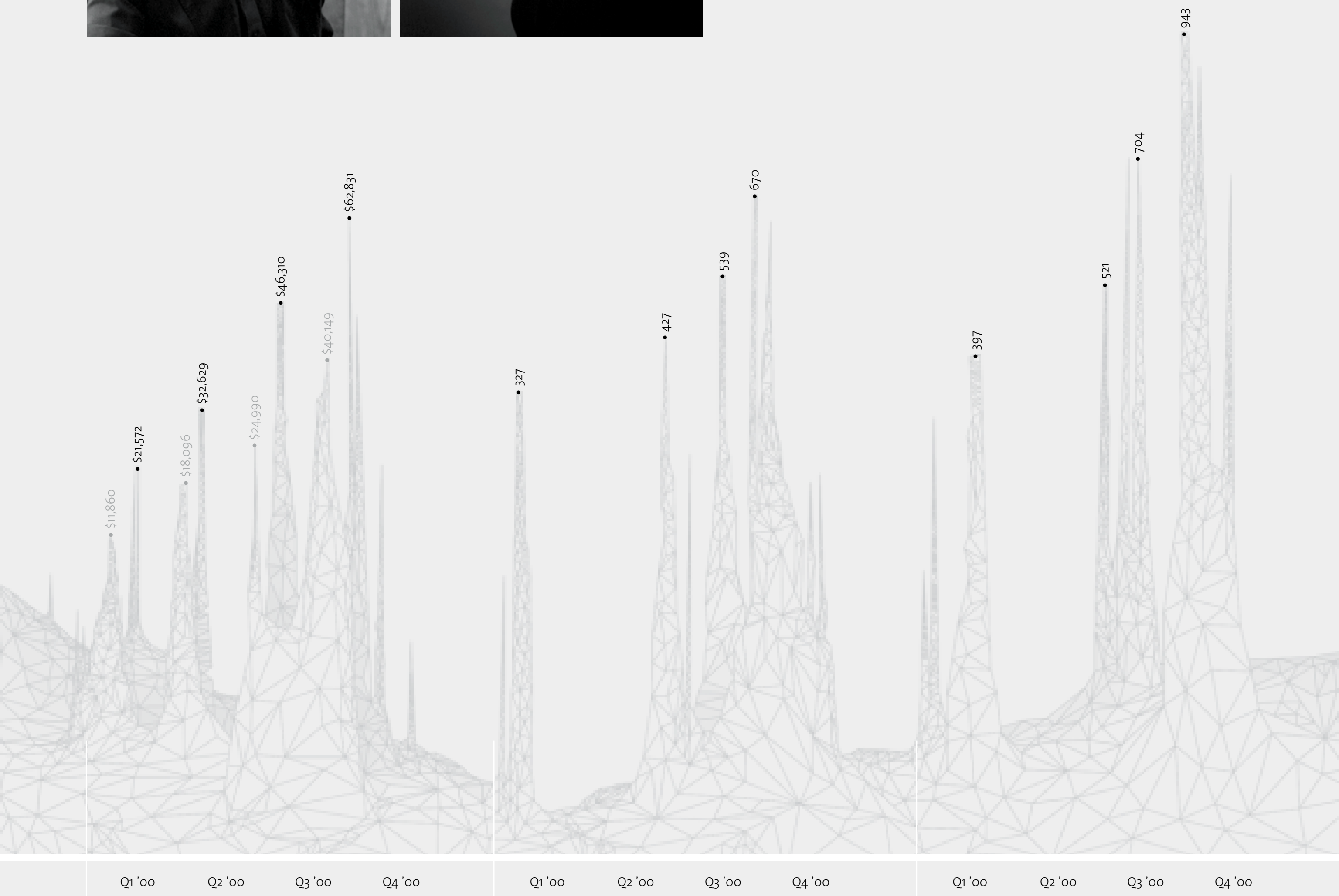
We enter 2001 strong and ready to take on new challenges. Awareness of ATG and our solutions has never been higher, and our list of technological firsts, customer wins, and industry awards continues to grow. Here is a brief overview of what's ahead for ATG:

- Our ongoing and deep commitment to research and product development ensures major ATG Dynamo announcements in 2001 that build on the success of our e-business product suite.
- We will continue to invest in sales and marketing in the coming year, enabling us to bring our solutions to new customers throughout the world, while deepening our relationships with our current partners and customers.
- Our international build-out will continue, expanding our scope and allowing us to serve our global customers even better.

As we move ahead in these areas and many others, we continue to be thankful for our many shareholders, who appreciate our vision, support our efforts, and share our success.

Jeet Singh
Chief Executive Officer

Joe Chung
Chairman & Chief Technology Officer



Total Revenue Growth (in Millions)

• Total Revenue
• Partner-driven Product Revenue

Number of Customers

Number of Employees

Financial and Organizational Highlights

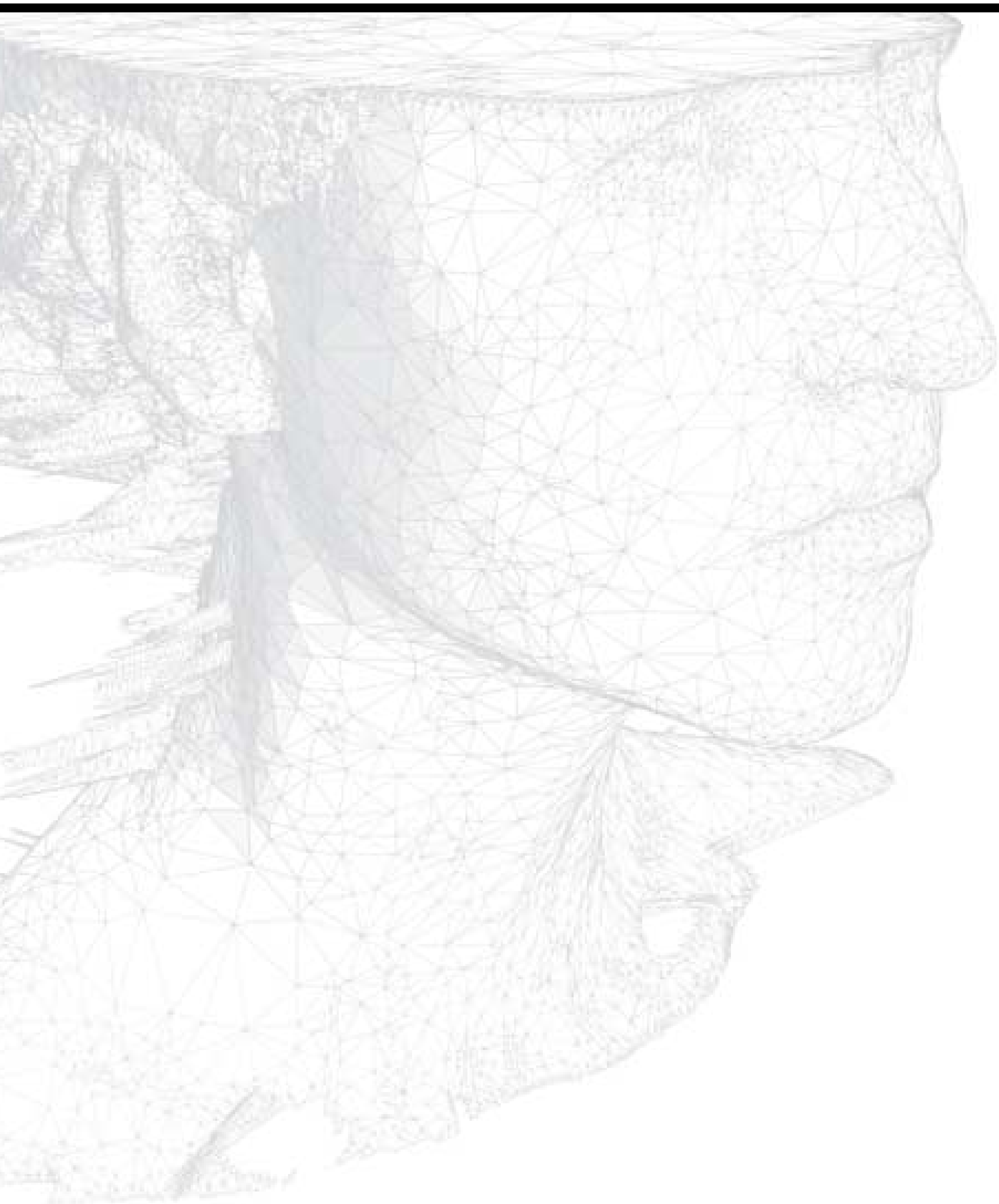
Our conservative approach to financial and organizational growth paid off with significant rewards in 2000. While many organizations in our industry struggled to survive, ATG thrived.

Healthy financial performance

From a financial perspective, 2000 was a phenomenal year for ATG. Here are some of the highlights:

- **Record revenues.** We charted record revenues of $163.3 million — up 409 percent from $32.1 million in 1999, and well above our internal expectations.
- **Profitability.** ATG achieved profitability in the second quarter and reported earnings growth in both the third and fourth quarters of 2000. Net income for the year was $14.5 million, or $.20 per fully diluted share — vs. a net loss of $17.5 million or $.45 loss per fully diluted share in 1999.
- **Higher gross profits.** Fueled by our rapid growth, gross profits for 2000 totaled $125.2 million in 2000 vs. a gross profit of $13.7 million in 1999.
- **Higher margins.** We achieved our target mix of 74 percent software licensing and 26 percent services revenue, contributing to higher margins of 77 percent — vs. 43 percent in 1999.

At the most basic level, the reason behind these impressive results is simple. We offer the most robust solution in an extremely promising long-term sector — the market for online customer relationship management and e-commerce. We continue to enhance our ATG Dynamo solution with breakthrough functionalities that go far beyond those of the competition.



A dedicated organization that delivers results

These results go beyond technology. Our business model has allowed us to achieve top-line growth and profitability long before expectations. We are building an organization capable of exceptional execution on both the financial and organizational level for the long haul. Our partners, customers, and vertical markets are remarkably diversified. We have been very successful in attracting large, global customers — in 2000, we attracted more enterprise-level customers, leading to increased opportunities for repeat business. And we continue to fine tune our budgeting and planning to help us better understand and manage our business, positioning us for success in the long term.

Staying nimble amid remarkable growth

Although our conservative approach serves us well, we are aggressive and proactive in our pursuit of new opportunities. Our rapid international expansion in 2000 made us truly global, and contributed to our highest international revenues yet, totaling 23 percent of all revenues — a number that we anticipate increasing to 30 percent over time. We hired intelligently in 2000, bolstering our organization with the talented, innovative people who contribute so much to our success. While most organizations in our industry reported high turnover in 2000, our employees stayed with us — resulting in a turnover rate of less than 10 percent. Our open company culture enables us to attract and retain the best and brightest talent.

Guided by a long-term vision

ATG remains unchanged at the core. Technologically, we continue to outdistance our competitors. We have created a thriving organization that rewards innovation and achievement. We are dedicated to our customers and partners, and to creating new programs — such as Customer Advocacy and our thriving Customer Advisory Council — that foster positive and proactive relationships with all members of the ATG community. And we continue to assess and meet the ongoing and ever-changing needs of the marketplace.

These qualities supported the company's extraordinary success in 2000, and will continue to drive ATG far into the future.

Paul G. Shorthose
President & Chief Operating Officer

Ann C. Brady
Chief Financial Officer


Deloitte Consulting
PricewaterhouseCoopers
Cap Gemini Ernst & Young
ATG Solution Providers
Fort Point Partners, Inc.
GTSI
EDS
Totality
Loudcloud
ATG Service Providers
Logictier, Inc.
Sun Microsystems
ATG Strategic Platform Partners
Hewlett Packard
TIBCO
ClearCommerce
Netegrity
ATG Complementary Software Vendors
Interwoven
NetGenesis
Documentum
XUMA
Thoughtmill
ATG Dynamo ISVs
YOUcentric, Inc.

The partners highlighted here are examples of the ATG Global Alliance Network, which now includes more than 250 members.

ATG Global Alliance Network

Strong alliances — vital to our ongoing success

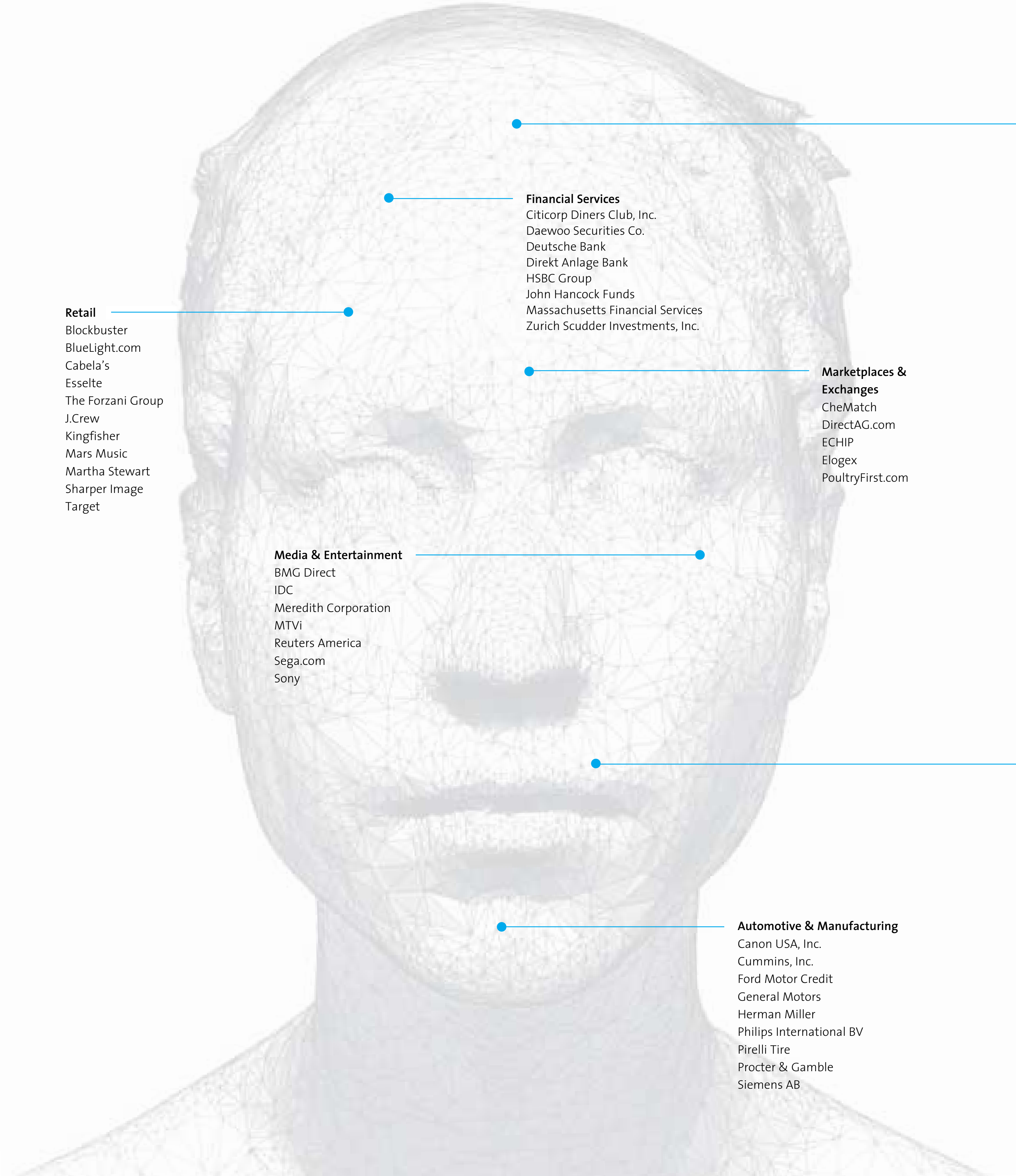
In 2000, our alliances with systems integrators, software developers, hardware manufacturers, and other key groups continued to grow and flourish. In all, the ATG Global Alliance Network doubled to include more than 250 partners. A substantial part of our revenue — almost 80 percent — came through our partner channels this year, attesting to the important role that they play in our success. Expanding our network enables us to diversify our channels and respond to the needs of our customers more quickly and completely.

Increasing the breadth and depth of our alliance network

In 2000, we focused our efforts on building key alliances that last. We combined our strengths with those of our partners to deliver the most complete, robust solutions to our customers. The ATG Global Alliance Network encompasses organizations with a wide range of experience, expertise, and technologies:

- **ATG Solution Providers** provide development, integration, deployment, and technical support services that enable our customers to launch powerful ATG Dynamo-driven e-business sites.
- **ATG Service Providers** bring our customers hosting, managed services, and support via hardware, software, and storage.
- **ATG Complementary Software Vendors** develop software products that enhance or broaden the scope of ATG Dynamo.
- **ATG Dynamo ISVs** include companies that build on or re-license ATG Dynamo.
- **ATG Strategic Platform Partners** develop the primary server hardware and operating system technology that serves as a foundation for ATG Dynamo.

As we move ahead, we will continue to expand the ATG Global Alliance Network and deepen our relationships with key partners. This approach enables us to maximize customer wins and revenues from each of our alliances while ensuring the best possible solutions for our customers.


Financial Services
Citicorp Diners Club, Inc.
Daewoo Securities Co.
Deutsche Bank
Direkt Anlage Bank
HSBC Group
John Hancock Funds
Massachusetts Financial Services
Zurich Scudder Investments, Inc.
Retail
Blockbuster
BlueLight.com
Cabela's
Esselte
The Forzani Group
J.Crew
Kingfisher
Mars Music
Martha Stewart
Sharper Image
Target
Marketplaces & Exchanges
CheMatch
DirectAG.com
ECHIP
Elogex
PoultryFirst.com
Media & Entertainment
BMG Direct
IDC
Meredith Corporation
MTVi
Reuters America
Sega.com
Sony
Automotive & Manufacturing
Canon USA, Inc.
Cummins, Inc.
Ford Motor Credit
General Motors
Herman Miller
Philips International BV
Pirelli Tire
Procter & Gamble
Siemens AB

Telecommunications
Alcatel
AT&T
Avaya Communications
Texas Instruments

ATG Customers

The ATG customer list more than doubled in 2000, growing to include more than 670 visionary organizations across a wide range of industries — from financial services to consumer retailing to manufacturing. Our customers include some of the world's largest and most successful global corporations. While we serve a diverse base of customers, the common theme is clear — each wants to leverage the Web to manage their customers, partners, and suppliers faster and better than ever before. ATG is committed to helping our customers achieve the greater efficiency and strong competitive advantage they need to thrive — now and far into the future.

For all these customers and hundreds more, ATG is the right partner, and ATG Dynamo is the right solution.

High Tech
Adobe Systems
Cadence Design Systems
Handspring
VeriSign
Sun Microsystems

ATG Board of Directors

Jeet Singh has been CEO of ATG since its founding in 1991. In that period, Singh has grown the firm to a market-leading position in the e-commerce and customer management software market, establishing a dominant brand and position in one of the most exciting technology growth markets in the world, as well as successfully taking the company into the public financial markets and leading the firm to profitability. Today, ATG operates globally in over 20 cities, and has over 600 customers including blue-chip firms such as AT&T, General Motors, Philips, Ford Motor Credit, Procter & Gamble, and Sun Microsystems.

Prior to founding ATG, Singh held a variety of positions in product marketing, planning, market management, and business development at start-up, medium, and large business environments including telecom software vendor Boston Technology and Groupe Bull. Singh received a bachelor of science degree in political science from the Massachusetts Institute of Technology.

Joseph Chung co-founded ATG with Jeet Singh in 1991, and has led the development of the company's innovative technology solutions ever since. As chairman and chief technology officer, he actively manages the long-term strategy and development of ATG products and services.

Prior to ATG, Chung was enrolled in the Ph.D. program at MIT Media Laboratory, where he studied computer music and electronic performance. As the technical director and chief technology designer of the hyperinstrument group at the MIT Media Lab, Chung was the co-creator and developer of the first hyperinstruments. His teams specialized in real-time, high-performance software used in major musical and media productions around the world, including the Pompidou Center in Paris, Bunkamura Hall in Tokyo, Boston Symphony Hall, Tanglewood Music Festival, and many others. Chung also held engineering positions at Apple Computer and Digital Equipment Corporation.

Chung presents at high-profile industry events, such as JavaOne and Comdex. He also is a member of the Board of Trustees of the Massachusetts Software and Internet Council. Chung is the author of Hyperlisp, and received both his bachelor of science and master of science degrees in computer science from MIT.

Scott A. Jones has been a member of the ATG board of directors since November 1997. Since co-founding Escient, Inc., a company focusing on Internet applications related to entertainment in the home, Jones has served as its chief executive officer and chairman. Jones also co-founded Boston Technology, Inc. and served as its chairman and chief scientist. He has been a principal of Threshold Technologies, Inc., a consulting firm, and King Air Charters, Inc., an air charter company. Jones also serves on the board of directors for HIE, Inc., a software integration services company.

Charles R. Lax has been a member of the ATG board of directors since December 1997. Mr. Lax is a general partner of SOFTBANK Capital Partners, a managing director of SOFTBANK Venture Capital, a director of SOFTBANK Investment America Corporation, and is managing general partner of Grand Banks Capital. Mr. Lax also serves on the boards of 1-800-Flowers.com, Inc. (FLWS), a leading floral and gifting firm; Global Sports Interactive (GSPT), a sports equipment company; Interliant, Inc. (INIT), an Internet hosting service company; and Webhire, Inc. (HIRE), a human resources staffing software company.

Thomas N. Matlack has been a member of the ATG board of directors since November 1997. He is currently a managing partner at Megunticook Management LLC, a private investment fund. Previously, Matlack held various positions with the Providence Journal Company, including chief financial officer, vice president of finance, and director of financial planning and analysis.

Phyllis S. Swersky has been a member of the ATG board of directors since May 2000. She is currently the president of The Meltech Group, a company that provides business advisory services to executive management teams at growing companies. Previously she served as vice president, chief financial officer, and executive committee member for Cullinet Software, a trailblazer in the software industry. Swersky also serves on the board of directors for Circles, Inc. and oversees the chair and finance committee of Northeastern University.

Robert F. Walters has been a member of the ATG board of directors since May 2000. He is presently the senior vice president and chief information officer of John Hancock Financial Services, responsible for the technology management activities for John Hancock and its subsidiaries. Walters has held key management positions at Citibank, Bankers Trust, and Marine Midland Bank. He also serves on the board of directors for the Essex Corporation.

Index to Consolidated Financial Statements

Management's Discussion and Analysis of Financial Condition and Results of Operations

Overview

We were founded in December 1991. From 1991 through 1995, we devoted our efforts principally to building, marketing and selling our professional services capabilities and to research and development activities related to our software products. Beginning in 1996, we began to focus on selling our software products. To date, we have enhanced and released several versions of our Dynamo Application Server product and have completed development of our current product suite. We began shipping the commercial version of Dynamo 5 e-Business Platform in September 2000. We market and sell our products worldwide through our direct sales force, systems integrators, technology partners and original equipment manufacturers.

We derive our revenues from the sale of software product licenses and related services. Product license revenues are derived from the sale of software licenses of our Dynamo products. Our software licenses are priced based on either the size of the customer implementation or site license terms. Services revenues are derived from fees for professional services, training and software maintenance and support. Professional services include custom application development and project and technical consulting. We bill professional service fees primarily on a time and materials basis or, in some cases, on a fixed-price schedule defined specifically in our contracts. Software maintenance and support arrangements are priced based on the level of services provided. Generally, customers are entitled to receive software updates, maintenance releases and technical support for an annual maintenance fee of 20% to 30% of the list price of the licensed product. Customers that purchase maintenance and support generally receive all product updates and upgrades of software modules purchased as well as Web-based and telephone technical support. Training is billed as services are provided.

We recognize revenue in accordance with Statement of Position (SOP) 97-2, *Software Revenue Recognition* and SOP 98-9, *Modification of* SOP 97-2, *Software Revenue Recognition, with Respect to Certain Transactions*. Revenues from software product license agreements are recognized upon execution of a license agreement and delivery of the software, provided that the fee is fixed or determinable and deemed collectible by management. If conditions for acceptance are required subsequent to delivery, revenues are recognized upon customer acceptance if such acceptance is not deemed to be perfunctory. In multiple element arrangements, we use the residual value method in accordance with SOP 97-2 and SOP 98-9. Revenues from software maintenance agreements are recognized ratably over the term of the maintenance period, which is typically one year. We enter into reseller arrangements that typically provide for sublicense fees payable to us based upon a percentage of our list price. Revenues are recognized under reseller agreements as earned which is generally ratably over the life of the reseller agreement for guaranteed minimum royalties or based upon unit sales by the resellers. We do not grant our resellers the right of return or price protection. Revenues from professional service arrangements are recognized on either a time and materials or percentage-of-completion basis as the services are performed, provided that amounts due from customers are fixed or determinable and deemed collectible by management. Amounts collected prior to satisfying the above revenue recognition criteria are reflected as deferred revenue. Unbilled services represent service revenues that have been earned by us in advance of billings.

Services revenues have increased primarily due to the expansion of our service capabilities by hiring additional service personnel and the increase in the number of customers using our Dynamo products. Sales of Dynamo products often lead to sales of consulting services and software maintenance and support. To date, substantially all of our Dynamo customers have entered into annual software maintenance and support agreements at the time of purchase and have renewed such maintenance and support contracts in subsequent periods. We believe that growth of our product license sales depends on our ability to provide customers with support, training, consulting and implementation services and to educate systems integrators and resellers on how to use and install our products. We have invested significantly and expect to continue to invest in expanding our services organization.

We have recently begun to invest significant financial and managerial resources to expand our sales and marketing operations in international markets. We currently maintain offices in Australia, Canada, England, France, Germany, Hong Kong, Japan, the Netherlands, Singapore and Sweden. Revenues from customers outside the United States accounted for 7% of our total revenues in 1998 and 1999, and 23% in 2000. We have not entered into contracts denominated in foreign currencies to date, but may in the future. We currently do not have hedging or similar arrangements to protect us against foreign currency fluctuations. We, therefore, increasingly may become subject to currency fluctuations, which could harm our operating results in future periods.

Results of Operations

The following table sets forth statements of operations data as percentages of total revenues for the periods indicated:

Year Ended December 31,	1998	1999	**2000**
Revenues:			
Product license	33%	58%	**74%**
Services	67	42	**26**
Total revenues	100	100	**100**
Total cost of revenues	42	57	**23**
Gross margin	58	43	**77**
Operating expenses:			
Research and development	27	20	**12**
Sales and marketing	34	50	**45**
General and administrative	19	17	**14**
Stock-based compensation	1	3	**1**
Total operating expenses	81	90	**72**
Income (loss) from operations	(23)	(47)	**5**
Interest income (expense), net	(1)	6	**6**
Income (loss) before provision for income taxes	(24)	(41)	**11**
Provision for income taxes	–	–	**2**
Net income (loss)	(24)%	(41)%	**9%**

The following table sets forth, for the periods indicated, the cost of product license revenues as a percentage of product license revenues and the cost of services revenues as a percentage of services revenues:

Year Ended December 31,	1998	1999	**2000**
Cost of product license revenues	1%	44%	**3%**
Cost of services revenues	62	76	**83**

Revenues

Total revenues increased 409% from $32.1 million in 1999 to $163.3 million in 2000. The increase was primarily attributable to market acceptance of our Dynamo suite of products as we continued to cultivate relationships with systems integrators and train our partner channels to encourage them to support our products. Additionally, global expansion and the release of our newest product offering in September 2000, ATG Dynamo 5, contributed to our revenue growth. Revenues generated from international customers increased to $37.6 million in 2000 from $2.2 million in 1999.

Total revenues increased 164% from $12.1 million in 1998 to $32.1 million in 1999. The increase was primarily attributable to growth in the number of customers and the number of larger deals with customers. In addition, we expanded our sales force and introduced Version 4.0 of our Dynamo product suite in December 1998, which increased our market presence.

No individual customer accounted for more than 10% of total revenues in 1999 or 2000. In 1998, three customers each accounted for more than 10% of total revenues, and collectively, accounted for 37% of total revenues.

Management's Discussion and Analysis of Financial Condition and Results of Operations
continued

Product License Revenues

Product license revenues increased 553% from $18.6 million in 1999 to $121.5 million in 2000. The increase was primarily attributable to the continued rapid growth in our partner channel, as well as increased sales to larger enterprises and international customers. Product license revenues generated from international customers increased to $27.1 million in 2000 from $1.2 million in 1999. We experienced an increase in the number of individual license arrangements under which the initial license fee was in excess of $1 million. Additionally, the increase was attributable to the market acceptance of ATG Dynamo 5, which was released in September 2000. We anticipate that product license revenues will continue to grow in absolute dollars, but expect the sequential rate of growth to decrease as compared to the past several quarters.

Product license revenues increased 358% from $4.1 million in 1998 to $18.6 million in 1999. This increase was attributable to the market acceptance of our ATG Dynamo product suite following the release of Dynamo 4.0 in December 1998 and an increase in the number of larger deals with customers. Additionally, 11% of our product license revenues in 1999 were the result of an agreement with an original equipment manufacturer or OEM. The OEM agreement had an initial term that ended on December 31, 2000. We elected not to renew the agreement.

Product license revenues as a percentage of total revenues for the years ended December 31, 2000, 1999 and 1998 were 74%, 58% and 33%, respectively. We expect this percentage to decrease in the foreseeable future until reaching a level of approximately two-thirds of total revenues.

Services Revenues

Services revenues increased 210% from $13.5 million in 1999 to $41.8 million in 2000. Professional services revenues increased 95% from $9.7 million in 1999 to $18.9 million in 2000. The increase in professional services revenues was primarily attributable to the continued growth of our customer base and an increase in resources in our professional services group including the acquisition of The Toronto Technology Group, Inc. Software maintenance and support revenues increased 496% from $2.8 million in 1999 to $16.7 million in 2000. The increase in software maintenance and support revenues was the result of continued increases in product revenues that generate software maintenance and support revenues and increases in software maintenance and support renewals. Training revenues increased 463% from $1.1 million in 1999 to $6.2 million in 2000. The increase in training revenues was primarily attributable to our extended training program offerings. Additionally, our acquisition of Petronio Technology Group on May 17, 2000 provided us with additional Java, J2EE and XML courseware, as well as strengthened our training capabilities with the addition of seasoned trainers and curriculum developers. We believe these capabilities enhance our selling efforts for product license revenues to end-users, resellers and partners. We anticipate that services revenues will continue to grow in absolute dollars, but expect the sequential rate of growth to decrease as compared to the past several quarters.

Services revenues increased 67% from $8.1 million in 1998 to $13.5 million in 1999. Professional services revenues increased 26% in 1999 from $7.7 million in 1998 to $9.7 million in 1999. The increase in professional services revenues was primarily attributable to the continued growth of our customer base and an increase in resources in our professional services group. Software maintenance and support revenues increased 653% from $372,000 in 1998 to $2.8 million in 1999. This increase in software maintenance and support revenues was attributable to an increase in the number of customers and sales of product licenses.

Services revenues as a percentage of total revenues for the years ended December 31, 2000, 1999 and 1998 were 26%, 42% and 67%, respectively. We expect this percentage to increase in the foreseeable future to approximately one-third of total revenues.

Cost of Product License Revenues

Cost of product license revenues decreased from $8.2 million in 1999 to $3.4 million in 2000. For the year ended December 31, 2000, approximately $2.3 million related to the BroadVision settlement which was included in cost of product license revenues. We paid BroadVision $750,000 per quarter in 2000 and will pay BroadVision $500,000 per quarter in 2001 and 2002. Cost of product license revenues also includes costs associated with sustaining the current release of the Dynamo suite of products.

Cost of product license revenues increased from $30,000 in 1998 to $8.2 million in 1999. In February 2000, we settled a lawsuit filed by BroadVision in December 1998, which alleged that we were infringing on a patent for a method of conducting e-commerce. As part of the settlement, we, in return for cash payments, received a non-exclusive, worldwide, perpetual, paid-up license to make, use and sell products arguably covered by the patent and any other patents that may be issued in the future that are related to the original patent. We agreed to pay BroadVision a total of $15.0 million in license fees, which are being accounted for as cost of product license revenues. An initial payment of $8.0 million in February 2000 was expensed during the year ended December 31, 1999, and the remaining $7.0 million is being expensed ratably over a three-year period that began in the first quarter of 2000.

Cost of Service Revenues

Cost of services revenues includes salary and other related costs for our professional services and technical support staff, as well as third-party contractor expenses. Cost of services revenues will vary significantly from year to year depending on the level of professional services staffing, the effective utilization rates of our professional services staff, the mix of services performed, including product license technical support services, the extent to which these services are performed by us or by third-party contractors, and the level of third-party contractors fees.

Cost of services revenues increased 240% from $10.2 million in 1999 to $34.7 million in 2000. The increase was attributable to the growth of our resources in our professional services group. Approximately 61% of the increase was related to compensation and benefit costs. Additionally, costs increased due to travel, recruiting, hiring and training.

Cost of services revenues increased 104% from $5.0 million in 1998 to $10.2 million in 1999. The increase was attributable to the increase in resources in our professional services group. Approximately 86% of the increase was attributable to increased compensation costs for continued increases in head count. Further, increased costs resulted from establishing a training organization and the introduction of training programs in December 1998. Additionally, costs increased due to travel, recruiting and facilities costs.

Research and Development Expenses

Research and development expenses consist primarily of salary and related costs to support product development. To date, all software development costs have been expended as research and development in the period incurred.

Research and development expenses increased 199% from $6.3 million in 1999 to $19.0 million in 2000. The increase was due principally to the research and development expenses associated with our Dynamo 5 e-Business Platform, which we announced in July 2000 and began shipping in September 2000. Approximately 73% of the increase was related to compensation and benefit costs. Additionally, costs increased due to travel, recruiting, hiring and training.

Research and development expenses increased 89% from $3.4 million in 1998 to $6.3 million in 1999. Approximately 79% of the increase was due to growth in hiring engineers into the group and related costs including salaries and related benefits. The remainder of the increase was primarily due to increased facilities costs.

For the years ended December 31, 2000, 1999 and 1998, research and development expenses as a percentage of total revenues were 12%, 20% and 27%, respectively. The percentage decrease principally reflected growth in the level of our total revenues. We expect that research and development expenses, in absolute dollars, will increase as we expand our research and development hiring efforts subsequent to the Dynamo 5 general release. We expect that research and development expenses will represent a greater percentage of total revenues in 2001 than in 2000. We anticipate, however, that research and development expenses will fluctuate as a percentage of total revenues based upon the level of revenue growth.

Sales and Marketing Expenses

Sales and marketing expenses consist primarily of salaries, commissions and other related costs for sales and marketing personnel, travel, public relations and marketing materials and events.

Sales and marketing expenses increased 360% from $15.9 million in 1999 to $73.3 million in 2000. The increase was associated primarily with international sales and marketing expansion, global hiring, advertising efforts, branding and increased commissions. Approximately 47% of the increase was related to compensation and benefit costs, and 28% of the increase was related to marketing and promotional expenses. Additionally, costs increased due to travel, recruiting, hiring and training.

Sales and marketing expenses increased 291% from $4.1 million in 1998 to $15.9 million in 1999. Approximately 44% of the increase was due to a significant increase in the number of sales and marketing personnel and related expenses, and 29% of the increase was related to new and increased marketing program expenditures.

For the years ended December 31, 2000, 1999 and 1998, sales and marketing expenses as a percentage of total revenues were 45%, 50% and 34%, respectively. We expect that sales and marketing expenses will increase in absolute dollars as we continue to execute our strategy for expansion of our sales and marketing efforts, both domestically and internationally. We will continue to hire and train new sales personnel, open additional sales offices, increase marketing and promotional spending and execute our global branding initiatives. We expect that sales and marketing expenses will represent a smaller percentage of total revenues in the next year than in 2000. We anticipate, however, that sales and marketing expenses will fluctuate as a percentage of total revenues depending on the level and timing of global expansion, program spending, the rate at which newly hired sales personnel become productive and the level of revenue growth.

Management's Discussion and Analysis of Financial Condition and Results of Operations
continued

General and Administrative Expenses

General and administrative expenses consist primarily of salaries and other related costs for operations and finance employees and legal and accounting fees.

General and administrative expenses increased 328% from $5.3 million in 1999 to $22.8 million in 2000. Approximately 48% of the increase was related to increases in personnel and related expenses, driven by expansion both domestically and internationally. Approximately 13% of the increase was related to an increase in consultant expenses. Additionally, the increase was the result of recording additional allowances for doubtful accounts as a result of the increases in revenues and the potential for a slowdown in the economy.

General and administrative expenses increased 132% from $2.3 million in 1998 to $5.3 million in 1999. Approximately 30% of the increase was related to the hiring of additional professionals to manage the growth of the company resulting in increased salaries and benefits. Approximately 19% of the increase was due to increased consulting services and approximately 13% of the increase was due to costs related to hiring and training new personnel.

For the years ended December 31, 2000, 1999 and 1998, general and administrative expenses as a percentage of total revenues were 14%, 17% and 19%, respectively. We plan to continue investing in infrastructure and personnel to help support our planned growth. As a result, we expect an increase, in absolute dollars, in general and administrative costs for the next year. We expect that general and administrative expenses will represent a smaller percentage of total revenues in the foreseeable future than in 2000. We anticipate, however, that general and administrative expenses will fluctuate as a percentage of total revenues depending upon the rate of growth in expenditures and total revenues.

Stock-based Compensation

Since the fourth quarter of 1998, we have recorded total deferred stock-based compensation of $4.9 million in connection with stock option grants. These amounts represent the difference between the exercise price of certain stock option grants and the deemed fair value for accounting purposes of our common stock at the time of such grants. Additionally, in July 2000, we recorded deferred stock-based compensation of $2.0 million for unvested stock options acquired in connection with the acquisition of The Toronto Technology Group, Inc. We are amortizing these amounts over the vesting periods of the applicable options. These amounts have been reduced due to the recipients of these grants terminating employment with the Company.

Stock-based compensation expense increased 18% from $1.1 million in 1999 to $1.3 million in 2000. This increase was due to the timing of our recording of stock-based compensation and the options acquired in connection with the acquisition of The Toronto Technology Group, Inc. We expect stock-based compensation expense to increase to approximately $1.5 million in 2001.

Stock-based compensation expense increased 953% from $107,000 in 1998 to $1.1 million in 1999. This was due to the timing of our recording of stock-based compensation.

Interest Income (Expense)

Interest income increased 350% from $2.0 million in 1999 to $9.0 million in 2000. The increase is primarily the result of the completion of our initial public offering in July 1999 and a follow-on public offering in November 1999, from which we received net proceeds of approximately $153.3 million that we invested primarily in cash, cash equivalents and marketable securities. Additionally, the positive cash flow from operations has contributed to the increase in interest income.

Interest expense decreased from $121,000 in 1999 to zero in 2000. The decrease was related to the repayment of outstanding indebtedness in 1999 with the proceeds from our initial public offering.

Interest income increased from $54,000 in 1998 to $2.0 million in 1999. The increase was the result of the completion of our initial and follow-on public offerings completed in July and November 1999, from which we received net proceeds of approximately $153.3 million that was invested primarily in cash, cash equivalents and marketable securities.

Interest expense decreased 27% from $165,000 in 1998 to $121,000 in 1999. The decrease was primarily related to the repayment of outstanding indebtedness with the proceeds from our initial public offering.

Provision for Income Taxes

As a result of achieving profitability in 2000, we recorded a provision for income taxes of $3.4 million, which represents an effective tax rate of 18.9%. Our effective tax rate for 2000 was below the statutory rate due primarily to the utilization of net operating loss carry forwards. As of December 31, 2000, all net operating loss carry forwards have been benefited for financial reporting purposes. We expect our effective tax rate for 2001 to be approximately 40%. We incurred losses in 1998 and 1999. Accordingly, there was no provision for income taxes for these periods.

Liquidity and Capital Resources

Our capital requirements relate primarily to facilities, infrastructure for new hires and working capital requirements. Historically, we have funded our cash requirements primarily through the public and private sale of equity securities, commercial credit facilities and capital leases. In 2000, we began to fund our cash requirements in part from operations. At February 28, 2001, we had $51.5 million in cash and cash equivalents and $65.8 million in marketable securities.

Cash provided by operating activities was $18.3 million in 2000. This consisted of operating income of $14.5 million and changes in working capital including cash provided by increases in accrued expenses of $24.7 million and deferred revenue of $14.4 million off set by cash used to fund an increase in accounts receivable $39.9 million. Cash used in operating activities was $2.0 million for 1999. This represented an operating loss of $13.1 million and changes in working capital items consisting primarily of cash provided by deferred revenue, accounts payable and accrued expenses, including the $8.0 million license fee paid to BroadVision in February 2000. The cash provided by the change in deferred revenue was primarily the result of $5.0 million we received from an original equipment manufacturer, of which $2.9 million was included in deferred revenue as of December 31, 1999.

Our investing activities for the year ended December 31, 2000 consisted primarily of capital expenditures of $21.7 million, net purchases of marketable securities of $66.4 million and the purchase of The Toronto Technology Group, Inc. and Petronio Technology Group which utilized a total of $5.8 million of cash. In the second quarter of 2000 we acquired Petronio Technology Group and, pursuant to the acquisition agreement, made an initial cash payment of $600,000 and may be obligated to make two additional contingent payments of $300,000 each. In addition, in July 2000 we acquired The Toronto Technology Group for $12.0 million in cash, options and exchangeable shares of common stock. We paid $5.2 million in cash upon the closing of this acquisition and will pay the remainder of the purchase price in options and exchangeable shares through 2003. To support growth in headcount and global expansion, assets acquired both in 1999 and 2000 consisted principally of leasehold improvements, computer hardware and software. We expect that our capital expenditures will continue to increase significantly as our employee base grows. We expect that capital expenditures will total approximately $45.0 million over the next twelve months. Our investing activities in 1999 consisted primarily of capital expenditures of $5.6 million and increases in other assets for facilities deposits and similar items of $690,000, in addition to the net purchase of marketable securities of $24.5 million.

We have a revolving line of credit with Silicon Valley Bank, which provides for borrowings of up to the lesser of $12.5 million or 80% of eligible accounts receivable. The line of credit bears interest at the bank's prime rate (8.5% at February 28, 2001). At February 28 2001, we had approximately $4.1 million available under the line of credit based upon our borrowing base, no outstanding borrowings and $8.4 million of outstanding letters of credit which apply against our availability. The line of credit is secured by all of our tangible and intangible intellectual and personal property and is subject to financial covenants and restrictions, including minimum liquidity requirements and a prohibition on the payment of dividends. We currently are in compliance with all related financial covenants and restrictions. We are negotiating with Silicon Valley Bank to increase the aggregate amount available under this facility from $12.5 million to $25.0 million.

In September 2000, we entered into a non-recourse receivables purchase agreement with Silicon Valley Bank, under which we can sell up to $10.0 million of our accounts receivable to the bank. Under the terms of the receivables purchase agreement, we can sell certain accounts receivable, subject to acceptance by the bank, on a non-recourse basis. Upon purchase, the bank assumes the risk of collection for the acquired accounts receivable except in the event we violate the terms of the receivables purchase agreement or the customer asserts a discount, allowance, warranty claim or right of return. The accounts receivable are sold at a discount to reflect a minimum of 45 days and a maximum of 135 days at the bank's prime rate plus 1%. This agreement will expire in September 2001. During the year ended December 31, 2000, we sold $9.6 million of accounts receivable to the bank under the receivables purchase agreement. As of February 28, 2001, all of the sold receivables have been collected. For the year ended December 31, 2000, we incurred approximately $166,000 in expenses related to this transaction.

Management's Discussion and Analysis of Financial Condition and Results of Operations continued

Net cash provided by financing activities was $3.6 million in 2000, principally representing proceeds from stock option exercises and the employee stock purchase plan, offset in part by payments on long-term obligations to Broadvision. Net cash provided by financing activities was $153.4 million for 1999, primarily resulting from the net proceeds from our initial and follow-on public offerings, which generated $153.3 million.

We believe that with our existing financial resources and commercial credit facilities, together with cash generated by our operations, will be able to meet our cash requirements for at least the next twelve months.

Recent Accounting Pronouncements

In September 2000, the Financial Accounting Standards Board (FASB) issued SFAS No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities*, which supercedes SFAS No. 125. SFAS No. 140 provides accounting and reporting standards for transfers and servicing of financial assets and extinguishments of liabilities. SFAS No. 140 is effective for transfers and servicing of financial assets and extinguishments of liabilities occurring after March 31, 2001 and for recognition and reclassification of collateral and for disclosures relating to securitization transactions and collateral for fiscal years ending after December 15, 2000. The Company does not expect the adoption of SFAS No. 140 to have a material impact on the results of its consolidated financial position or results of operations.

In June 1998, the FASB issued SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*. As amended in June 1999 by SFAS No. 137, the statement is effective for all fiscal quarters of all fiscal years beginning after June 15, 2000. In June 2000, the FASB issued SFAS No. 138, *Accounting for Certain Derivative Instruments and Certain Hedging Activities* which is a significant amendment to SFAS No. 133. SFAS No. 133 and its amendments establish accounting and reporting standards for derivative instruments, including certain derivative instruments embedded in other contracts (collectively referred to as derivatives) and for hedging activities. The Company does not expect the adoption of these statements to have a material impact on its consolidated financial position or results of operations.

Market for Equity

Our common stock began trading on the Nasdaq National Market under the symbol "ARTG" on July 21, 1999. Prior to that time, there was no established public trading market for our common stock. The following table sets forth the high and low reported sales prices of our common stock for the periods indicated as reported by the Nasdaq National Market.

Year Ending December 31, 1999	High	Low
Third Quarter (commencing July 21, 1999)	$ 19.06	$ 5.13
Fourth Quarter	66.00	17.56
Year Ending December 31, 2000	**High**	**Low**
First Quarter	**106.50**	**43.81**
Second Quarter	**101.94**	**28.63**
Third Quarter	**126.88**	**76.00**
Fourth Quarter	**96.50**	**20.50**

On March 26, 2001 the last reported sale price on the Nasdaq National Market for our common stock was $ 20.00 per share. On March 26, 2001, there were 16,740 holders of record of our common stock.

Market Risk

The majority of our operations are based in the U.S. and, accordingly, the majority of our transactions are denominated in U.S. dollars. However, we have foreign-based operations where transactions are denominated in foreign currencies and are subject to market risk with respect to fluctuations in the relative value of currencies. The impact of fluctuations in the relative value of other currencies was not material for each of the three years ended December 31, 2000. We do not use derivative financial instruments for investment purposes and only invest in financial investments that meet high credit quality standards, as specified in our investment policy guidelines; the policy also limits the amount of credit exposure to any one issue, issuer, and type of investment.

Selected Financial Data

In thousands, except per share data

Consolidated Statement of Operations Data

Year Ended December 31,	1996	1997	1998	1999	**2000**
Operations:					
Total revenues	$ 3,902	$ 6,458	$ 12,137	$ 32,077	**$ 163,342**
Income (loss) from operations	(1,412)	(4,015)	(2,740)	(15,029)	**8,886**
Net income (loss) per share					
Basic	$ (0.09)	$ (0.25)	$ (0.25)	$ (0.45)	**$ 0.22**
Diluted	(0.09)	(0.25)	(0.25)	(0.45)	**0.20**
Weighted average common shares outstanding					
Basic	17,698	17,744	17,394	38,777	**66,932**
Diluted	17,698	17,744	17,394	38,777	**73,138**

Consolidated Balance Sheet Data

December 31,	1996	1997	1998	1999	**2000**
Cash, cash equivalents, and short-term marketable securities	$ 2,358	$ 187	$ 4,093	$ 129,848	**$ 126,473**
Working capital (deficit)	902	(1,328)	3,649	117,727	**122,422**
Long-term marketable securities	–	–	–	19,394	**17,734**
Total assets	3,038	1,672	7,766	177,735	**259,515**
Long-term obligations, less current maturities	24	122	322	4,000	**2,000**
Redeemable convertible preferred stock	3,000	3,153	8,313	–	**–**
Stockholders' equity (deficit)	(1,648)	(4,060)	(4,034)	146,385	**191,973**

Consolidated Balance Sheets

In thousands, except share and per share information

December 31,	1999	2000
Assets		
Current Assets:		
Cash and cash equivalents	$ 124,711	**$ 53,255**
Marketable securities	5,137	**73,218**
Accounts receivable, net of reserves of approximately $460 and $2,655 at December 31, 1999 and 2000, respectively	12,539	**52,440**
Unbilled services	782	**1,273**
Prepaid expenses and other current assets	1,908	**4,222**
Deferred tax asset	–	**3,556**
Total current assets	145,077	**187,964**
Property and Equipment, Net	5,465	**23,492**
Long-Term Marketable Securities	19,394	**17,734**
Other Assets	7,799	**13,246**
Deferred Tax Asset	–	**17,079**
	$ 177,735	**$ 259,515**
Liabilities and Stockholders' Equity		
Current Liabilities:		
Current maturities of long-term obligations	$ 3,000	**$ 2,000**
Accounts payable	11,285	**11,375**
Accrued expenses	4,728	**29,402**
Deferred revenue	8,337	**22,765**
Total current liabilities	27,350	**65,542**
Long-Term Obligations, Less Current Maturities	4,000	**2,000**
Commitments and Contingencies (Note 3 and 8)		
Stockholders' Equity:		
Preferred stock, $0.01 par value		
Authorized — 10,000,000 shares		
Issued and outstanding — no shares	–	**–**
Common stock, $0.01 par value		
Authorized — 100,000,000 shares and 500,000,000 shares at December 31, 1999 and 2000, respectively		
Issued and outstanding — 65,551,024 shares and 67,894,357 shares at December 31, 1999 and 2000, respectively	656	**679**
Additional paid-in capital	178,218	**209,338**
Deferred compensation	(3,628)	**(3,670)**
Accumulated deficit	(28,861)	**(14,374)**
Total stockholders' equity	146,385	**191,973**
	$ 177,735	**$ 259,515**

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

Consolidated Statements of Operations

In thousands, except share and per share information

Year ended December 31,	1998	1999	**2000**
Revenues:			
Product license	$ 4,059	$ 18,590	**$ 121,525**
Services	8,078	13,487	**41,817**
Total revenues	12,137	32,077	**163,342**
Cost of Revenues:			
Product license	30	8,160	**3,426**
Services	5,020	10,232	**34,739**
Total cost of revenues	5,050	18,392	**38,165**
Gross profit	7,087	13,685	**125,177**
Operating Expenses:			
Research and development	3,355	6,343	**18,966**
Sales and marketing	4,074	15,921	**73,261**
General and administrative	2,291	5,323	**22,791**
Stock-based compensation	107	1,127	**1,273**
Total operating expenses	9,827	28,714	**116,291**
Income (loss) from operations	(2,740)	(15,029)	**8,886**
Interest Income	54	2,018	**8,979**
Interest Expense	(165)	(121)	**–**
Income (loss) before provision for income taxes	(2,851)	(13,132)	**17,865**
Provision for Income Taxes	–	–	**3,378**
Net income (loss)	(2,851)	(13,132)	**14,487**
Accretion of Dividends, Discount and Offering Costs on Preferred Stock	(1,594)	(4,395)	**–**
Net income (loss) available for common stockholders	$ (4,445)	$ (17,527)	**$ 14,487**
Net Income (Loss) Per Share:			
Basic	$ (0.25)	$ (0.45)	**$ 0.22**
Diluted	$ (0.25)	$ (0.45)	**$ 0.20**
Weighted Average Common Shares Outstanding:			
Basic	17,934	38,777	**66,932**
Diluted	17,934	38,777	**73,138**

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

Consolidated Statements of Stockholders' Equity (Deficit)

In thousands, except share and per share information

	SERIES A&C CONVERTIBLE PREFERRED STOCK		COMMON STOCK					
	NUMBER OF SHARES	CARRYING VALUE	NUMBER OF SHARES	$ 0.01 PAR VALUE	ADDITIONAL PAID-IN CAPITAL	DEFERRED COMPENSATION	ACCUMULATED DEFICIT	STOCKHOLDERS' EQUITY (DEFICIT)
Balance, December 31, 1997	2,509,875	$2,461	17,813,400	$178	$191	$–	$(6,890)	$(4,060)
Sale of Series C convertible preferred stock	246,914	400	–	–	–	–	–	400
Issuance costs related to sale of Series D redeemable convertible preferred stock	–	–	–	–	–	–	(106)	(106)
Accretion of Series B and Series D redeemable convertible preferred stock to redemption value	–	–	–	–	–	–	(434)	(434)
Exercise of stock options	–	–	442,710	5	68	–	–	73
Deferred compensation related to stock option grants	–	–	–	–	1,799	(1,799)	–	–
Amortization of deferred compensation	–	–	–	–	–	107	–	107
Warrants issued in connection with the sale of Series D redeemable convertible preferred stock	–	–	–	–	2,775	–	–	2,775
Issuance of Series B redeemable convertible preferred stock warrants	–	–	–	–	1,053	–	(1,053)	–
Grants of options to consultants (Note 6(b))	–	–	–	–	4	–	–	4
Issuance of warrants (Note 3(d))	–	–	–	–	58	–	–	58
Net loss	–	–	–	–	–	–	(2,851)	(2,851)
Balance, December 31, 1998	2,756,789	2,861	18,256,110	183	5,948	(1,692)	(11,334)	(4,034)
Accretion of Series B and Series D redeemable convertible preferred stock redemption value	–	–	–	–	–	–	(2,576)	(2,576)
Exercise of stock options	–	–	1,956,820	20	815	–	–	835
Exercise of warrant	–	–	314,476	3	(3)	–	–	–

	Series A&C Convertible Preferred Stock		Common Stock					
	Number of Shares	Carrying Value	Number of Shares	$ 0.01 Par Value	Additional Paid-in Capital	Deferred Compensation	Accumulated Deficit	Stockholders' Equity (Deficit)
Deferred compensation related to stock option grants	–	–	–	–	3,063	(3,063)	–	–
Amortization of deferred compensation	–	–	–	–	–	1,127	–	1,127
Conversion of preferred stock into common stock	(2,756,789)	(2,861)	31,419,278	314	13,436	–	–	10,889
Common stock issued to the holders of Series C convertible preferred stock and Series D redeemable convertible preferred stock in lieu of special payments (Note 5)	–	–	242,500	2	1,817	–	(1,819)	–
Initial and follow-on public offerings of common stock	–	–	13,361,840	134	153,142	–	–	153,276
Net loss	–	–	–	–	–	–	(13,132)	(13,132)
Balance, December 31, 1999	–	–	65,551,024	656	178,218	(3,628)	(28,861)	146,385
Exercise of stock options of $23,057 related to the income tax benefit of disqualifying dispositions	–	–	2,164,234	21	27,705	–	–	27,726
Issuance of common stock in connection with the employee stock purchase plan	–	–	179,099	2	1,881	–	–	1,883
Options issued in connection with the acquisition of Toronto Technology Group, Inc	–	–	–	–	2,238	(2,019)	–	219
Amortization of deferred compensation	–	–	–	–	–	1,273	–	1,273
Reversal of deferred compensation	–	–	–	–	(704)	704	–	–
Net income	–	–	–	–	–	–	14,487	14,487
Balance, December 31, 2000	**–**	**$–**	**67,894,357**	**$679**	**$209,338**	**$(3,670)**	**$(14,374)**	**$191,973**

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

Consolidated Statements of Cash Flows

In thousands

Year Ended December 31,	1998	1999	2000
Cash Flows from Operating Activities:			
Net income (loss)	$ (2,851)	$ (13,132)	**$ 14,487**
Adjustments to reconcile net income (loss) to net cash (used in) provided by operating activities —			
Stock-based compensation	111	1,127	**1,273**
Non-cash interest expense related to issuance of warrants	18	40	**–**
Depreciation and amortization	347	836	**3,629**
Tax benefit from the exercise of stock options	–	–	**23,057**
Loss on disposal of fixed assets, net	–	120	**27**
Changes in operating assets and liabilities —			
Accounts receivable, net	(1,575)	(10,221)	**(39,901)**
Unbilled services	(93)	(491)	**(491)**
Prepaid expenses and other current assets	(112)	(1,795)	**(2,314)**
Deferred tax assets	–	–	**(20,635)**
Accounts payable	(128)	10,564	**90**
Accrued expenses	827	3,508	**24,674**
Deferred revenue	515	7,459	**14,428**
Net cash (used in) provided by operating activities	(2,941)	(1,985)	**18,324**
Cash Flows from Investing Activities:			
Purchases of marketable securities, net	–	(24,531)	**(66,421)**
Purchases of property and equipment	(623)	(5,579)	**(21,683)**
Acquisition of Petronio Technology Group, Inc.	–	–	**(600)**
Acquisition of The Toronto Technology Group, Inc.	–	–	**(5,191)**
(Increase) decrease in other assets	(44)	(690)	**563**
Net cash used in investing activities	(667)	(30,800)	**(93,332)**
Cash Flows from Financing Activities:			
Proceeds from exercise of stock options	73	835	**4,669**
Proceeds from employee stock purchase plan	–	–	**1,883**
Payments on long term obligations	–	–	**(3,000)**
Net proceeds from sale of Series C convertible preferred stock	400	–	**–**
Net proceeds from sales of Series D redeemable convertible preferred stock	7,394	–	**–**
Net proceeds from initial and follow-on public offerings of common stock	–	153,276	**–**
Proceeds from line of credit	1,496	–	**–**
Payment on line of credit	(1,800)	–	**–**
Payments on term loan to a bank	(167)	(319)	**–**
Proceeds from equipment line of credit	200	–	**–**

Years Ended December 31,	1998	1999	**2000**
Payments on capital lease obligations	(82)	(189)	**–**
Payments on equipment line of credit	–	(200)	**–**
Net cash provided by financing activities	7,514	153,403	**3,552**
Net Increase (Decrease) in Cash and Cash Equivalents	3,906	120,618	**(71,456)**
Cash and Cash Equivalents, Beginning of Period	187	4,093	**124,711**
Cash and Cash Equivalents, End of Period	$ 4,093	$ 124,711	**$ 53,255**
Supplemental Disclosure of Cash Flow Information:			
Cash paid during the period for interest	$ 143	$ 87	**$ –**
Cash paid during the period for income taxes	$ –	$ –	**$ 175**
Supplemental Disclosure of Non-cash Investing and Financing Activities:			
Accretion of dividends, discounts and special payments on Series B, Series C, and Series D convertible preferred stock	$ 434	$ 4,395	**$ –**
Value ascribed to Series B and Series D redeemable convertible preferred stock warrants	$ 3,828	$ –	**$ –**
Equipment acquired under capital leases	$ 87	$ –	**$ –**
Original issue discount related to warrants issued to a bank	$ 58	$ –	**$ –**
Conversion of preferred stock into common stock	$ –	$ 13,750	**$ –**
Value ascribed to options issued in connection with the acquisition of The Toronto Technology Group Inc	$ –	$ –	**$ 2,238**
Income tax effect of disqualifying dispositions	$ –	$ –	**$ 23,057**
In connection with the acquisition of The Toronto Technology Group Inc., the following non-cash transaction occurred:			
Fair value of tangible assets acquired	$ –	$ –	**$ 699**
Intangible assets acquired	–	–	**5,124**
Liabilities assumed	–	–	**(632)**
Cash paid for acquisition including acquisition costs	$ –	–	**$ 5,191**

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

Notes to Consolidated Financial Statements

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Art Technology Group, Inc. (ATG or the Company) is a Delaware company which was incorporated on December 31, 1991. ATG offers an integrated suite of Internet customer relationship management and electronic commerce software applications, as well as related application development, integration and support services.

The accompanying consolidated financial statements reflect the application of certain significant accounting policies, as described below and elsewhere in the accompanying notes to the consolidated financial statements.

a. Principles of Consolidation

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

b. Use of Estimates

The preparation of consolidated 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.

c. Public Offerings of Common Stock

On July 26, 1999, ATG closed its initial public offering of 10,000,000 shares of common stock at a public offering price of $6 per share. The net proceeds to ATG from the offering were approximately $54,302,000. On July 30, 1999, in connection with the exercise of the underwriters' over-allotment option, ATG issued an additional 336,000 shares of common stock at the initial public offering price of $6 per share. Net proceeds to ATG from the exercise of the over-allotment option were approximately $1,875,000. In connection with ATG's initial public offering in July 1999, all shares of preferred stock were converted into 31,419,278 shares of common stock.

On November 10, 1999, ATG closed its follow-on public offering of 9,000,000 shares of common stock, of which 2,850,000 shares were sold by the Company at a public offering price of $33.75. The net proceeds to ATG from the offering were approximately $91,428,000. On November 22, 1999, in connection with the exercise of the underwriters' over-allotment option, ATG issued an additional 175,840 shares of common stock at the public offering price of $33.75 per share. Net proceeds to ATG from the exercise of the over-allotment option were approximately $5,671,000.

d. Revenue Recognition

ATG recognizes product license revenue from licensing the rights to use its software to end-users. ATG also generates service revenues from integrating its software with its customers' operating environments, the sale of maintenance services and the sale of certain other consulting and development services. ATG generally has separate agreements with its customers, which govern the terms and conditions of its software license, consulting and support and maintenance services. These separate agreements, along with ATG's price list and business practices, provide the basis for establishing vendor-specific objective evidence of fair value. This allows ATG to appropriately allocate fair value among the multiple elements in an arrangement.

ATG recognizes revenue in accordance with Statement of Position (SOP) No. 97-2, *Software Revenue Recognition* and SOP 98-9, *Modification of* SOP 97-2, *Software Revenue Recognition*, *with Respect to Certain Transactions*. Revenues from software product license agreements are recognized upon execution of a license agreement and delivery of the software, provided that the fee is fixed or determinable and deemed collectible by management. If conditions for acceptance are required subsequent to delivery, revenues are recognized upon customer acceptance if such acceptance is not deemed to be perfunctory. In multiple element arrangements, ATG uses the residual value method in accordance with SOP 97-2 and SOP 98-9. Revenues from software maintenance agreements are recognized ratably over the term of the maintenance period, which is typically one year. ATG enters into reseller arrangements that typically provide for sublicense fees payable to ATG based upon a percentage of ATG's list price. Revenues are recognized under reseller agreements as earned, which is generally ratably over the life of the reseller agreement, for guaranteed minimum royalties or based upon actual sales by the resellers. ATG does not grant its resellers the right of return or price protection. Revenues from professional service arrangements are recognized on either a time-and-materials or percentage-of-completion basis as the services are performed, provided that amounts due from customers are fixed or determinable and deemed collectible by management. Amounts collected or billed prior to satisfying the above revenue recognition criteria are reflected as deferred revenue. Unbilled services represent service revenues that have been earned by ATG in advance of billings.

e. Net Income (Loss) Per Share

Net income (loss) per share is computed under Statement of Financial Accounting Standards (SFAS) No. 128, *Earnings Per Share*. Basic net income (loss) per share is computed by dividing net income (loss) available for common stockholders by the weighted average number of shares of common stock outstanding during the period. Diluted net income (loss) per share is computed by dividing net income (loss) available for common stockholders by the weighted average number of shares of common stock outstanding, including potential common shares from exercise of stock options and warrants using the treasury stock method, if dilutive. The following table sets forth basic and diluted net income (loss) per share computational data for the years ended December 31, 1998, 1999 and 2000 (in thousands, except per share amounts):

	1998	1999	**2000**
Net income (loss) available for common stockholders	$(4,445)	$(17,527)	**$14,487**
Weighted average common shares outstanding used in computing basic net income (loss) per share	17,934	38,777	**66,932**
Weighted average common equivalent shares outstanding:			
Employee common stock options(1)(2)	–	–	**6,206**
Total weighted average common and common equivalent shares outstanding used in computing diluted net income (loss) per share	17,934	38,777	**73,138**
Basic net income (loss) per share	$(0.25)	$(0.45)	**$0.22**
Diluted net income (loss) per share	$(0.25)	$(0.45)	**$0.20**

(1) Options and warrants to purchase a total of 11,366,000 and 8,348,000 common shares have been excluded from the computation of diluted weighted average shares outstanding for the years ended December 31, 1998 and 1999, as the effect of their inclusion would have been anti-dilutive.

(2) Options to purchase a total of 3,902,173 weighted shares of common stock outstanding for the year ended December 31, 2000 were excluded from the calculation of diluted net income per share because the exercise prices of those options exceeded the average market price of common stock during the periods, as the effect of their inclusion would have been anti-dilutive.

Notes to Consolidated Financial Statements
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f. Cash, Cash Equivalents and Marketable Securities

ATG accounts for investments under SFAS No. 115, *Accounting for Certain Investments in Debt and Equity Securities*. Under SFAS No. 115, investments for which ATG has the positive intent and the ability to hold to maturity, consisting of cash equivalents and marketable securities, are reported at amortized cost, which approximates fair market value. Cash equivalents are highly liquid investments with original maturities of less than 90 days. Marketable securities are investment grade securities with original maturities of greater than 90 days. At December 31, 1999 and 2000, all of ATG's marketable securities were held in commercial paper and corporate bonds and were classified as held-to-maturity. The average maturity of ATG's marketable securities is approximately 13.6 months and 11.4 months at December 31, 1999 and 2000, respectively. At December 31, 1999 and 2000, the difference between the amortized cost and market value of ATG's marketable securities was approximately $24,000 and $181,000, respectively. At December 31, 1999 and 2000, ATG's cash, cash equivalents and marketable securities consisted of the following (in thousands):

December 31,	1999	**2000**
Cash and cash equivalents—		
Cash	$ 884	**$ 4,880**
Money market accounts	123,827	**35,314**
Corporate securities	–	**13,061**
Total cash and cash equivalents	$ 124,711	**$ 53,255**
Marketable securities—		
Corporate securities	$ 24,531	**$ 90,952**
Total marketable securities	$ 24,531	**$ 90,952**

g. Property and Equipment

Property and equipment are stated at cost, net of accumulated depreciation and amortization. ATG provides for depreciation and amortization using the straight-line method and it charges to operations the amounts estimated to allocate the cost of the assets over their estimated useful lives. Property and equipment at December 31, 1999 and 2000 consisted of the following (in thousands):

December 31,	Estimated useful life	1999	**2000**
Computer equipment	3 years	$ 3,577	**$ 9,786**
Leasehold improvements	lesser of useful life or life of lease	1,721	**11,990**
Furniture and fixtures	7 years	1,321	**4,496**
Computer software	3 years	530	**2,011**
		7,149	**28,283**
Less — Accumulated depreciation and amortization		1,684	**4,791**
		$ 5,465	**$ 23,492**

Depreciation expense included in the accompanying statements of operations was approximately $347,000, $836,000 and $3,768,000 for the years ended December 31, 1998, 1999 and 2000, respectively.

h. Research and Development Expenses for Software Products

ATG has evaluated the establishment of technological feasibility of its products in accordance with SFAS No. 86, *Accounting for the Cost of Computer Software to be Sold, Leased, or Otherwise Marketed*. ATG sells products in a market that is subject to rapid technological change, new product development and changing customer needs; accordingly, ATG has concluded that technological feasibility is not established until the development stage of the product is nearly complete. ATG 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 ATG's financial position or results of operations. Therefore, ATG has charged all such costs to research and development in the period incurred.

i. Income Taxes

ATG accounts for income taxes in accordance with the provisions of SFAS No. 109, *Accounting for Income Taxes*. This statement requires ATG to recognize a current tax asset or liability for current taxes payable or refundable and to record a deferred tax asset or liability for the estimated future tax effects of temporary differences and carry forwards to the extent that they are realizable. A deferred tax provision or benefit results from the net change in deferred tax assets and liabilities during the year. A deferred tax valuation allowance is required if it is more likely than not that all or a portion of the recorded deferred tax assets will not be realized (see Note 4).

j. Stock-Based Compensation

SFAS No. 123, *Accounting for Stock-Based Compensation*, requires the measurement of the fair value of stock options or warrants to be included in the statement of operations or disclosed in the notes to financial statements. ATG has determined that it will continue to account for stock-based compensation for employees under the Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees*, and elect the disclosure-only alternative under SFAS No. 123 (see Note 6(b)).

k. Comprehensive Income (Loss)

ATG's comprehensive income (loss) is equal to its reported consolidated net income (loss) for all periods presented.

l. Fair Value of Financial Instruments

Financial instruments consist mainly of cash and cash equivalents, marketable securities, accounts receivable, accounts payable and long-term obligations. The carrying amounts of these instruments approximate their fair value.

m. Concentrations of Credit Risk

SFAS No. 105, *Disclosure of Information About Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk*, requires disclosure of any significant off-balance-sheet and credit risk concentrations. ATG has no significant off-balance-sheet concentrations such as foreign exchange contracts, option contracts or other foreign hedging arrangements. To reduce its credit risk, the Company routinely assesses the financial strength of its customers. ATG maintains an allowance for potential credit losses but historically has not experienced any significant losses related to individual customers or groups of customers in any particular industry or geographic area. ATG places its cash, cash equivalents and marketable securities in several accredited financial institutions. ATG has not experienced any material losses to date.

For the years ended December 31, 1999 and 2000, no customers accounted for more than 10% of the Company’s total revenues. For the year ended December 31, 1998, three customers each accounted for 17%, 10% and 10% of the Company's total revenues.

As of December 31, 2000, no customers accounted for greater than 10% of accounts receivable. As of December 31, 1999, one customer accounted for 12% of accounts receivable.

n. Long-Lived Assets

The Company assesses the realizability of intangible assets in accordance with SFAS No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed of*. Under SFAS No.121, the Company is required to assess the valuation of its long-lived assets, including intangible assets, based on the estimated cash flows to be generated by such assets. The Company believes that no material impairment of long-lived assets exist at December 31, 2000.

Notes to Consolidated Financial Statements
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o. Foreign Currency Translation
The financial statements of the Company's foreign subsidiaries are translated in accordance with SFAS No. 52, *Foreign Currency Translation*. The functional currency of the Company's foreign subsidiaries is the U.S. dollar. Accordingly, all assets and liabilities of the foreign subsidiaries are translated using the exchange rate at the balance sheet date, except for property and equipment, other assets and stockholders' equity, which are translated at historical rates. Revenues and expenses are translated at historical rates. Translation gains and losses arising from the translations were not material to the financial statements taken as a whole for the year ended December 31, 2000.

p. Recent Accounting Pronouncements
In September 2000, the Financial Accounting Standards Board (FASB) issued SFAS No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities* which supercedes SFAS No. 125. SFAS No. 140 provides accounting and reporting standards for transfers and servicing of financial assets and extinguishments of liabilities. SFAS No. 140 is effective for transfers and servicing of financial assets and extinguishments of liabilities occurring after March 31, 2001 and for recognition and reclassification of collateral and for disclosures relating to securitization transactions and collateral for fiscal years ending after December 15, 2000. The Company does not expect the adoption of SFAS No. 140 to have a material impact on the results of its consolidated financial position or results of operations.

In June 1998, the FASB issued SFAS No. 133, A*ccounting for Derivative Instruments and Hedging Activities*. As amended in June 1999 by SFAS No. 137, the statement is effective for all fiscal quarters of all fiscal years beginning after June 15, 2000. In June 2000, the FASB issued SFAS No. 138, *Accounting for Certain Derivative Instruments and Certain Hedging Activities* which is a significant amendment to SFAS No. 133. SFAS No. 133 and its amendments establish accounting and reporting standards for derivative instruments, including certain derivative instruments embedded in other contracts (collectively referred to as derivatives) and for hedging activities. The Company does not expect the adoption of these statements to have a material impact on its consolidated financial position or results of operations.

2. DISCLOSURES ABOUT SEGMENTS OF AN ENTERPRISE
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 for those segments to be presented in interim financial reports issued to stockholders. SFAS No. 131 also establishes standards for related disclosures about products and services and geographic areas. 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 how to allocate resources and assess performance. The Company's chief operating decision-makers, as defined under SFAS No. 131, is its executive management team. To date, the Company has viewed its operations and manages its business as principally one segment with two product offerings: software licenses and services. The Company evaluates these product offerings based on their respective gross margins. As a result, the financial information disclosed herein represents all of the material financial information related to the Company's principal operating segment.

Revenues from sources outside of the United States were approximately $850,000, $2,245,000, and $37,569,000 in 1998, 1999 and 2000, respectively. ATG's revenues from international sources were primarily generated from customers located in Europe and Asia Pacific. All of the ATG's product sales for the years ended December 31, 1998, 1999 and 2000 were delivered from its headquarters located in the United States.

The following table represents the percentage of total revenues by geographic region from customers for 1998,1999 and 2000:

December 31,	1998	1999	**2000**
United States	93%	93%	**77%**
Europe, Middle East and Africa	4	6	**19**
Asia Pacific	–	1	**2**
Other	3	–	**2**
	100%	100%	**100%**

3. LONG-TERM OBLIGATIONS

a. Credit Facility

ATG has a working capital line-of-credit agreement with a bank, which provides for borrowings of up to the lesser of $12,500,000 or 80% of eligible accounts receivable. The line of credit bears interest at the bank's prime rate (9.5% at December 31, 2000) and expires in 2001. As of December 31, 2000 approximately $5,077,000 was available for future borrowings. The working capital line of credit is secured by all of ATG's tangible and intangible intellectual and personal property and is subject to financial covenants and restrictions, including minimum liquidity requirements and a prohibition on the payment of dividends. As of December 31, 2000, ATG was in compliance with all covenants. As of December 31, 2000, there were no amounts outstanding under the working capital line of credit; however, ATG had commitments totaling approximately $7,423,000 in the form of outstanding standby letters of credit in favor of ATG's various landlords to secure obligations under ATG's facility leases.

b. Non-Recourse Receivables Purchase Agreement with a Bank

In September 2000, ATG entered into a Non-Recourse Receivables Purchase Agreement with a bank (the Receivables Agreement), whereby ATG can sell up to $10.0 million of its accounts receivable to the bank. Under the terms of the Receivables Agreement, ATG can sell certain accounts receivable, subject to acceptance by the bank, on a non-recourse basis. Upon purchase, the bank assumes the risk of collection for the acquired accounts receivable except in the event that ATG violates the terms of the receivables purchase agreement or the customer asserts a discount, allowance, warranty claim or right of return. The accounts receivable are sold at a discount to reflect a minimum of 45 days and a maximum of 135 days at the bank's prime rate (9.5% at December 31, 2000) plus 1%. This agreement will expire in September 2001. In September 2000, ATG sold $9.6 million of accounts receivable to the bank under the Receivables Agreement. ATG has determined that, in accordance with SFAS No. 125 *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* and SFAS No. 140, the transaction is accounted for as a sale of accounts receivable and accordingly has reduced accounts receivable by the amount of the accounts receivable which have been sold in the accompanying consolidated balance sheets. As of December 31, 2000, $3,906,000 of the sold receivables were uncollected. For the year ended December 31, 2000, ATG incurred approximately $166,000 in expenses related to this transaction.

c. Equipment Line of Credit

On July 2, 1998, ATG entered into an equipment line of credit with a bank. Under the equipment line of credit, ATG could borrow up to $200,000 for capital expenditures. During 1998, ATG borrowed $199,915, all of which was outstanding as of December 31, 1998. Borrowings bore interest at the bank's prime rate plus 1.25%. In July 1999, in connection with ATG's initial public offering, ATG repaid all outstanding amounts under the line of credit.

In April 1999, ATG entered into an additional equipment line of credit with the same bank. Under the equipment line of credit, ATG may borrow up to $200,000 for capital expenditure purchases. Borrowings bear interest at the bank's prime rate (9.5% at December 31, 2000) plus 0.75%. Interest accrues and is payable monthly. Principal is due in 30 monthly installments following a six-month interest-only period. The equipment line of credit expired during the year ended December 31, 2000.

d. Term Note Payable to a Bank

ATG entered into a term note payable with a bank under which ATG could have borrowed up to $500,000 based upon certain conditions, as defined. Borrowings bore interest at the bank's prime rate plus 1%. During July 1999, in connection with ATG's initial public offering, all amounts were repaid. In connection with the term note payable, ATG issued warrants to purchase 56,296 shares of Series C convertible preferred stock to the bank. One warrant provided for the purchase of 46,296 shares at an exercise price of the stock of $1.62 per share and the other warrant provided for the purchase of 10,000 shares at an exercise price of $0.01 per share. These warrants vested immediately. ATG valued the warrants at $58,000, using the Black-Scholes option pricing model and the following assumptions: fair market value of $1.62; risk free interest rate of 4.74%; an expected volatility factor of 70%; an expected life of four years; and an expected dividend yield of zero. The warrants were recorded as a debt discount. For the years ended December 31, 1998 and 1999, ATG amortized $18,000 and $40,000, respectively. In July 1999, in connection with ATG's accelerated debt repayment, ATG amortized the remainder of the debt discount. In connection with ATG's initial public offering, the warrants were converted into warrants to purchase 342,970 shares of common stock. In July 1999, the warrants to purchase 342,970 shares of common stock were exercised through a cashless exercise resulting in the net issuance of 314,476 shares of common stock.

Notes to Consolidated Financial Statements
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e. BroadVision Settlement

In connection with a settlement of the patent infringement claim by BroadVision, ATG acquired a perpetual, paid-up license for BroadVision's patented technology. ATG paid $11,000,000 during the year ended December 31, 2000 and will pay the remaining $4,000,000 over the next two years in quarterly installments of $500,000. At December 31, 1999, these payments are included in the accompanying consolidated balance sheet as follows: $8,000,000 in accounts payable, $3,000,000 in current maturities of long-term obligations and $4,000,000 in long-term obligations. At December 31, 2000, these payments are included in the accompanying consolidated balance sheet as follows: $2,000,000 in current maturities of long-term obligations and $2,000,000 in long-term obligations. ATG expended $8,000,000 and $2,333,000 of the settlement as cost of service revenues in the years ended December 31, 1999 and 2000, respectively, and is amortizing the remainder over its remaining estimated life of two years.

4. INCOME TAXES

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

Year Ended December 31,	1998	1999	**2000**
Domestic	$ (2,851)	$ (13,132)	**$ 16,651**
Foreign	-	-	**1,214**
Total	$ (2,851)	$ (13,132)	**$ 17,865**

The provision for income taxes shown in the accompanying consolidated statements of operations is composed of the following (in thousands):

Year Ended December 31,	1998	1999	**2000**
Federal			
Current	$ –	$ –	**$ 8,780**
Deferred	–	–	**(7,385)**
State			
Current	–	–	**1,789**
Deferred	–	–	**(1,533)**
Foreign			
Current	–	–	**1,727**
	$ –	$ –	**$ 3,378**

The provision for income taxes differs from the federal statutory rate due to the following:

Year Ended December 31,	1998	1999	2000
Federal tax at statutory rate	34.0%	34.0%	**35.0%**
State taxes net of federal benefit	6.0	6.0	**6.5**
Meals and entertainment	–	–	**6.1**
Deferred compensation	–		**4.9**
Other	–	–	**1.8**
Valuation allowance	(40.0)	(40.0)	**(35.4)**
	– %	– %	**18.9%**

The components of the net deferred tax asset recognized in the accompanying consolidated balance sheets are as follows (in thousands):

December 31,	1999	2000
Deferred tax assets	$ –	**$ 20,846**
Deferred tax liabilities		**(211)**
	$ –	**20,635**

The approximate tax effect of each type of temporary difference and carryforward is as follows (in thousands):

December 31,	1999	2000
Cumulative temporary differences	$ 4,154	**$ 6,882**
US Income tax credits	642	**642**
Net operating losses	3,555	**14,110**
Acquisition related	–	**(999)**
Valuation allowance	(8,351)	**–**
	$ –	**$ 20,635**

Notes to Consolidated Financial Statements
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As of December 31, 2000, ATG had net operating loss carry forwards of approximately $42.2 million for federal income tax purposes and approximately $49.6 million for state income tax purposes. Approximately $31.8 million of the federal and state income tax net operating loss carry forwards relate to the exercise of incentive and nonqualified stock options which are treated as compensation deductions for federal and state income tax purposes. ATG also has available federal tax credit carry forwards of approximately $642,000. If not utilized, these carry forwards will expire at various dates beginning 2011 and ending 2020. If substantial changes in ATG's ownership should occur, as defined by Section 382 of the Internal Revenue Code (the Code), there could be annual limitations on the amount of carry forwards that can be realized in future periods. ATG has completed several refinancings since its inception and has incurred ownership changes, as defined under the Code. ATG does not believe that those changes in ownership will have a material impact on its ability to use its net operating loss and tax credit carry forwards.

5. PREFERRED STOCK

As of December 31, 1998, ATG's Board of Directors had authorized 10,000,000 shares of preferred stock and had designated 1,300,000, 851,064, 2,000,000 and 2,343,750 shares as Series A convertible preferred stock (Series A Preferred Stock), Series B redeemable convertible preferred stock (Series B Preferred Stock), Series C convertible preferred stock (Series C Preferred Stock) and Series D redeemable convertible preferred stock (Series D Preferred Stock), respectively. On July 26, 1999, in conjunction with ATG's initial public offering, all outstanding shares of preferred stock were converted into shares of common stock. Additionally, all authorized shares were cancelled.

In conjunction with the issuance of the Series B Preferred Stock in December 1996, ATG issued to a holder of Series B Preferred Stock a performance-based warrant to purchase up to 425,532 shares of Series B Preferred Stock at $7.05 per share. The performance criteria was based upon sales generated by ATG from the affiliates of the Series B Stockholder. ATG generated negligible revenues from the affiliates of the Series B Stockholder; therefore, the warrant was not measured or recorded. As a condition for obtaining the Series B Stockholder's approval of the terms of the Series D Preferred Stock financing in 1999, the warrant was canceled and ATG granted to the Series B Preferred Stockholder a new warrant to purchase 425,532 shares of ATG's Series B Preferred Stock at a purchase price of $1.385 per share, which was immediately exercisable and fully vested. The warrant was to expire on the earlier of: (1) the closing of a public offering of ATG's common stock, as defined, at a price of at least $10 per share resulting in gross proceeds to ATG of at least $10,000,000, (2) the closing of a liquidation, merger, sale of all or substantially all assets of ATG or other similar event, as defined, or (3) August 18, 2003. ATG has valued this warrant at $1,053,000, using the Black-Scholes option pricing model and the following assumptions: a fair market value of $3.20 per share, a risk-free interest rate of 5.0%, an expected volatility of 70%, an expected life of five years, and an expected dividend yield of zero. ATG has recorded the value of the warrant in the accompanying statement of stockholders' equity (deficit) and as a component of dividends on preferred stock in computing net loss per share available to common stockholders for the year ended December 31, 1999.

In addition, in connection with the issuance of the Series D Preferred Stock, ATG issued to the holders of Series D Preferred Stock, warrants to purchase up to 4,292,650 shares of ATG's common stock at $0.11 per share, adjusted for certain dilutive events, as defined. The warrants were to vest 5% per quarter beginning on September 30, 1998 and expire August 18, 2003. ATG valued these warrants using the Black-Scholes option pricing model and the following assumptions: a fair market value of $3.20 per share, a risk free interest rate of 4.74%, an expected volatility of 70%, an expected life of five years and an expected dividend yield of zero. ATG allocated the consideration received from the sale of the Series D Preferred Stock of $7,500,000 between the Series D Preferred Stock and warrants on the basis of the fair value of the individual component at the date of issuance and determined that the warrants were valued at $2,775,000. These warrants were recorded as a discount to the Series D Preferred Stock and the resulting discount was amortized over the redemption period in computing net loss per share. For the years ended December 31, 1999 and 1998, ATG amortized $2,491,000 and $284,000, respectively. The amortization for the year ended December 31, 1999 included the accelerated amortization in connection with the conversion of the Series D Preferred Stock in connection with the initial public offering.

In conjunction with ATG's initial public offering, the warrants to purchase Series B Preferred Stock and common stock were canceled and the number of shares of common stock issuable upon conversion of the Series B and D Preferred Stock were increased to reflect the shares that would have been received upon exercise of the warrants based upon the initial public offering price.

6. STOCKHOLDERS' EQUITY

a. Stock Splits and Authorized Shares of Common Stock

ATG's authorized capital stock at December 31, 2000 consists of 10,000,000 shares of $0.01 par value preferred stock and 500,000,000 shares of $0.01 par value common stock.

On February 28, 2000, ATG's Board of Directors approved a 2-for-1 stock split of ATG's common stock. The split was effective on March 10, 2000. In addition, on May 10, 1999, ATG's Board of Directors approved a 3-for-2 stock split of ATG's common stock. The stock split was effective on June 18, 1999. All share and per share amounts of common stock for all periods have been retroactively adjusted to reflect the stock splits.

b. Stock Plans

1996 Stock Option Plan

In April 1996, the 1996 Stock Option Plan (the 1996 Plan) was approved by ATG's Board of Directors and stockholders. The purpose of the 1996 Plan is to reward employees, officers and directors, and consultants and advisors to ATG who are expected to contribute to the growth and success of ATG. The 1996 Plan provides for the award of options to purchase shares of ATG's common stock.

Stock options granted under the 1996 Plan may be either incentive stock options or nonqualified stock options.

The 1996 Plan is administered by the Board of Directors, which has the authority to designate participants, determine the number and type of options to be granted, the time at which options are exercisable, the method of payment and any other terms or conditions of the options. Options generally vest annually over a two- to four-year period and expire 10 years from the date of grant.

While the Board determines the prices at which options may be exercised under the 1996 Plan, the exercise price of an incentive stock option shall be at least 100% (110% for incentive stock options granted to a 10% stockholder) of the fair market value of ATG's common stock on the date of grant. A total of 19,600,000 shares of common stock have been reserved for options to be granted under the 1996 Plan. As of December 31, 2000, there are 4,469,000 shares available for future grant under the 1996 Plan.

Additionally, in May 1999, ATG granted 150,000 options outside ATG's stock option plans to an executive of ATG. At December 31, 2000 these options have not been exercised.

1999 Outside Director Stock Option Plan

The 1999 Outside Director Stock Option Plan (Director Plan) was adopted by ATG's Board of Directors and approved by stockholders in May 1999. Under the terms of the Director Plan, nonemployee directors of ATG receive nonqualified options to purchase shares of common stock. A total of 300,000 shares of common stock have been reserved under the Director Plan.

Under the terms of the Director Plan, each currently active nonemployee director received an option to purchase 10,000 shares of common stock on the effective date of the Company's initial public offering at the public offering price. Individuals who become directors after the initial public offering and are not employees of ATG will receive an option to purchase 10,000 shares of our common stock on the date of initial election to ATG's Board of Directors at an exercise price equal to the then current fair market value. In addition, each non-employee director will receive an option to purchase 5,000 shares of common stock on the date of each annual meeting of stockholders commencing in the year 2000 at an exercise price per share equal to the closing price of ATG's common stock on the date of grant. All options granted under the Director Plan will be fully vested upon grant. As of December 31, 2000, there are 215,000 shares available for future grant under the Director Plan.

1999 Employee Stock Purchase Plan

The 1999 Employee Stock Purchase Plan (the Stock Purchase Plan) was adopted by ATG's Board of Directors and approved by stockholders in May 1999. The Stock Purchase Plan authorizes the issuance of up to a total of 1,000,000 shares of ATG's common stock to participating employees. All ATG employees, including directors who are employees, are eligible to participate in the Stock Purchase Plan. Employees who would immediately after the grant own 5% or more of the total combined voting power or value of our stock are not eligible to participate. During each designated semiannual offering period, each eligible employee may deduct between 1% to 10% of base pay to purchase common stock of ATG. The purchase price will be 85% of the closing market price of ATG's common stock on either: (1.) the first business day of the offering period or (2). the last business day of the offering period, whichever is lower.

ATG accounts for the Stock Purchase Plan in accordance with APB No. 25 and, accordingly, no compensation cost has been recognized under the Stock Purchase Plan. ATG has elected the "disclosure only" alternative under SFAS No. 123.

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The following table summarizes ATG's option activity (in thousands, except per share information):

	Number of Shares	Exercise Price	Weighted Average Exercise Plan
Outstanding, December 31, 1997	4,280	$.07 –.25	$.18
Granted	3,272	.25	.25
Exercised	(442)	.07 –.25	.17
Canceled	(1,232)	.07 –.25	.22
Outstanding, December 31, 1998	5,878	.07 –.25	.22
Granted	4,960	1.00 – 52.50	14.52
Exercised	(1,957)	.07 – 5.75	.40
Canceled	(543)	.07 – 5.75	1.20
Outstanding, December 31, 1999	8,338	.07 – 52.50	8.65
Granted	4,917	.06 – 120.00	66.93
Exercised	(2,164)	.07 – 81.56	2.23
Canceled	(549)	.06 – 120.00	22.25
Outstanding, December 31, 2000	10,542	$.06 – 120.00	$36.42
Exercisable, December 31, 2000	2,297	$.06–120.00	$13.81
Exercisable, December 31, 1999	2,200	$ .07–19.03	$ 1.16
Exercisable, December 31, 1998	2,488	$ .07–.25	$ .19

The following table summarizes information relating to currently outstanding and exercisable options as of December 31, 2000 (in thousands except per share information):

	Outstanding			Exercisable	
Range of Exercise price	Number of Shares	Weighted Average Remaining Contractual Life Outstanding (Years)	Weighted Average Exercise Price	Number of Shares	Weighted Average Exercise Price
$.06 – $.08	150	6.0	$ .08	140	$ .08
.25	1,655	7.3	.25	758	.25
1.00 – 1.33	606	8.1	1.14	232	1.14
1.67 – 2.00	119	8.2	1.79	33	1.85
4.00 – 6.00	1,996	8.4	4.85	578	4.94
11.61 – 13.41	214	8.7	13.38	62	13.40
19.03 – 28.13	147	8.8	19.19	34	19.03
28.56 – 40.88	868	9.9	33.88	12	32.37
44.00 – 65.69	2,211	9.2	52.07	311	52.03
67.88 – 95.00	2,127	9.5	79.83	135	74.84
101.94 – 120.00	449	9.6	118.00	2	101.94
	10,542	8.8	$ 36.42	2,297	$ 13.81

In the year ended December 31, 1998, ATG granted 30,000 nonqualified stock options exercisable at $0.25 per share, which are fully vested, to consultants as payment for services performed. ATG recorded an expense for the year ended December 31, 1998 related to this grant of $4,000. ATG valued the options issued in exchange for services based upon the Black-Scholes option pricing model and the following assumptions: a fair market value of $0.81; risk-free interest at 4.74%; an expected volatility factor of 70%; an expected life of four years; and an expected dividend yield of zero. The options expire 10 years from the date of grant.

Since the fourth quarter of 1998, ATG has recorded deferred compensation of approximately $4.9 million, which represents the aggregate difference between the exercise price and the fair market value of the common stock, as determined for accounting purposes. The deferred compensation is being recognized as an expense over the vesting period of the underlying stock options. ATG recorded compensation expense of $107,000, $1,127,000, and $1,013,000 for the years ended December 31, 1998, 1999, and 2000, respectively, related to these options.

ATG has computed the pro forma disclosures required under SFAS No. 123 for options granted during the years ended December 31, 1998, 1999 and 2000. The fair value of options granted during the years ended December 31, 1998, 1999 and 2000 was approximately $462,000 or $0.07 per share, $53,234,000 or $10.84 per share and $256,901,000 or $52.64 per share, respectively. These amounts will be amortized over the underlying option period. The amounts were computed using the Black-Scholes option pricing model prescribed by SFAS No. 123. The assumptions used and weighted average calculations are as follows:

Years Ended December 31,	1998	1999	**2000**
Risk-free interest rate	5.00%	5.29-6.06%	**5.92%**
Expected dividend yield	–	–	–
Expected lives	4 years	4 years	**4 years**
Expected volatility	70%	95%	**115%**
Weighted average remaining contractual life of options outstanding	8.40 years	8.90 years	**8.80 years**

Notes to Consolidated Financial Statements
continued

Had compensation expense for ATG's stock option plans been determined consistent with SFAS No. 123, the pro forma net loss available for common stockholders and pro forma net loss per share would have been as follows (in thousands except per share information):

Year Ended December 31,	1998	1999	**2000**
Net income (loss) available for common stockholders —			
As reported	$ (4,445)	$ (17,527)	**$ 14,487**
Pro forma	$ (4,755)	$ (20,225)	**$ (13,786)**
Basic net income (loss) per share —			
As reported	$ (0.25)	$ (0.45)	**$ 0.22**
Pro forma	$ (0.27)	$ (0.52)	**$ (0.21)**
Diluted net income (loss) per share —			
As reported	$ (0.25)	$ (0.45)	**$ 0.20**
Pro forma	$ (0.27)	$ (0.52)	**$ (0.21)**

7. ACQUISITIONS

On June 1, 2000, ATG completed the acquisition of Petronio Technology Group, a Boston-based provider of educational training and consulting services. ATG acquired Petronio Technology Group for $1,200,000, consisting of an initial payment of $600,000 at the closing and two annual contingent payments of $300,000 each. The acquisition has been accounted for under the purchase method of accounting and the results of operations for Petronio Technology Group have been included in ATG's results from the acquisition date. ATG recorded $600,000 in goodwill that is being amortized over two years and the Company is recognizing the contingent payments as compensation expense ratably over the two-year vesting period. For the year ended December 31, 2000, ATG recorded amortization expense of $188,000 and compensation expense of $188,000.

On July 17, 2000, ATG completed the acquisition of The Toronto Technology Group, Inc., a privately held 30-person consulting and educational services company based in Toronto, Canada, for approximately $12.0 million in cash, options and shares of common stock. The acquisition has been accounted for under the purchase method of accounting. Upon the closing of the transaction, ATG paid $5.2 million in cash, issued 19,634 employee stock options and also issued 56,237 exchangeable shares of ATG's subsidiary Art Technology Group (Canada), Inc. The exchangeable shares will become exchangeable for 56,237 shares of ATG's common stock, subject to a three-year vesting schedule. As of December 31, 2000, no shares are exchangeable. ATG allocated $2.75 million of the purchase price to the acquired workforce which is being amortized over five years. The remainder of the purchase price has been allocated to goodwill and is being amortized ratably over five years. Additionally, ATG is recording the value of the stock options and exchangeable shares of $7.5 million as compensation expense over three years. For the year ended December 31, 2000, ATG recorded compensation expense relating to the stock options and exchangeable shares of approximately $1,228,000. Additionally, amortization expense of approximately $482,000 was recorded based on the intangible assets.

8. COMMITMENTS AND CONTINGENCIES

Leases

In August 1999, ATG entered into a new facility lease for its corporate headquarters that expires in August 2006. Upon occupancy of the new facility, ATG has issued the lessor a letter of credit in the amount of $1,500,000 as a security deposit. Additionally, ATG has offices, primarily for sales and support personnel, in ten domestic locations as well as ten foreign countries.

The approximate future minimum payments of ATG's facility leases and certain operating equipment leases as of December 31, 2000 are as follows (in thousands):

Year Ended December 31,	Operating Leases
2001	**$ 9,084**
2002	**10,327**
2003	**10,259**
2004	**8,958**
2005	**9,660**
Thereafter	**33,266**
Total future minimum lease payments	**$ 81,554**

Rent expense included in the accompanying statements of operations was approximately $810,000, $1,752,000, and $6,029,000 for the years ended December 31, 1998, 1999, and 2000 respectively.

Notes to Consolidated Financial Statements
continued

9. EMPLOYEE BENEFIT PLAN

Effective January 1, 1997, ATG adopted the Art Technology Group 401(k) Plan (the 401(k) Plan). All employees, as defined, are eligible to participate in the 401(k) Plan. The 401(k) Plan allows eligible employees to make salary-deferred contributions of up to 15% of their annual compensation, as defined, subject to certain Internal Revenue Service limitations. ATG may contribute to the 401(k) Plan at its discretion. No discretionary employer contributions were made to the Plan for the years ended December 31, 1998 or 1999. For the year ended December 31, 2000, ATG made a discretionary contribution to the Plan of approximately $888,000.

10. ACCRUED EXPENSES

Accrued expenses at December 31, 1999 and 2000 consist of the following (in thousands):

December 31,	1999	**2000**
Payroll and related costs	$ 3,066	**$ 18,006**
Accrued accounts payable	817	**1,376**
Other	845	**10,020**
	$ 4,728	**$ 29,402**

11. VALUATION AND QUALIFYING ACCOUNTS

The following is a rollforward of ATG's allowance for doubtful accounts (in thousands):

	Balance at Beginning of Period	Additions	Deductions	Balance at End of Period
Year Ended December 31, 1998	$ 21	$ 265	$ (36)	$ 250
Year Ended December 31, 1999	$ 250	$ 210	$ –	$ 460
Year Ended December 31, 2000	**$ 460**	**$ 2,976**	**$ (781)**	**$ 2,655**

12. QUARTERLY RESULTS OF OPERATIONS (UNAUDITED)

The following table presents a condensed summary of quarterly results of operations for the years ended December 31, 1999 and 2000:

Year Ended December 31, 1999	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
Total revenues	$ 4,420	$ 6,233	$ 8,140	$ 13,284
Gross profit	2,607	3,985	5,532	1,561
Net loss	(877)	(1,396)	(1,382)	(9,477)
Net loss per share				
Basic	(0.06)	(0.08)	(0.10)	(0.15)
Diluted	(0.06)	(0.08)	(0.10)	(0.15)

Year Ended December 31, 2000	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
Total revenues	**$ 21,572**	**32,629**	**46,310**	**62,831**
Gross profit	**15,872**	**24,867**	**35,318**	**49,120**
Net income (loss)	**(607)**	**2,869**	**5,009**	**7,216**
Net income (loss) per share				
Basic	**(0.01)**	**0.04**	**0.07**	**0.11**
Diluted	**(0.01)**	**0.04**	**0.07**	**0.10**

Report of Independent Public Accountants

To the Stockholders and Board of Directors of Art Technology Group, Inc.

We have audited the accompanying consolidated balance sheets of Art Technology Group, Inc. (a Delaware corporation) and subsidiaries as of December 31, 1999 and 2000 and the related consolidated statements of operations, stockholders' equity (deficit) and cash flows for each of the three years in the period ended December 31, 2000. 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 auditing standards generally accepted in the 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 examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Art Technology Group, Inc. and subsidiaries as of December 31, 1999 and 2000, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2000 in conformity with accounting principles generally accepted in the United States.

Arthur Andersen LLP
Boston, Massachusetts
January 24, 2001

ATG Corporate and Stockholder Information

Executive Officers

Jeet Singh
Chief Executive Officer

Joseph T. Chung
Chief Technology Officer,
Treasurer,
Chairman of the Board

Ann C. Brady
Chief Financial Officer,
Vice President, Finance

Paul G. Shorthose
Chief Operating Officer,
President

William Wittenberg
Senior Vice President,
Product Development

Lauren J. Kelly
Senior Vice President,
Worldwide Sales

Ian Reid
Senior Vice President,
Worldwide Marketing

Bernard Bailey
Senior Vice President,
Global Services

Transfer Agent and Registrar
Fleet National Bank
c/o Equiserve, Limited Partnership
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Canton, MA 02021
www.equiserve.com

Form 10-K
Copies of the Company's Annual Report on Form 10K for the Fiscal year ended December 31, 2000, as filed with the Securities and Exchange Commission, may be obtained free of charge by writing to:

Investor Relations
Art Technology Group
25 First Street
Second Floor
Cambridge, MA 02141

Annual Meeting
May 14, 2001
10:00 am
Hale and Dorr LLP
60 State Street
Boston, MA 02109

Independent Accountants
Arthur Andersen LLP
225 Franklin Street
Boston, MA 02110–2812

Corporate Counsel
Hale and Dorr LLP
60 State Street
Boston, MA 02109

Stock Trading Information
Nasdaq National Market
Symbol: ARTG

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NASDAQ: ARTG